# UNIT 8 BROKING AND TRADING IN DEBT INSTRUMENTS

## Objectives

The main objectives of the unit are to :

- know the various debt instruments in the Indian market;
- understand trading in debt instruments;
- study the current developments in Indian debt market; and
- identify the areas in which changes will be required by regulator(s) and policy makers.

## Structure

8.1 Introduction
8.2 Different Types of Debt Instruments
8.3 Indian Debt Market
  8.3.1 Government Securities Market
  8.3.2 Corporate Debt Securities Market
8.4 Listing of Debt Instruments on Stock Exchange
8.5 Trading in Corporate Debt Securities
8.6 Execution of Trades on Stock Exchange
8.7 Settlement of Trades in Debt Securities
8.8 Future Outlook for a Vibrant Indian Debt Market
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## 8.1 INTRODUCTION

Debt market is an important segment of the financial markets. The Government, corporate and other institutions borrow funds from the market through issuing various debt instruments. Such instruments are issued for various maturity period. If the debt instruments are issued for a period of one year or less, it is called as money market debt instruments. Such instruments are also known as short term debt instruments. As against this, if the debt instruments are issued for a period beyond one year, such instruments are called as capital market debt instruments.

A debt instrument is a promissory note that evidences obligation of debt towards payment to the creditor. By issuing debt instruments issuer raises funds from the market. The issuer promises to repay the borrowed funds together with interest as per terms and conditions to the investor. The borrowing party is the debtor and the lending party is the creditor. The issuer sells his securities to the lender who is called an investor or holder. All securities which are sold as a part of the same issuance are called, collectively, an issue. The length of time until the debt instrument matures is called its term to maturity or, more simply, its term or tenor.

## 8.2 DIFFERENT TYPES OF DEBT INSTRUMENTS

The various types of debt instruments are as under :

**Fixed and Floating Rate Instruments:** Debt instruments are issued either at a fixed or floating rate of interest. In case of fixed rate debt instruments, interest rate is fixed and paid periodically (semi annually or annually). The fixed rate of interest, which is always stated on the annual basis, is called the coupon rate and the payment itself is called the coupon. The coupon rate of the instrument is fixed at the time of issuance. The coupon is determined by a number of factors which includes the credit worthiness of the issuer, tax benefits, the collateral securities offered to secure the issue, overall interest rate scenario in the market and special features offered to the investors. Debt instruments, are also issued at a floating interest rate. In such case the floating interest rate is periodically changed reflecting changes in market conditions particularly changes in rate of interest payable on the gilt securities. Such instruments are also known as adjustable rate or variable debt instruments.

**Debt Instruments with Call and Put Option:** Nowadays debt instruments are issued with call and put option. A call option allows the bond issuer to call back the bonds and repay them at a predetermined price before maturity. Issuer exercises call option when general interest rates are lower than the coupon rate on the existing debt instrument thereby retiring expensive debt instrument and refinancing at a lower rate. As against this, put option allows the bond holder to sell the bonds to the issuer at a predetermined price before maturity or redemption date. Holder of debt instrument will exercise the put option when general interest rates are higher than the coupon rate on the existing debt instrument.

**Zero Interest Debt Instruments:** Such instruments are issued or sold at discounted value and accordingly have zero interest rate. The difference between the discounted value and face value of the instrument is the gain to the subscribers. In other words, investors are not entitled to any interest and thus are entitled to receive only repayment of par value of the security on the maturity date.

**Convertible Debt Instrument:** A debt instrument is issued with convertible option. Holder of such instrument can exercise the right to convert debt instrument or its portion into equity. On conversion of debt instrument into equity, investors will not be paid interest. Instead of this, shares will be issued and dividend will be paid, to the holder of convertible debt instrument.

## 8.3 INDIAN DEBT MARKET

Indian debt market is comprised of Government debt securities and corporate debt securities. The Government securities market is the most dominant segment of the financial markets in India. Of the debt market, the Government securities market accounts for 75 per cent of the outstanding stock and nearly 95 per cent of the volumes traded in the secondary market.

### 8.3.1 Government Securities Market

The RBI manages the public debt issue (i.e. issue of Government securities) on behalf of the Central and State Governments. As a result of this, cost of borrowing (i.e. interest rate), timing of issue and framework (i.e. terms and conditions) of raising of loans are decided by the RBI. The Government Securities are issued on the basis of liquidity conditions in the market, Government borrowing programme and expectations of the market. This market was dormant and inactive till 1992. The RBI introduced various reforms to make Government securities market more vibrant and active.

### Types of Government Securities

Government securities are sovereign debt instruments. These securities are issued by the RBI on behalf of Central as well as state Governments to finance deficit budgets, social expenditures and economic activities in the public sector. The following types of securities are issued by the RBI.

i) Treasury Bill of 91 day, 182 day and 364 day.

ii) Government of India dated securities.

iii) State Government securities.

