Debt Market in India: An Overview

The growth of any country is highly dependent on the availability of finance in its economic machinery. Before understanding the sources of finance, it is imperative to discuss the major users of such finance. The corporates or big business houses can be treated as the first user of finance to run their business; the government which is generally one of the biggest spender in an economy, the second; the financial institutions which provide the finances to other users as the third user of finance; and then the smaller businesses and individuals may be treated as the fourth user. Generally, the smaller business and individuals rely on funding available from financial institutions to meet their requirements. However, the appetite of the other three participants may not be satisfied solely by the financial institutions. Hence, now we need to understand the overall sources of funds available in the economy. Read on to know more…

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The financial market is broadly divided into two categories, money market and capital market. Further, the capital market, which forms the primary source of funds for major players in the economy, is divided into two major categories – Equity Market and Debt Market. From the discussion above we can summarise that the major source of finance in the economy can be funds from financial institutions, short term funds in money market, raising equity in the share market and raising debt in the debt market. In this article we will focus on the capital market and within the capital market broadly on the debt market.

The capital market of an economy is considered to be well developed, only when a parallel development is ensured both in the equity and the debt segment. A well developed debt market can be the optimal alternative, not only to support the financing requirement for infrastructural development, but also to relieve banks from all the problems of long-term financing, and spreading out the huge financing risk to a wider investor base to strengthen India's bank-based financial system, to allow corporate borrowers to tap the low cost market, to enable investors including FIIs to earn fixed but higher returns, and above all to ensure overall growth of the economy.

Capital market, both debt and

equity, has become increasingly important for India's growth story. During the last 5 years', India's nominal GDP grew by over 67%. Over the same time period, while outstanding bank credit increased by 63%, outstanding corporate bonds increased by over 117%, i.e., from ₹ 12.6 trillion to ₹ 27.4 trillion. Financing through equity, during the same time period, was over ₹ 6.2 trillion. As a result, the share of bank loans in credit disbursed to the commercial sector declined from 56% in 2011 to 38% in 2017. On the other hand, over the same time period non-bank sources of credit such as commercial paper, corporate bonds and external commercial borrowings increased from 44% to 62%.

Debt Market

Once the stats have highlighted the significance, let us understand the debt market. The Debt Market is the market where fixed income securities of various types and features are issued and traded. Debt Market is therefore; market for fixed income securities issued by Central and State Governments, Municipal Corporations, Government bodies and commercial entities like Financial Institutions, Banks, Public Sector Units, Public Ltd. Companies, Private Ltd.

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Depending on the issuer of fixed income securities, it can be classified as Government Securities, i.e. bonds issued by the Central / State Government of an economy, and Corporate Bonds, i.e. bonds issued by private and public corporations. Debt instruments can also be categorised in terms of their maturity, nature of interest, special features embedded in it, etc. Short term debt instruments, issued by the Central Government and by corporates, are respectively known as Treasury Bills and Commercial Papers. Similarly, securities issued with a maturity of more than one year are known as dated securities. The original maturity of a debt security may range from 1 year to 30 years. The instruments with short term maturities or quasi-money instruments form part of the money market. The Instruments traded in the money-market are Treasury Bills, Certificates of Deposits (CDs), Commercial Paper (CPs), Bills of Exchange, Call Money, Repo/Reverse Repo, Collateralised Borowing and Lending Obligation (CBLO) and other such instruments of short-term maturities (i.e. not exceeding 1 year with regard to the original maturity). The other instruments with maturity of more than 1 year form part of the debt market.

Types of securities

There are variety of securities and products available in the debt market. Let us try and understand the nature of some of the most prominent products in the Indian economy.

- G-Sec (government securities): G-Secs in India currently have a face value of ₹ 100/- and are issued by the RBI on behalf of the Government of India. All G-Secs are normally coupon (Interest rate) bearing and have semi-annual coupon or interest payments with tenure of between 5 to 30 years. This may change according to the structure of the Instrument.
- SDLs (State Development Loans): SDLs are issuance of respective states in order to manage finances of their own state. All the features of SDLs are similar to G-Sec except that normally they are issued for maximum maturity of 10 Years and their pricing considers fiscal health of the respective states and risk element associated therein. For this reason SDLs are issued/traded at market determined spread above the corresponding benchmark G-Sec.
- Treasury Bills/Cash Management Bills (CMB): Treasury Bills are for short-term instruments issued by the RBI for the Government for financing the temporary funding requirements and are issued for maturities of 91 Days, 182 Days and

364 Days, whereas CMBs are issued for maturity below 91 days. T-Bills/ CMBs have a face value of ₹ 100 but have no coupon (no interest payment). T-Bills are instead issued at a discount to the face value (say @ ₹ 95) and redeemed at par (₹ 100). The difference of ₹ 5 (100 - 95) represents the return to the investor obtained at the end of the maturity period.

