Government Securities Market in India

R.V.Joshi
Managing Director
Securities Trading
Corporation of India Ltd.

Overview

Government Securities market leads Indian debt market today. Public Sector Units (PSU) bonds and private sector corporate bonds are the other two segments that still remains way off both in terms of volume and liquidity. Government Securities are issued by the Central as well all provincial governments as a part of their borrowing programme, though for state governments it forms a relatively small portion of their fiscal deficits.

Total outstanding debt in 2002 formed around 37% of Indian GDP. Central government dated securities formed around 23% of GDP as compared to 4.5% of the State Government. PSU Bonds/Private Corporate bonds amounted to around 9% of GDP. Thus Government accounted for nearly three-fourth of the debt instruments. Though exact figures are yet to be made available, government borrowing as a percentage of GDP has gone up in 2002-03 This trend gets further biased in secondary market. Here government securities accounted for more than 90% of the transactions. Average daily transaction volume in secondary market for government securities during 2001-02 stood at Rs. 4,000 crores as compared to Rs. 200 to Rs. 400 crores for corporate securities including PSU bonds.

With credit and equity markets remaining subdued, government securities market experienced an intense increase in treasury activity in the recent past. Surplus liquidity conditions drove down yields by unprecedented 298 basis points (average across 1yr. to 20 yr. segment) during 2001-02 as against a moderate decline of 57 basis points during 2000-01. The aggregate volume of secondary market transaction in State and Central Govt. dated securites and T-bills (outright as well as repos) more than doubled to Rs. 15,73,893 crore during 2001-2002 from Rs. 6,98,121 crore crore during 2000-2001. During 2002-03 the decline in 2 to 5 year segment averaged around 60 basis points and those in 6 to 10 year and 11 to 20 year tenors was of the order of 102 and 115 basis points. The falling interest rate scenario has helped the Reserve bank to achieve the twin objectives of elongating the maturity profile of new debt and reducing the cost of borrowing at the same time. The average cost of issuance of dated securities has come down from 10.95% in 2000-01 to 7.34% in 2002-03, though the average maturity of outstanding stock has increased to around 8.5% in 2002-03 from around 7.5% in 2000-01.

A Necessary Impetus For Overall Bond Market Development

Bond market is an integral part of overall capital market infrastructure for any economy. It's development depends upon a number of issues. They could be financing government deficit, funding bank restructuring, creating more complete financial markets, avoiding banks from taking on excessive credit, risk diversification in the financial system, providing a range of long-term assets for pension funds, etc.

Development of a deep and liquid government securities market facilitates public borrowings at reasonable costs and avoidance of automatic monetisation of government deficit by the central bank - resulting to better coordination between monetary policy and debt management. A well developed government securities market helps in the pricing of various debt instruments through the creation of a benchmark, enables a proper evaluation of risk and also act a conduit for convergence of interest rates in other markets. It facilitates implementing indirect instruments of monetary policy as well.

Region wise segregation of the causes for debt market development in "emerging" economies can be grouped as follows:

Asia	Latin America	Eastern Europe
1.Need to recapitalise banking system	1. Rapid Growth of Local Institutional	1.Build up of institutions like debt mgmt. Investors
2.Refinance Expansionary Fiscal Policy	2.Large refinancing needs of the corporate sector in difficult external environment	2. Harmonisation of regulation in the process of EU accession
3.Lack of bank Credit in some cases	3. Lack of bank Credit in some cases	

Factors Facilitating Development of Government Securities Market in India

Before 1991-92, internal-debt management in India remained passive under Fiscal policy compulsions. Low coupon rates offered on government securites to facilitate lower borrowing costs for the government made real rates of return negative for several years till mid-1980's.

Fundamental changes in the government securities market was initiated since early 1990's with the onset of liberalization when interest rates started to be governed more by market forces of demand and supply and less by centralized supervision. Since then, RBI has taken several steps for the development of debt market as a part of its efforts to develop the entire gamut of financial markets - making it deep, wide, transparent and vibrant. Continuously large government borrowings have provided primary impetus for the development of Indian bond market.