### Primary Market

#### *Treasury Bills*

Treasury bills are issued under multiple price based auctions. Bidders are required to quote price per Rs. 100 face value of treasury bill. The competitive bids offered at the minimum offer price as determined by the RBI are accepted. Other bids tendered at higher than the minimum offer price are accepted at the price as quoted in the respective bid. Bids quoted lower than the minimum price are rejected. The details about the size of issue and implicit yield emerged in recent auctions of various T-bills are given in Table 8.1.

**Table 8.1: Auctions of Government of India Treasury Bills**

(Rs. in crore)

| *Date of Auction* | *Notified Amount* | *Bids Received (Competitive)* | *Bids Accepted (Competitive)* | *Implicit Yield at Cut off Price (%)* |
|---|---|---|---|---|
| **(1)** | **(2)** | **(3)** | **(4)** | **(5)** |
| | | **91 Day Treasury Bills** | | |
| **2005-06** | | | | |
| March 30 | 2000 | 4223 | 2000 | 5.3241 |
| June 29 | 2000 | 4030 | 2000 | 5.3653 |
| July 13 | 2000 | 1805 | 837 | 5.4889 |
| | | **182 Day Treasury Bills** | | |
| **2005-06** | | | | |
| April 6 | 1500 | 6710 | 1500 | 5.4381 |
| June 29 | 1500 | 1507 | 1500 | 5.6711 |
| July 13 | 1500 | 3868 | 550 | 5.6711 |
| | | **364 Day Treasury Bills** | | |
| **2005-06** | | | | |
| April 13 | 2000 | 6195 | 2000 | 5.6456 |
| July 6 | 2000 | 4046 | 2000 | 5.7351 |

**Source :** RBI website, Weekly Statistics.

### Government of India Dated Securities

Such securities are issued for various tenors ranging from two to thirty years. The coupons offered on dated Government securities are either pre-determined by RBI or arrived through competitive bidding or auction process. The RBI has issued variety of dated Government securities such as fixed semi annual coupons, zero coupon bonds, floating rate bonds etc.

### State Government Securities

State Government securities are issued by the RBI on behalf of various State Governments. Such securities like dated Government securities are issued either through auctions or with pre-announced coupon rates. Such securities are also issued through tap sale.

The details about the interest rates on central and state Government dated securities during the period 1995-96 to 2003-04 are given in the Table 8.2.

**Table 8.2 : Interest Rates on Central and State Government Dated Securities**

(Per cent per annum)

| *Year* | *Central Government Securities* | | *State Government Securities* | |
|---|---|---|---|---|
| | *Range* | *Weighted Average* | *Range* | *Weighted Average* |
| **1** | **2** | **3** | **4** | **5** |
| 1995-96 | 13.25-14.00 | 13.75 | 14.00 | 14.00 |
| 1996-97 | 13.40-13.85 | 13.69 | 13.75-13.85 | 13.82 |
| 1997-98 | 10.85-13.05 | 12.01 | 12.30-13.05 | 12.82 |
| 1998-99 | 11.10-12.60 | 11.86 | 12.15-12.50 | 12.35 |
| 1999-00 | 10.73-1245 | 11.77 | 11.00-12.25 | 11.89 |
| 2000-01 | 9.47-11.70 | 10.95 | 10.50-12.00 | 10.99 |
| 2001-02 | 6.98-11.00 | 9.44 | 7.80-10.53 | 9.20 |
| 2002-03 | 6.57-8.62 | 7.34 | 6.67-8.00 | 7.49 |
| 2003-04 | 4.62-6.35 | 5.71 | 5.78-6.40 | 6.13 |

**Source :** Reserve Bank of India Records.

### *Participants*

Banks and Primary Dealers are major holders of Government securities and thus participants in the Government securities market. These securities are approved securities for the purpose of maintenance of Statutory Liquidity Ratio by the banks. As against Statutory Liquidity Ratio (SLR) of 25 per cent of Net Demand and Time Liabilities (NDTL), it is estimated that banks hold around 40 per cent of NDTL in the form of Government securities.

Primary dealers are wholesale traders in the Government securities market. They are active participants in the primary market. They require to achieve a minimum success ratio of 40 per cent for both dated Government securities and treasury bills vis-à-vis bidding commitment and provide underwriting support to the auctions of Government securities. At present 17 primary dealers have been operating in the market.

Apart from banks and Primary dealers, investment companies and provident funds, also hold substantial amount of Government securities. Other investors include mutual funds, charitable trusts and individuals.

Any person including firm, corporate body, institution, State Government, provident fund, trust, non-resident Indians (NRI), Foreign Institutions Investors (FIIs) registered with SEBI and approved by RBI can submit offers including in electronic form for purchase of Government securities.

