Debt Private Placements - The Future Ahead

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The present market

Primary Market

The size of the debt private placement market has increased considerably in the last 8 years. From a total volume of INR 100 bln in 1995-96, the total volume has increased to INR 701 bln in 2002-03.

In the corresponding period, public debt issues have been very few and comprised issues by the Development Financial Institutions, which specifically targeted the retail segment.

The reasons for the growth of the Private Placement market vis-à-vis Public issue are many. The Private placement route enables issuers to raise resources at a lower cost, with faster turn-around time, with minimum disclosures and without involvement of regulatory intervention. For Public issues, a detailed Information Memorandum is required to be vetted by Securities & Exchange Board of India (SEBI). This involves additional cost and time. Moreover, issues incur incremental administrative expenses such as advertising, printing and distribution of Information Memorandum, brokerage to collecting agents, payments to collecting bankers etc. And post issue, costs of servicing large number of retail lenders. As a result, the private placement market developed considerably during the last couple of years. Table 1 below shows the growth of the private placement market in the last 8 years.

Table 1: Volume in the Private Placement Market

Year	All Issues			Excluding issues less than 1 year		
	No. of issues	Volume (INR bln)	Increase/ Decrease over Previous year	No. of issues	Volume (INR bln)	Increase/ Decrease over Previous year
1995-96	73	100.35				
1996-97	204	183.91	83%			
1997-98	252	309.83	68%			
1998-99	445	387.48	25%			
1999-00	711	550.73	42%			
2000-01	881	624.61	13%	596	524.33	
2001-02	1052	591.27	-5%	558	462.20	-12%
2002-03	1134	701.54	19%	485	484.24	5%

Source: Prime Database

Note: Data for issues having tenor > 1 year not available prior to 2000-01

As seen from this table, the private placement market witnessed good growth in the period 1995-96 onwards till 2000-01. Thereafter, volume of total issuances declined in 2001-02. Again, 2002-03 witnessed a pick-up in debt placement. If we consider only issues with tenors>1 year, annualised YoY volume increased by 19% in 2002-03.

Table 2 below shows the segment wise distribution of the private placement debt market over the last 3 years. This excludes issuances with tenors of less than 1 year.

Table 2: Segment-wise volumes (excludes issues with tenors < 1 year)

Private Placements	2000-01		2001-02		2002-03	
Amounts in INR bln	Amount	%	Amount	%	Amount	%
All-India Fin. Inst. & Banks	216.73	41	186.03	40	173.69	36
Private Sector	91.69	17	111.99	24	102.50	21
State Level Undertakings	114.66	22	63.33	14	43.89	9
Public Sector Undertakings	78.39	15	83.75	18	125.49	26
State Fin. Inst.	22.86	4	17.09	4	38.66	8
Total	**524.33**		**462.20**		**484.24**	

Source: Prime Database

As seen from table above, the volume of private sector debt continued to show growth over this 3 year period considering annualised figures for 2002-03.

The decline in overall volume of debt placed is due to decline in debt placed by Financial Institutions & Banks, as well as State Level Undertakings. In the past, large issuers in the Financial sector included ICICI Limited, Industrial Development Bank of India and IFCI. Borrowings by these organisations have come down. Also, with most of the State governments in poor financial condition, their credit ratings have been downgraded, which has impaired their debt raising ability.

Secondary Market

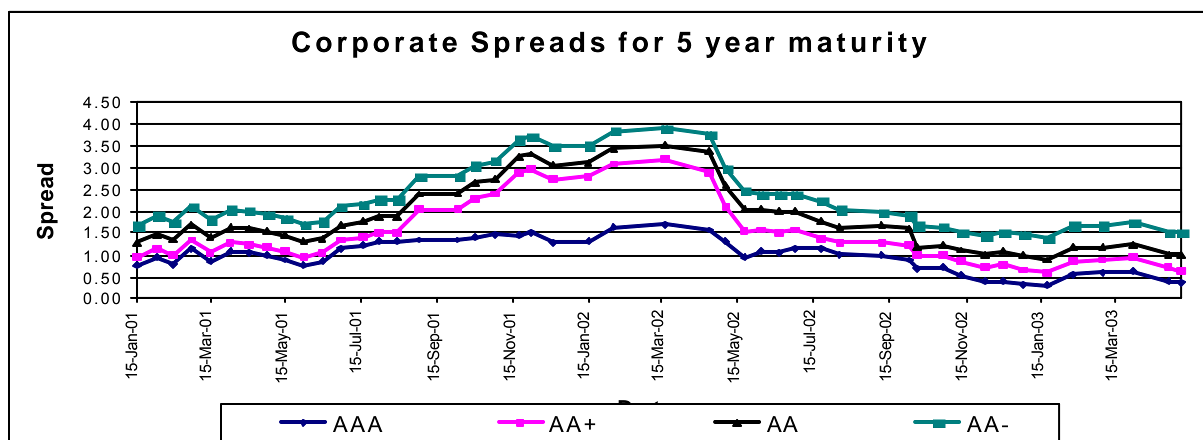
The secondary market for debt securities has picked up considerably in terms of depth and volume with the introduction of de-materialisation. All new issuances have to be done in the dematerialised form as per regulations.