Abolition of automatic monetization through ad-hoc Treasury Bills (1997) and replacing it by Ways and Means Advances (WMA) facility with imposed limits to meet temporary cash flow mismatches for the central Government has been a critical step towards this direction. Government borrowing was made market based through the introduction of auction system in primary issues. Improvements in institutional infrastructure were aimed at by setting up the system of Primary Dealers. Though plain vanilla bonds remained the mainstay, the breadth and depth of the markets were sought to be improved by the introduction of a variety of new instruments viz., Zero Coupon Bonds, Capital Indexed Bonds, Floating Rate Bonds, Call and Put Option Bonds, etc. Active pursuing and consolidation of debt through re-issuance/re-openings by RBI since April 1999 has resulted to the improvement in market liquidity and helped in the emergence of benchmark securities. Trading and settlement systems have also been improved through the introduction of Delivery-versus-Payment (DvP introduced in 1995) system, operationalisation of Negotiated Dealing System (NDS) and the clearing Corporation of India Ltd. (CCIL) from February 15, 2002.

Followed by the setting up of the NDS and CCIL, the RBI went ahead and decided to allocate 5% of the notified amount in G-sec auctions to the retail segment, namely, individuals, urban co-operative banks, NBFCs, trusts and corporate bodies, among others under the non-competitive bidding category. The latest development has been the operationalisation of trading G-sec's on stock exchanges.

Participants in Government Securities Market

The Government securities market in India has been dominated by commercial banks, insurance companies, financial institutions and provident funds, mutual funds and NBFCs. Close to 60 per cent of the holdings of gilts are held by commercial banks. Considering that the banking and insurance sectors still account for the bulk of investment in Government securities, there is a strong case for promoting retailing of Government securities and broaden the investors base. A broader investor base improves bond market liquidity not only because of the size effect but also because of having a large number of investors with diverse risk profiles that enable smooth dissipation of market shocks. Large investor bases also generate incentives for financial innovation, leading to greater market dynamism and lower transaction cost.

There exist competing views on the role of individuals in promoting liquidity. One is that individual investors play a much greater role in the local bond market through mutual funds, which diversify risk on their behalf. Many countries have, therefore promoted mutual funds and have set up specialized guilt funds (Mexico for example). The other notion pledges for a more direct participation of individual investors in developing bond markets on grounds that this would reduce the reliance of governments on captive investors, promote fixed income investment culture among households and increase competition in the deposit market.

Though RBI has allowed investment by individuals in gilt's through non-competitive bidding, entertaining low-valued individual transactions could fail to attract banks and PD's given the transaction cost and minimal commission involved which make such deals unattractive. Moreover, schemes, such as the RBI Relief Bonds, the Public Provident Fund and the National Savings Certificates all yield better rates than those of Government securities to attract individual trading on stock exchanges. The tax benefits also remain biased against it. Any rationalization of the tax structure in bringing all these products on an equal footing may enhance retailing in government securities to a larger extent.

Government Securities Market: Way Ahead

Debt management in India has clearly come a long way from a passive system to a market driven exercise with developed institutions, instruments and markets. In terms of international benchmarks, India ranks on par with some of the developed countries in areas like institutional framework, risk management set-up, market development, clearing and settling procedures and transparency in debt management operations. The guiding objectives in the development of the government securities market have been to develop a smooth yield curve, to create a suitable benchmark for pricing of various debt instruments, diversification of investors base and enable the use of indirect instruments for operation of monetary policy.

With NDS and CCIL in place significant developments have already taken place on the settlement systems in the Indian debt market. RBI has been working towards the development of the system for Real Time Gross Settlement (RTGS). Sufficient groundwork has already been made is this front as well. Market is looking forward to enjoy its operational benefits in enhancing the efficiency of existing financial system in the immediate future.

Introduction of treasury STRIPS is another issue the market would be looking forward to. STRIPS is the acronym for Separate Trading of Registered Interest and Principal of Securities. The STRIPS program let investors hold and trade the individual interest and principal components of eligible Treasury notes and bonds as separate securities. The flexibility to strip and reconstitute securities allows investors to take advantage of various holding and trading strategies under changing financial market conditions. It has the benefit of expanding investor base, improve tracking of effective yield curve and also allow institutional investors to reduce reinvestment risk. Though we are yet to have treasury STRIPS in the Indian market there have been few instances of privately placed corporate debt, which have stripped coupons.

Derivatives enable banks, PD's and Financial Institution's (FI's) to hedge interest rate risk for their own balance-sheet and also for market making purposes. Banks/PD's/FI's can undertake different types of plain vanilla FRA's/IRS. Exchange traded interest rate futures have also been started from June 24, 2003 onwards and interest rate options are to be introduced shortly once the regulatory mechanisms are put in place. To ensure further deepening of the money market and enable market participants to manage and control interest rate risk, expansion of (OTC) rupee derivative market and exchange traded interest rate derivatives needs to be explored[1] .