### *Secondary Market*

Most of the deals in secondary market of Government securities are negotiated between market participants like banks, PDs, MFs having SGL (Subsidiary General Ledger) accounts with the RBI. Such deals may be negotiated directly by participants themselves or negotiated through brokers. The RBI has introduced Negotiated

Dealing System (NDS) and accordingly members of NDS have been provided connectivity. Negotiated Dealing System (NDS) is an electronic platform for facilitating deals in Government securities and other money market instruments. If the members of NDS have executed deals outside NDS system (i.e over telephone or through brokers) then such deals have to be reported on NDS within 15 minutes of concluding such deals. Thus NDS is also used to report transactions in Government securities in the secondary market. Once a trade is done or reported over NDS, it is settled either through Clearing Corporation of India (CCIL) or directly through RBI – Subsidiary General Ledger (SGL), CCIL clears and settles trades of its members transacted on NDS. The trades include outright sale and purchase of Government securities, repo and reverse repo transactions (other than repo with RBI). The settlement of these trades is guaranteed by CCIL through a process called novation whereby CCIL becomes central counterparty for each trade.

Commercial banks in India have been the single largest participant segment in the secondary market of Government securities. Most of them have invested more than 35 per cent of their NDTL in Government securities as against a minimum of statutory liquidity ratio of 25 per cent. Further minimum of 75 per cent or above of their total investment portfolio have to be kept in the form of Held for Trading (HFT) and Available for Sale (AF) category. Such securities are identified for sale in the secondary market. In view of this, by and large all the commercial banks have been active participants in the secondary market. Their objective is to earn sizeable capital profit from trading in Government securities in the secondary market.

Primary dealers are the second largest segment in the secondary market of Government securities. As mentioned earlier, they are essentially wholesale traders in Government securities market. Their total portfolio is in the nature of trading portfolio. As they are market makers in Government securities market, they require to provide two way quote at least in respect of few securities.

Alongwith banks and primary dealers, mutual funds, non banking financial institutions, financial institutions and insurance companies are also active participants in the secondary market.

### *Repo and Reverse Repo Transactions*

The Government securities are used as collateral securities to undertake both repo and reverse repo transactions. Under repo transactions Government securities are sold for cash with an agreement to repurchase the same securities at a future date. In reverse repo transactions Government securities are purchased with an agreement to resell the same securities at a future date. Banks, primary dealers, financial institutions and insurance companies etc., have been undertaking repo and reverse repo transactions amongst themselves to manage their liquidity.

The details about secondary market transactions in Government securities are given in the Annexure 1.

In order to encourage participation of retail investors in the Government securities market, the RBI has allowed retail investors to invest in Government securities. In order to provide liquidity in respect of Government securities, the RBI allowed trading in gilt securities through stock exchanges. This was introduced on January 16, 2003. Trades on the National Stock Exchange (NSE), the Bombay Stock Exchange (BSE) and the Over the Counter Exchange of India (OTCEI) are anonymous, order driven and screen based. With online retail trading in Government securities, individual investors, pension funds, etc., can approach brokers (i.e. member of stock exchanges) to trade in gilt securities. The clearing corporation of the exchange provides the financial guarantee for settlement of obligation to its clearing members as in the equity market. This facility is available for trading in dematerialised form only.

**Activity 1**

a) Give the differences between fixed and floating rate debt instruments.

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b) List out some government of India securities that are issued in the primary market.

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### 8.3.2 Corporate Debt Securities Market

Companies, non-bank finance companies, financial institutions also issues debt instruments to raise funds from the market. These instruments are discussed below :

1) **Commercial Papers**

Commercial papers are unsecured money market instruments. These are issued in the form of promissory notes. CPs are issued by corporates, financial institutions and primary dealers to raise funds for working capital. All CP issues have to be mandatorily rated by one of the recognised credit rating agencies in India. The minimum required rating is P-2 of CRISIL or such equivalent rating by other recognised rating agencies in India. In view of this, companies having highest rating will be able to raise funds at reasonable cost through CP for working capital. Every issuer must appoint a schedule bank as an Issuing and Paying Agent (IPA) for issuance of CPs. The IPA has to ensure that the issuer has the minimum rating stipulated by the RBI and amount mobilised through the issuance of CP is within the quantum indicted by the credit rating agency. In order to provide transparency and also facilitate benchmarking of CP issues, IPA would report issuance of CP on NDS platform by the end of the day.

Individuals, corporates, insurance companies, banks, etc., are eligible to subscribe CPs. Non-Resident Indians can invest in CP on a non-repatriable, non-transferable basis. FIIs (Foreign Institutional Investors) also can invest in CPs within the overall limits prescribed by the SEBI. Of these various investors, banks, corporates and mutual funds are the most active investors in CPs.