Trading in dematerialised form benefits all the market participants by improving liquidity and reducing transaction cost. Earlier, the transfer of securities in the name of the buyer used to be a time consuming affair and in the interim period, the paper was illiquid, as it could not be sold even if a buyer was available. In the dematerialised mode, transfer time is only 24 hours. The transaction costs have also reduced, as stamp duty is not payable on secondary transfers. Also, settlement risks have come down.

The trading volumes in the secondary market have been growing steadily. Monthly volumes which used to be in the region of INR 15 bln 2 years ago, have gone up to INR 30 bln in some of the active months.

The secondary market is also witnessing increased acceptance of 'AA' and 'AA-' rated papers. Previously, trading interest was limited only to 'AAA' papers. However, with declining interest rates and attractive spread levels available on these relatively lower rated credits, investors are finding value in these papers. In terms of credit quality, difference between 'AA' rated paper and 'AAA' is marginal. Moreover, in a declining interest rate scenario, players are exploring means of improving returns on portfolio without taking on substantially higher risk.

Graph 1: Corporate spreads for AAA, AA+, AA & AA- rated papers for 5 year tenors



The Future Ahead

The Indian Debt Capital Markets have progressed a long way over the past few years, not only in size but also in sophistication. The primary markets are expected to witness surge in volumes with the entry of new players from the insurance industry and with introduction of new instruments / products. The dynamics of the market are set to change with the introduction of the following:

i) Move to lower rated credits for higher risk adjusted returns - widening category of issuers to include issuers with credit rating below AA,
ii) Derivatives – Increasing use of derivatives embedded in new bond issues, or stand-alone structures to hedge risk of bonds already issued or invested in,
iii) Increased use of securitisation as a product, and
iv) Introduction of credit derivatives

Move to lower rated credits for higher risk adjusted returns

One of the important pieces of legislation passed by the Government during the current year is the Securitisation & Asset Reconstruction Ordinance. The ordinance provides a framework, which is more conducive towards recovery of security in cases where secured bonds/ loans have turned bad. The legal

recourse available earlier to the lenders was borrower friendly and proved ineffective in making recoveries. Legal cases have been known to take extremely long to be resolved by the courts. As a result, the bond markets were restricted to only the highest rated issuers.

Over the last few years, the credit off-take had become skewed towards the higher credit-worthy borrowers, thereby even the deserving companies lower down in the credit spectrum were not able to obtain institutional funding. With higher lender protection in place, banks would be more comfortable giving secured credit to such companies and thereby improving returns on their loan portfolio. This would also expand the scope of the debt capital markets to lower rated credits such in the 'A' category, which would be able to access the debt market.

Embedding derivatives into bond issues

The Indian bond markets have progressed from the plain vanilla bond issues to bond issues embedded with derivative structures. Such structures enable issuers to hedge their currency/ interest rate risk or take a view on the same through market instruments. The following examples illustrate some of the structures that have been successfully placed.

Example 1: An issuer may want to issue floating rate paper in the market based on a view that interest rates are expected to decline. However, investors may be un-willing to invest in floating rate paper. In such a scenario, issuer may issue fixed rate paper and embed the issue with an interest rate derivative. As a result, issuer would pay the floating rate to the swap counterparty and at the same time investors would receive a fixed rate. In 2001-02, a large number of issuers took advantage of this structure, using the 5 year GoI security as a benchmark, and benefited from the secular decline in interest rates.

Example 2: An issuer wants to take advantage of lower interest rates prevailing in USA, but investors want a fixed rate in Rupee terms. In this scenario, issuer can embed the bond issue with a currency derivative structure, whereby issuer pays a floating rate linked to LIBOR to the swap counterparty, and investors receive fixed interest rate in Rupee terms.