Current ban on short selling has also been a much-discussed cause of worry and concern among dealers. With such a ban "received" risks in the books of the dealers can only be hedged on a portfolio basis, which is inefficient and fraught with different kinds of risks particularly "basis risks". Permitting "short selling would" reduce such risks. Reviewing the definition of short sales as per international best practices has also been one of the recommendations of recent Report of the Working Group on Rupee derivatives.

Most advanced markets allow trading during the period between the time a new issue is announced and the time it is actually issued - ranging from one week to two weeks in US market to as short as two days in France. This is the "When Issued" market for Government Securities. Trading of this form function like trading in the forward market. Major benefits that accrue are minimization of price and quantity uncertainties, lower underwriting risk and increased revenue from the new issue. Feasibility of such arrangements in the Indian could be a further issue to explore.

Many have pointed out the importance of securities lending/borrowing transactions in boosting market liquidity. This requires permitting market participants to short sell a security and, at the same time, enabling them to borrow the shorted security temporarily from its owner with a contractual obligation to redeliver at a later date. Securities lending operations promote liquidity by preventing settlement failures and increasing arbitrage opportunities. Another potential benefit of securities lending transactions is that they provide opportunities for fund managers and institutional investors to earn additional income from their idle security holdings. This, in turn has implications for fund flows in the money market. Primarily because of their favourable impact on market liquidity, many industrial economies relaxed restrictions on domestic and cross-border securities lending transactions during 1990's. The feasibility of this instrument would definitely be an issue for consideration in the near future.

Broadening the range of instruments is a pertinently important issue. The choice of debt instruments typically depends on several considerations: market preference, cost to government and, in some cases, monetary policy objectives. In Latin America and some central European economies, the pattern has been to issue floating rate bonds and bonds indexed to inflation and exchange rate. In Saudi Arabia, floating rates notes were introduced in 1996 to broaden the range of instruments and diversify price risk. Financial Year 2001-2002 saw the re-introduction of Floating Rate Bonds in the Indian market. Floating rate bonds usually shortens the maturity profile of debt, transfer market risks to the government and might constrain monetary policy from raising interest rate. Indexed bonds are more attractive to long-term investors preferring fixed real return on their assets. They could also reduce interest costs to the government by eliminating the inflation risk premium and serve a useful monetary policy function by providing a market indicator of inflation expectations. Incidentally such a bond in the Indian system has matured on December 2002, there are none of their types outstanding at present. Exploring the feasibility of re-introducing inflation indexed bonds and addressing their issues of pricing and liquidity in the Indian system could be another aspect to delve into the future.

Coordinating debt management and monetary policy when the central bank is directly involved in developing bond market has always been a critically important issue because of the potentially conflicting nature of their objectives. When debt management is focused on the cost/risk trade-off to minimize borrowing costs to the Government, monetary policy is directed towards price stability. In some of the industrial countries operations (eg.UK & France), debt management operations are separated from the central bank's monetary policy, with government using the primary market to issue bonds while the central bank uses the secondary market for liquidity operations. Minimizing borrowing costs to the government is achieved through product innovation and improvement of the price discovery process. In India such a success of separation of Government debt management from RBI, if it were to happen, would be dependent to a large extent on the development of financial markets, reasonable control over fiscal deficit and necessary legislative changes. A lot along this front has to depend on the status of enactment of the Fiscal Responsibility bill. There has already been some development along this front. On February 05, 2003 the Cabinet approved the changes proposed by the finance ministry to the original fiscal responsibility and budget management bill. Though the revised bill brings in greater flexibility it will still not specify a target for fiscal deficit contraction within the law. Given the developments, possibly we will have to wait for some more time to see a separation of debt management operations from RBI.

Notwithstanding the above, debt market in India led by Gilt market is poised for exciting growth in all parameters be it in terms of products or volumes. Whatever we have seen so far is only the beginning.

[1]OTC derivatives in the form of Forward Rate Agreements (FRA's) and Interest Rate Swaps (IRS) have already been introduced in India since July 1999. Exchange traded derivatives in the form of interest rate futures has also been launched on June 24, 2003.