2) **Certificate of Deposits**

Certificate of Deposit (CD) is a money market debt instrument. CDs are issued as a discounted instruments. CDs are issued by banks and financial institutions mainly to raise funds by offering higher interest rates from corporates, high net worth individuals and trusts etc. Some of the top commercial banks in India have been getting their CDs rated for better access to the market even though such rating is not required under existing guidelines. Foreign and private sector banks especially those who do not have wide branch network in urban and rural areas to tap low cost deposit funds use this instrument to raise funds. Banks can issue CDs from 7 days to 1 year period. Financial institutions can issue CDs with an initial maturity of one year to 3 years. CDs have to be compulsorily issued in the dematerialised form.

### 3) Bonds Issued by Public Sector Undertaking (PSUs)

Several central as well as state level public sector undertakings (PSUs) entered the market for the first time in 1985-86 to raise funds through debt securities. Since then, many such public sector undertakings have raised funds through tax free as well as taxable bonds.

Even though these bonds were not having any Government guarantee nevertheless bonds became attractive because from the investors point of view mainly because of the tax exempt status and the high coupon rates. A large proportion of these funds was raised through private placement from a few large investors like the banks, insurance companies and other institutions. Alongwith tax free characteristics, PSU also have issued bonds with other characteristics like floating rate, etc.

The bonds are normally issued as instruments transferable by endorsement and delivery. They are issued as certificates, and in non standard sizes depending on the requirements of each of the subscribers in the private placement. The interest on some categories of these bonds is through post dated interest warrants. In others, interest payment is distributed by the PSU on the due date to the holder as recorded in the books.

The details about the bonds issued by public sector undertakings are given in Table 8.3.

**Table 8.3 : Bonds Issued by Public Sector Undertakings***

(Rupees crore)

| *Year* | *Tax-free bonds* | *Taxable bonds* | *Total (2+3)* |
|---|---|---|---|
| **1** | **2** | **3** | **4** |
| 1995-96 | 547.4 | 1743.8 | 2291.2 |
| 1996-97 | 67.0 | 3327.3 | 3394.3 |
| 1997-98 | 570.1 | 2412.4 | 2982.5 |
| 1998-99 | 406.0 | 3956.9 | 4362.9 |
| 1999-00 | 400.0 | 8296.8 | 8696.8 |
| 2000-01 | 662.2 | 15969.4 | 16631.6 |
| 2001-02 | 274.2 | 14161.5 | 14435.7 |
| 2002-03P | 286.0 | 7243.0 | 7529.0 |
| 2003-04 P | 239.0 | 12297.2 | 12536.2 |

P Provisional

* Data include both public issues of bonds and privately placed bonds.

**Source :** RBI's website (Data on Indian Economy)

### 4) Bonds Issued by Financial Institutions (FIs)

Financial institutions which cannot accept demand deposits like banks depend on bond instruments to raise funds from the market. Because of higher rating from rating agency, these institutions issue bonds at lower interest rates. In the past may financial institutions like NABARD, IFCI, IDBI Ltd., erstwhile ICICI Ltd. raised funds through various bonds such as capital gain bonds, deep discount bonds, floating rate bonds, etc.

### 5) Corporate Debentures

Private corporate enterprises have been issuing debentures to raise funds for longer period. They have issued various types debentures such as convertible debentures, debentures with put and call options, floating rate debentures. A very large proportion of such debts instruments have been issued through private placement to institutional investors such as banks, mutual funds, insurance companies, etc. They have also issued debentures through public offer to retail investors. SEBI has stipulated that credit ratings are compulsory on all public issues of debentures. All debt instruments issued by companies to raise funds through public issue must be listed on stock exchange. The recent Government guideline to permit listing of privately placed debt provided it is of investment grade has thrown open opportunities for large institutional investors to trade on their portfolio of corporate debt as well.

***Participants***

Banks, mutual funds, financial institutions, insurance companies, etc., are major institutional investors in the corporate debt market. With effect from October 31, 2001, banks, financial institutions and primary dealers have been permitted to make fresh investments and hold bonds and debentures only in dematerialised form.

***Regulation of Corporate Debt***

The SEBI's Secondary market advisory committee has recommended a regulatory framework for the issuance and trading of all corporate debt securities including those placed on a private placement basis.

Some of the recommendations include :

- Disclosure norms as applicable for public issue
- Appointing of debenture trustees
- Listing of debt on stock exchanges
- Issuance and trading of securities in a demat form.

## 8.4 LISTING OF DEBT INSTRUMENTS ON STOCK EXCHANGE

Like equity, a company or institution issuing a debt instrument through public issue has to be listed on stock exchange for facilitating trading. Depending on the stock exchange rules, listing of debt instruments can be along with equity instrument or in a distinct segment of the stock exchange. For the facility offered to the company or institution to list its debt securities, it has to pay a listing fee to the stock exchange. This fee varies from one exchange to another stock exchange. (All Government securities and Treasury bills are deemed to be listed automatically as and when they are issued.)

