Debt Market - Emerging Scenario

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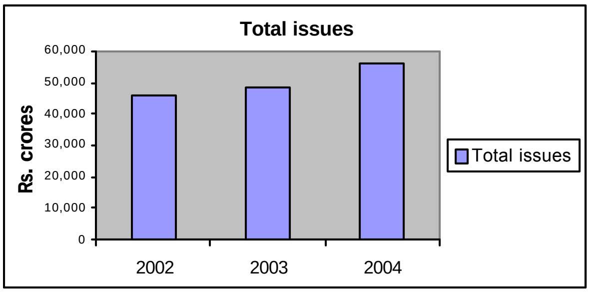
During last three years, debt markets in India have not only grown in terms of amount of placement of debt securities but have also matured in depth of trading, diversity of issuers and nature of instruments. This trend can be expected to continue and markets are likely to grow in size with more innovative instruments being issued.

1.1 Future Markets? In order to answer this question, it is very important to see the various developments which have taken place over the last 2-3 years, mainly:

- Benchmark 10 year G-Sec yield has moved from 10.25% to 5.05% during 2001 – 2003 and is currently at 5.23%
- Benchmark 5 year corporate bonds moved from 11.00% to 5.60% during the same period

1.2 It is interesting to note that the secondary market trading in the debt securities (non-SLR securities) has witnessed growth in the average daily volumes from around Rs.80-100 crores in year 2001 to Rs.250-300 crores by the year 2003.

1.3 In primary debt securities issuance, the market has grown steadily over last three years as can be seen from the following graph.



1.4 During this period sovereign papers with non-SLR status (viz., Oil Bonds and UTI Bonds) were most liquid and accounted for 32.6% of the total secondary market volume in non-SLR debt securities during the calendar year 2003.

1.5 From a macro perspective, the GDP is expected to grow at over 6.5% - 7% during FY 2004-05. Point to point inflation at the end of FY 2004-05 is estimated to be around 5%. However, if the domestic oil prices are raised to realign with the global oil prices, the inflation rate could reasonably be expected to be higher than 5%. High oil prices combined with strong growth in imports may result in widening of trade deficit. There are also signs of growth in physical investments resulting from greenfield / brownfield projects in the industrial sector. Good monsoon may see increase in food credit and increased purchasing power in the rural sector. All this would lead to higher Govt. / corporate borrowings which will have to be met through internal savings / external inflows. As regards external inflows, there would be a competition vis-à-vis developed economies which would be coming out of recession and inter se emerging markets.

As regards corporate borrowings, it is observed that stronger of the corporates have been directly accessing the debt market through short term instruments such as CPs and MIBOR linked debentures instead of raising loans from banks. This has helped them in reducing the interest cost substantially. This has developed a strong short term money market.

1.6 It may be noted that the yields in US treasuries have gone up during last two months in anticipation of economic recovery and hike in Fed-rate. The 10-year benchmark US G-Sec yield has gone up from a low of 3.69% on 17-March-2004 to 4.78% currently. This shows that the markets have perhaps already discounted a hike in Fed-rate. In the meantime, Bank of England has raised repo rate by 25 bps on in May 2004. This is third rate hike since November 2003 (25 bps each) and the repo rate now stands at 4.25%, up 75 bps from its 48 year low of 3.50% in July-2003.

1.7 In view of the above, it is felt that the yields may rise at the long end of the curve by around 50-75 bps over the coming year but the short tenor yields may not rise as sharply due to continuing liquidity overhang. This also implies that corporates would like to lock in for long term at fixed rates.

2. It is also pertinent to note some of the regulatory developments affecting the debt market.

2.1 Regulatory issues

During the year 2003-04, some important developments have taken place on the regulatory front. SEBI has come out with guidelines relating to issuance of debt securities; the notable requirements being compliance with certain disclosure requirements, compulsory credit rating and listing of debt securities on stock exchange, trading only in demat form, appointment of debenture trustee, etc. Besides, the Reserve Bank of India (RBI) has also issued guidelines for investments by banks in non-SLR debt securities mainly restricting investments only to investment grade rated debt securities and capping of investments in unlisted debt securities.