Increased use of Securitisation as a product

Securitisation involves structuring of a series of future cashflows into marketable securities. The most common form of transactions involves the asset classes – housing finance receivables and auto loan receivables. Some of the other transactions that have been executed in India are securitisation of aircraft lease receivables, credit card receivables, oil & gas sale receivables, etc.

The securitisation market in India progressed slowly due to lack of separate securitisation laws in the country. Though securitisation transactions were taking place under existing laws, many large financial players did not participate in the market.

The Government of India has now passed the Securitisation & Asset Reconstruction Ordinance, which defines securities and security receipts (instrument which is held by investors) under the Securities Contracts (Regulation) Act. Earlier, there was ambiguity on this count, as a result of which a number of financial institutions did not participate in the securitisation market. Now that legal validity is explicitly provided to securitisation transactions, the market is set to expand.

Table 3: Volume of securitised paper

Year	No. of issues	Volume (INR bln)
2000-01	13	25.27
2001-02	22	15.75
2002-03	54	58.89

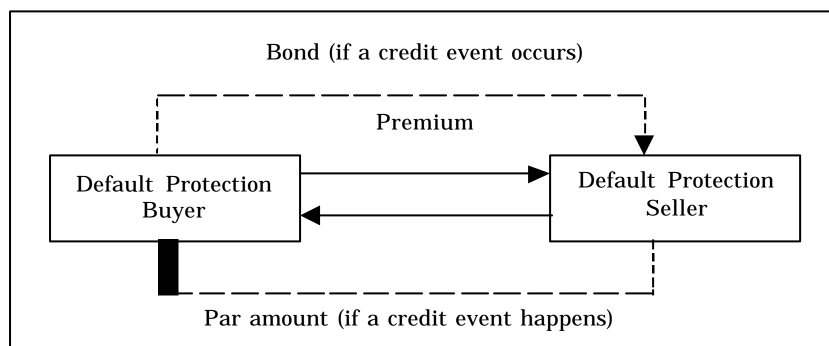
As seen above, the number of issues as well as volume of securitised debt placed has been on the increase for the last 3 years. In the year 2002-03, a total of 54 deals were executed with an aggregate volume of INR 58.89 bln.

Introduction of Credit Derivatives

The introduction of credit derivatives in India is expected to revolutionize the bond markets. The Reserve Bank of India has recently put out draft guidelines for introduction of Credit Derivatives in the Indian financial markets for comments. Market participants have responded already with feedback and the final guidelines in this context are expected shortly.

Credit Derivatives are over the counter financial contracts. As per the commonly used definition, credit derivatives are off-balance sheet financial instruments that permit one party to transfer credit risk of a reference asset, which it owns, to another party without actually selling the asset. It therefore unbundles the credit risk from the credit instrument and trades it separately.

The easiest and the most traditional form of a credit derivative is a guarantee. Financial guarantees have existed for thousands of years. However, the present day concept of credit derivatives has traveled much farther than a simple bank guarantee. Credit default swap is a refined form of a traditional financial guarantee, with the difference that a credit swap need not be limited to compensation upon an actual default but might even cover events such as downgrading, apprehended default etc. In a credit default swap, the protection seller agrees, for an upfront or continuing premium or fee, to compensate the protection buyer upon the happening of a specified event, such as a default, downgrading of the obligor, apprehended default etc. Credit default swap covers only the credit risk inherent in the asset, while risks on account of other factors such as interest rate movement remains with the originator. This structure has been diagrammatically explained below.



Some other types of credit derivatives are:
- Credit Default options
- Credit Linked Note
- Credit Linked deposits
- Collateralised Debt obligations
- Total Return Swaps

The use of credit derivatives benefits users in the following ways:
- Transfers credit risk and therefore free-up capital for alternate use
- Helps diversify credit risk
- Helps maintain client relationships
- Attain desired credit profile

In developed markets, credit derivatives are widely used by banks for all the above mentioned reasons. The size of the market can be gauged from a recent survey by British Bankers Association (BBA), which has been tracking the growth of global credit derivatives almost since their inception. BBA expects credit derivative volumes to touch USD 2,000 bln by end of 2002 and further to USD 4,800 bln by end of 2004. The estimates at the end of last year, the global market for credit derivatives reached USD 1,189 bln, more than estimated by BBA in its earlier surveys

Conclusion
The Indian Debt Capital Markets have progressed a long way over the past few years, not only in size but also in the kind of structures that are being placed. As more sophisticated products are permitted, the markets are set to expand further. Overall, one can expect all round development and exponential growth in the Indian debt markets in the years to come.