The process of applying for listing of debt instruments is similar to the process stipulated for listing of shares. The issuer has to provide periodic information about itself and the kind of information to be supplied, the periodicity of such information, disclosure norms, etc. is specifically laid out in the Listing Agreement. In fact, many exchanges have a common listing agreement, both for equity and debt instruments. Violation of the listing agreement could lead to suspension or delisting of debt as well as equity securities. At worst, this could also result in prosecution of persons responsible for the violation of rules of stock exchanges.

Just as in the case of equity shares, an exchange may allow debt instruments not listed in the exchange to be traded under the permitted category. This is to facilitate trading by investors spread across the country.

## 8.5 TRADING IN CORPORATE DEBT SECURITIES

Debt instruments are traded in stock exchanges in a manner similar to equity instruments. Depending on the exchange where such trading takes place, debt instruments can be traded along with equity instruments or a separate trading segment can be designated for such trading.

The National Stock Exchange (NSE) provides a distinct platform for trading in debt securities and has created a separate segment for the same, which is called the Wholesale Debt Market (WDM) segment. This segment commenced operations on June 30, 1994. This segment caters to large players in the market, like banks, institutions, etc.

The NSE-WDM segment provides a trading platform for trading in various debt securities such as Government securities, PSU bonds, corporate debentures, bonds issued by financial institutions, commercial papers, etc. Trades in debt securities are executed through the National Exchange for Automated Trading (NEAT) system which is an automatic system that provides trading and reporting facilities. NSE's trading platform has a screen based, order driven and automated order matching system.

The Bombay Stock Exchange (BSE) has introduced trading in all types of debt instruments in the Wholesale Debt Market (WDM) segment through GILT system. This system is an automatic online trading system. Trading members and participants are identified as entities in the system. Trading members (brokers) are admitted on the exchange with trading rights. These trading members have to continuously meet predetermined criteria for membership, which as in the other case include capital adequacy norms, adequate infrastructure facilities, periodic disclosure of information, etc. Trading members execute trades on GILT system for entities like banks, financial institutions, corporate bonds, statutory corporation, etc. Participants can be like banks and individuals who can transact in debt securities including Government securities through the members of BSE who have been permitted to undertake deals in debt securities.

### Intermediaries in Debt Trading

As in the case of equity instruments, trading in the debt instruments can also be through intermediaries, who are members of the exchange (i.e. brokers). Similar to the trading in shares, only brokers are authorised to trade in debt instruments on the stock exchange. Orders of the investors can be placed in the trading system only through these brokers. However, the obligations of the broker depends on the manner in which trading is structured by the stock exchange/s. The stock exchanges have specified the maximum rates of brokerage chargeable by trading members in relation to trade done in debt securities.

In addition to adhering to the stipulations of the exchange, these brokers have also to abide by the directions/guidelines issued by the SEBI. As in the case of brokers trading in the equity segment, both the stock exchanges, under their Rules and Bye Laws, and the SEBI, under its Regulations, are empowered to initiate action for any violation or breach of norms by the members.

### Activity 2

State whether the following statements are True or False:

1. Primary dealers are essentially wholesale traders in Corporate Bond Market — Yes / No
2. Dated government securities are issued as discounted instruments — Yes / No

3. Government securities are issued with fixed interest rates Yes / No
4. Transactions in corporate debt securities are routed through Clearing Corporation of India Ltd. Yes / No
5. Banks have been allowed to issue commercial papers Yes / No

## 8.6 EXECUTION OF TRADES ON STOCK EXCHANGE

Trading in the distinct segment, like the WDM segment of the NSE, is screen based with order matching facility. Members are connected from their respective offices at dispersed locations to the main system premises through a high-speed efficient satellite telecommunication network. The trading system is order driven, which does not reveal the identity of the parties to an order or a trade. This helps orders whether large or small to be placed without the members being disadvantaged by disclosure of their identity. The trading system operates on a prime-time priority. When an order does not find a match it remains in the system and is displayed to the whole market, till a fresh order matching it or the earlier order is cancelled or modified.

The trading system provides tremendous flexibility to the user in terms of type of orders that can be placed on the system. Several time related, price related or volume related conditions can easily be placed on an order. The trading system also provides complete on-line market information through inquiry facilities. Detailed information on the total order depth in a security, the best buys and sells available in the market, the quantity traded, the high, the low and the last traded price is available through the market screen at all points of time.

The trades on the WDM segment of the NSE can be executed in the continuous or negotiated market. In the continuous market, orders entered by the trading members are matched by the trading system. In the negotiated market, both the parties through negotiations agrees to execute deal in debt securities in terms of security description, order price and order volume.