Initially, the debt market activities almost came to a halt until transition time was given to the market participants to comply with the requirements. However, the issuers and investors getting used to compliance with the new norms. During the quarter January – March 2004, the market activity picked up considerable pace. Eventually, the steps taken by regulators may help in healthy development of the debt market in as much investment books will be healthier, valuations and pricing more transparent.

3. Some of the emerging trends in the debt market are discussed below:

3.1 Structured Bonds / Debentures

Over a period of years the markets have become more matured and corporates are coming out with more and more structured issues. Structured debenture issues attempt to enhance the credit rating of the instrument or strip identified risks. The structures may provide for escrow of a flow of receivables. The most commonly used method is by providing guarantees for timely servicing of the securities, which can be provided by:

- group company which enjoys higher rating
- bank or domestic financial institution
- multi-lateral agencies (MLAs) such as ADB, IFC (Washington), NIB, FMO, etc.

There have been some issues in India with partial / rolling guarantees from multi-lateral agencies which not only help the corporates raise money at lower interest rates but also encourage a wider base of investors to participate in long term instruments. Such issues are likely to become more popular as these replace term loans and being tradable provide flexibility in asset liability management.

3.2 Securitisation

Securitisation has emerged as another area with huge potential. Typically the securitisation involves assignment of rights in a series of cashflows to a trust which issue Pass Through Certificates (PTCs) to the participant investors. The instruments could be Asset Backed Securities (ABS) or Mortgage Backed Securities (MBS) such as Collateralised Loan Obligation (CLOs), Collateralised Debt Obligation (CDOs), Residential Motgage Back securities (RMBS), etc.

The number of securitisation transactions has grown rapidly. Securitisation route has been undertaken largely by banks and non-banking finance companies for securitising their retail assets pool. The securitisation market is estimated to have increased from 6 transactions worth Rs. 430 crores in year 2000-01 to 53 transactions of Rs. 5,460 crores in year 2002-03, an annualised growth of 256%. The securitisation volume during Apr-Dec 2003 has been over Rs. 5,280 crores. Again these being tradable provide flexibility in Asset Liability Management and using capital more efficiently by improving the turnover.

Overall, this market is likely to grow at a rapid pace and help generate liquidity.

3.3 Supranantional Bonds

During FY2003-04, ADB issued rupee denominated bonds in the Indian market to raise funds. It is interesting to note that these bonds are internationally rated higher than the sovereign rating for Indian securities. However, these were issued and traded at a spread higher than the corresponding G-Sec yield. This marks a new trend where the multi-Lateral Agencies (MLAs) which have committed funds to domestic projects (in India) in sectors such as power, road, urban infrastructure, etc. access the domestic debt market to raise funds. With the currency (Rupee) expected to remain stable and need for deployment of funds in the infrastructure sector, such issuances could be more often.

3.4 Floating Rate Bonds (FRB)

While FRBs are not new instruments, it is only recently that these have been put to frequent use. Recently, FRBs have been issued by financial institutions at tight spreads ranging from 50 bps to 100 bps over 1-year G-Sec benchmark yield for 5 year instruments. However, these have become popular among the investors as these are seen as a tool to protect yields in rising interest rate scenario.

4. As the market grows, new instruments such as inflation indexed bonds may be introduced. Some of the large corporates have been market savvy in using derivatives as a tool for liability management and to take advantage of the international interest rates. Some of the highest ranking Indian corporates

have also been using cheap buyers' credit such as 10 to 30 basis points over LIBOR. This market may grow in depth in time to come.

In summary, the key emerging trends can be listed as :

- Introduction of more new/innovative instruments
- Transactions with more complex and exotic structures being executed
- Unlike in the past when only credits with highest rating (such as AAA, AA+, AA) have been liquid, the market could grow in range and depth and secondary market may develop even in low rated papers (such as A+, A)
- Greater transparency in dissemination of information regarding (i) corporates and their debt issuances, and (ii) secondary market transactions, as a consequence of regulatory steps being taken to help in healthy growth of the market.
- Widening of investor basket. A truly deep and liquid market should see corporate bonds as a saving instrument for retail investor according to his own risk perceptions.