## 8.7 SETTLEMENT OF TRADES IN DEBT SECURITIES

In contrast to settlement of trades in equity instruments through the clearing house, the primary responsibility of settling trades concluded in the WDM segment of the NSE rests directly with the participants and the exchange monitors the settlements. These trades are settled in Mumbai. Trades are settled gross, i.e. on a trade for trade basis directly between the constituents/participants to the trade. Thus, each transaction is settled individually and netting of transactions is not allowed.

Settlement is on a rolling basis i.e. there is no account period settlement. Each order has a unique settlement date specified up front at the time of order entry and used as a matching parameter. It is mandatory for trades to be settled on the predefined settlement date. The exchange currently allows settlement periods ranging from same day (T+0) settlement to a maximum of three working days (T+2).

On the scheduled settlement date, the Exchange provides data/information to the respective member/participant regarding trades to be settled on that day with details like security, counterparty and consideration.

The exchange closely monitors the settlement of transactions through the reporting of settlement details by members and participants. In case of deferment of settlement or cancellation of trade, participants are required to seek prior approval from the exchange. For any dispute arising in respect of the trades or settlement, the exchange has an established arbitration, mechanism for resolving the same.

Since settlement is bilateral and there is no settlement guarantee mechanism, every participant can set up counterparty exposure limits in the trading system to ensure that all its trades are within the exposure limits set up for the respective counterparty. This provision enables the participants to minimise counterparty risk.

**Settlement on the GILT System of BSE**

The BSE has introduced settlement system which is based on Trade by Trade Delivery versus Payment basis for the securities traded in the debt segment. Members of the stock exchange need to report the settlement to the BSE specifying the details of the settlement process. The BSE monitors the clearing and settlement process for all the trades executed or reported through the GILT system. The settlement system is on a rolling basis. The BSE allows settlement periods ranging from the same day (T+0) to a maximum of 3 working days (T+2).

## 8.8 FUTURE OUTLOOK FOR A VIBRANT INDIAN DEBT MARKET

At present Government securities market is a well developed market as compared to corporate debt market. However, overall debt market in India is yet to be fully developed. In this context certain issues need to be addressed and changes will have to be made in the existing policy framework. These issues are discussed below. Resolving the following issues will help to make Indian debt market more efficient and vibrant.

**Lack of Liquidity in Respect of many Debt Instruments**

Though the size of the debt market is reasonably large, the market relatively lacks liquidity. Within the Government securities, only few dated government securities and treasury bills have liquidity in the market. Therefore, there is need to create active secondary market for other Government Securities. Primary dealers will require to become market makers in respect of large number of government securities specially in respect of dated and state government securities. Similarly, active secondary market have to be created in respect of corporate debt securities which are not listed on stock exchanges.

**Increasing the Number of Players**

Increasing the number of players in the market will result in participants being available on both sides of the market and will also boost volumes. Various institutional investors need to be encouraged to participate in the secondary market. FIIs also will have to be encouraged to invest in government securities and corporate debt securities. Pension funds, provident funds, charitable funds, etc., need to be encouraged to participate in the market.

**Trading Infrastructure**

A good beginning has been made with the setting up of the wholesale debt market segment of the NSE. Yet this segment caters only to big investors. Even here, improvements in trading and post trading issues will go a long way in boosting volumes in this segment.

However, trading in debt instruments can really take off only if retail investors accept debt in their portfolio. Apart from requiring a change in mind set, they will require adequate trading facilities. Debt trading along with equity instruments is not conducive for such trading. A separate retail debt segment, with adequate safeguards for the investor is necessary for debt trading to take off. The NSE has plans to introduce such a segment, which will go a long way in this direction.

### Need for Market Making

Another major drawback is the absence of an effective market making mechanism. An active secondary market was expected to be developed in respect of Government securities with the setting up of the system of primary dealership, which were intended to be market makers in government securities and T-bills. But so far they have not been able to serve their purpose effectively. These institutions, will have to act as market makers in respect of large number of government securities also.

### Need for Change in Attitude of Retail Investors

The retail investors have not shown interest in the secondary market. The normal tendency is to invest in and hold debt securities till maturity. This could be due to the fact that most debt instruments were issued by Government and PSUs with low coupons. The attraction was tax exemptions. Thus trading in such instruments was never conceived by retail investors. This attitude will have to be changed. The retail investors will have to be encouraged to trade in debt instruments in the secondary market.

### Innovative Instruments

With a captive investor base that looked for tax advantages while buying debt instruments, the market had no variety. All offerings provided for plain vanilla debt instruments, that did not have any special requirements of the investor in mind. Innovative instruments will mobilise savings from retail investors, household savings, etc., rather than institutional investors. A bond issue can be a success only if a large part of the subscription comes from the public. Monthly interest payment bonds, index bonds, deep discount bonds, bonds with put and call options, etc., are a few innovations that the market has witnessed in the recent past. This may not be adequate. Much more variety of debt instruments need to be offered to the retail and institutional investors.

### Greater Disclosure in Respect of Privately Placed Debt Instruments

A larger portion of the corporate debt market is privately placed. In view of this, various issues relating to the private placements need to be addressed. In this context, it is essential to ensure greater transparency, adequate disclosures, minimum credit rating and proper accounting standards. This will enhance the confidence of investors in the debentures issued by private corporate entities. Credit rating agencies will require to take utmost care while rating of debt instruments which are privately placed.

### Settlement Systems in Respect of Trade in Corporate Debt Securities

The existing settlement system adopted by stock exchanges has eliminated counter party risk in equity trading. However, except when debt instruments are traded along with equity instruments, settlement of trades is not institutionalised. Parties to a trade are to settle the trade bilaterally. Thus parties to a trade are exposed to unknown counterparty risks. Small investors are more vulnerable to such an environment. It is therefore imperative that settlement procedures are institutionalised to eliminate these risks.

## 8.9 SUMMARY

Debt market is an important segment of financial markets. With the liberalisation and activation of insurance sector, long term saving through debt instruments is bound to increase and debt market will have an important role to play in this regard. Both

Government and Non-government corporate entities have been raising funds through issue of various debt instruments. The government securities market is the major segment of the debt market in India. On account of various reforms introduced by the RBI and Government the government securities market has emerged as more vibrant and efficient market. The corporate debt market is yet to be fully developed in India. The regulators, policy makers and other interested parties will require to take proper initiatives to make corporate debt market more vibrant and efficient.

## 8.10 KEY WORDS

**Amortizing** debt instruments provide for periodic payments that include both interest and principal.

**Capital Market Instruments** are debt instruments with maturities of more than a year.

**Coupon Rate** is the rate of interest payable, which is stated on an annual basis.

**Continuous Market** means orders put on the trading system are matched by the system directly with out any manual intervention.

**Debt Instrument** is a promissory note that evidences a debtor/creditor relationship.

**Floating Rate Bonds** are short to medium term interest bearing instruments issued by financial intermediaries and corporates, in which the coupon rate changes to reflect market conditions.

**Dated and State Government Securities** are issued by RBI on behalf of Government of India and various state governments for a period of 2 years or more.

**Issuer** is the borrower who issues marketable debt instruments.

**Marketable Debt Instruments** are transacted in an exchange and are considered as securities.

**Money Market Instruments** are debt instruments having maturities of less than one year.

**Negotiated Market** refers to deals that have been negotiated outside the exchange and are reported on the trading system for approval by the exchange.

**Non-repo Trade** outright purchase and sale of securities.

**Repo Trades** are repurchase agreements wherein a trader sells securities to a customer while simultaneously agreeing to repurchase them at a future date.

**Subsidiary General Ledger** is a facility provided by the RBI for maintaining the records of the beneficial owners of Government securities in demand form.

**Term to Maturity** (or term) is the length of time until the debt instrument matures.

**Treasury Bills (T-bills)** are short-term obligations issued by RBI on behalf of Government of India at a discount.

**Zero Coupon Bonds** or **zeros** require no payment of interest or principal until such time as the instrument matures.

## 8.11 SELF ASSESSMENT QUESTIONS

1) Distinguish between equity and debt instruments. What are the different instruments in the debt market?
2) What do you mean by Government securities market? Why the banks invest in Government securities?
3) Why investor prefer to have debt portfolio? Which factors need to be considered while investing in debt portfolio?
4) Explain current development in Indian Debt market.
5) Enumerate any three initiatives necessary to make Indian debt market more efficient and vibrant.
6) Write short notes on :
   a) Primary dealers in the Government securities market
   b) Floating rate bonds
   c) Trading in Government securities

## 8.12 FURTHER READINGS

Bond and Money Markets, Indian Institute of Banking and Finance, Taxmann Publications Pvt. Ltd., New Delhi, 2004.

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*Annexure 1*

## Secondary Market Transactions in Government Securities

(Amount in Rupees crore)

| *Year/ Month* | *Outright Transactions* | | | | | | | *Total (2+3+8)* |
|---|---|---|---|---|---|---|---|---|
| | *Central Government Securities* | *State Government Securities* | *Treasurey Bills* | | | | | |
| | | | *14-day* | *91-day* | *182-day* | *364-day* | *Total* | |
| **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** |
| **2003** | | | | | | | | |
| January | 177910.36 | 939.61 | - | 6789.54 | - | 3361.01 | 10150.55 | 189000.52 |
| February | 69844.43 | 525.22 | - | 4567.98 | - | 2604.54 | 7172.52 | 77542.17 |
| March | 65990.63 | 1418.99 | - | 4210.06 | - | 4641.38 | 8851.44 | 76261.06 |
| April | 113401.26 | 555.18 | - | 3666.82 | - | 7687.16 | 11353.98 | 125310.42 |
| May | 149966.30 | 918.83 | - | 2012.00 | - | 4744.03 | 6756.03 | 157641.16 |
| June | 150251.91 | 1534.97 | - | 2861.33 | - | 4320.82 | 7182.15 | 158969.03 |
| July | 152293.60 | 943.31 | - | 5322.03 | - | 5824.38 | 11146.41 | 164383.32 |
| August | 204934.06 | 1921.41 | - | 6219.99 | - | 4838.91 | 11058.90 | 217914.37 |
| September | 134471.77 | 1428.57 | - | 7064.99 | - | 5548.36 | 12613.35 | 148513.69 |
| October | 194983.73 | 1521.19 | - | 4297.06 | - | 5485.09 | 9782.15 | 206287.07 |
| November | 88531.49 | 620.33 | - | 3914.66 | - | 4634.71 | 8549.37 | 97701.19 |
| December | 90995.64 | 1385.49 | - | 3662.06 | - | 5085.14 | 8747.20 | 101128.33 |
| **2004** | | | | | | | | |
| January | 90809.62 | 1076.50 | - | 3274.11 | - | 4758.09 | 8032.21 | 99918.33 |
| February | 69479.17 | 1318.56 | - | 3390.07 | - | 4904.60 | 8294.67 | 79092.40 |
| March | 111342.50 | 2870.27 | - | 3651.74 | - | 8987.27 | 12639.01 | 126851.78 |
| April | 150431.83 | 1216.27 | - | 7533.31 | - | 6816.96 | 14350.27 | 165998.37 |
| May | 96132.13 | 1648.91 | - | 11145.63 | - | 7104.91 | 18250.54 | 116031.58 |
| June | 87900.75 | 3032.97 | - | 10091.78 | - | 8844.75 | 18936.53 | 109870.25 |

**Secondary Market Transactions in Government Securities (Contd.)**

(Amount in Rupees crore)

| *Year/ Month* | *Repo Transactions* | | | | | | | *Total (10+11+ +16)* | *Grand Total (9+17)* |
|---|---|---|---|---|---|---|---|---|---|
| | *Central Govt.* | *State Govt.* | *Treasury Bills* | | | | | | |
| | | | *14-day* | *91-day* | *182-day* | *364-day* | *Total* | | |
| **1** | **10** | **11** | **12** | **13** | **14** | **15** | **16** | **17** | **18** |
| **2003** | | | | | | | | | |
| January | 48048.78 | 0 | - | 5097.17 | - | 13453.20 | 18550.37 | 66599.15 | 255599.67 |
| February | 50319.93 | 0 | - | 3240.26 | - | 11852.31 | 15092.57 | 65412.50 | 142954.68 |
| March | 66571.45 | 20.00 | - | 880.03 | - | 6764.24 | 7644.27 | 74235.72 | 150496.78 |
| April | 35101.13 | 0 | - | 214.00 | - | 6499.84 | 6713.84 | 41814.97 | 167125.39 |
| May | 37623.97 | 99.00 | - | 520.10 | - | 5084.86 | 5604.96 | 43327.93 | 200969.08 |
| June | 40807.01 | 0 | - | 743.70 | - | 7054.19 | 7797.89 | 48604.90 | 207573.93 |
| July | 67382.59 | 0 | - | 1218.64 | - | 6334.42 | 7553.06 | 74935.65 | 239318.97 |
| August | 65603.83 | 597.00 | - | 3565.75 | - | 4077.56 | 7643.31 | 73844.14 | 291758.50 |
| September | 64138.73 | 1490.62 | - | 2623.91 | - | 3187.66 | 5811.57 | 71440.92 | 219954.61 |
| October | 82463.15 | 2107.36 | - | 1876.46 | - | 3005.35 | 4881.81 | 89452.32 | 295739.39 |
| November | 92425.71 | 1404.50 | - | 819.47 | - | 2173.86 | 2993.33 | 96823.54 | 194524.73 |
| December | 94770.04 | 1369.99 | - | 1434.38 | - | 2700.12 | 4134.50 | 100274.53 | 201402.86 |
| **2004** | | | | | | | | | |
| January | 114134.89 | 876.58 | - | 382.24 | - | 4159.73 | 4541.97 | 119553.44 | 219471.77 |
| February | 89412.97 | 1183.40 | - | 253.50 | - | 934.00 | 1187.50 | 91783.87 | 170876.27 |
| March | 101272.91 | 600.50 | - | 585.84 | - | 1217.43 | 1803.27 | 103676.68 | 230528.46 |
| April | 105184.45 | 1027.50 | - | 1773.54 | - | 5979.95 | 7753.49 | 113965.44 | 279963.81 |
| May | 103793.68 | 1637.00 | - | 8404.66 | - | 9635.96 | 18040.62 | 123471.30 | 239502.88 |
| June | 110164.85 | 1062.96 | - | 11892.15 | - | 8259.59 | 20151.74 | 131379.55 | 241249.80 |