- Commercial Paper: Commercial Paper (CP) is an unsecured money market instrument issued by corporates in the form of a promissory note.
- Certificate of Deposit: Certificate of Deposit (CD) is a negotiable money market instrument issued by banks in dematerialised form or as Usance Promissory Note in the form of a promissory note.
- Fixed Rate Bonds: This is the most popular type of corporate bond traded in most of the markets, paying a semiannual but fixed coupon over their life and the principal at the end of the maturity.
- Floating Rate Bonds: These are the bonds, even if the coupon of which are usually paid semi-annually, the coupon rate is not fixed throughout the life and varies over time with reference to some benchmark rate. These types of bonds may have some Floor or Cap attached on it, representing that even if the benchmark rate changes by any value, the coupon rate even if floating but will always lie within the range of Floor and Cap rate. Some of the well known benchmark rates used in Indian market are MIBOR, Call Rate, T-bill rate, PLR, etc.
- Debentures: Debentures are also fixed interest debt instruments with different maturity, but is usually secured in nature and therefore offers lower interest comparative to bonds. Debentures, based on their convertibility to the form of equity, can be of three types: Non Convertible (NCD), Partially Convertible (PCD), and Fully Convertible Debenture (FCD).
- Tax-saving infrastructure Bonds: In order to facilitate infrastructure financing through the bond route, some special types of tax-free bonds, issued by some infrastructure companies, are offered to the investors.
- Zero Coupon Bonds: Zero Coupon Bonds (ZCBs) are issued at a discount to their face value and the principal/face value is repaid to the holders at the time of maturity. Instead of paying any periodic coupons, the ZCB holder gets the price discount in the beginning itself. Therefore, ZCBs are alternatively known as Deep Discount Bonds. Treasury Bills and CMBs are example of Zero Coupon Bonds.
- Market Linked Debentures (MLD): MLDs have an underlying principal component in the form of debt securities and where the returns are linked to market returns on other underlying securities/ indices such as Nifty or a 10-year government security paper. MLDs can be of two types: principal protected and principal non-protected.

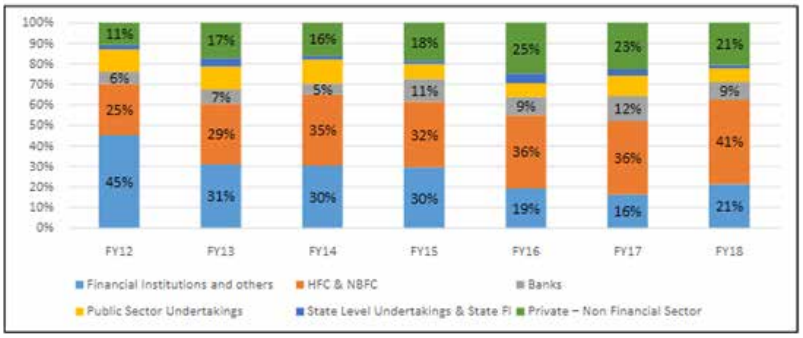
Issuer of securities

Once we have understood the different type of debt securities, let us focus on who can issue such securities. The various participants who are permitted to issue debt securities in India are:

- Central Government
- State Governments
- Government Agencies/ Statutory Bodies
- Public Sector Units
- Corporate
- Banks
- Financial Institutions
- NBFCs

The quantum of participation by various issuers can be gauged from following data[1] (1)

Chart 3 - Issuer wise breakup of bond issuances



Platform for issue of securities Corporate Bonds

Similar to equity market, debt market also has primary market and secondary market. The primary market can be further divided into private placements and public issue. A private placement is defined as an issue of securities by a company to a selected group of persons. On the other side, a public issue is an offer made to the public in general to subscribe to the bonds. In a public issue, the company has to issue a prospectus before issuing the bonds. After the public issue, these bonds are listed on a recognised stock exchange in India. Unlike equities, the debt securities which are privately placed can be listed on a recognised stock exchange. Hence, both the privately placed and public issue based securities can be traded on a recognised stock exchange. Even though any securities including corporate bonds are primarily issued in the primary market, either through public or private placements, the secondary market plays a number of important function, including: providing effective price discovery; shifting risk; pricing new issues; offering an alternative mode of investment; aiding management of resources; and enforcing discipline on the issuer.

> A private placement is defined as an issue of securities by a company to a selected group of persons

The secondary debt market further has segments in India. The segments in the secondary debt market based on the characteristics of the investors and the structure of the market are:

- Wholesale Debt Market - where the investors are mostly Banks, Financial Institutions, the RBI, Primary Dealers, Insurance companies, MFs, Corporates and FIIs.
- Retail Debt Market involving participation by individual investors, provident funds, pension funds, private trusts, NBFCs and other legal entities in addition to the wholesale investor classes.

The above markets are provided by stock exchanges through various platforms. The BSE and NSE, both provide trading platforms for both wholesale and retail debt market. For eg. BSE provides the facilities through its NDS-RST platform and the BOLT System of the Exchange. The size and significance of these platforms can be assessed from the data available with SEBI, in the month of April and May 2019, Corporate bonds worth ₹ 113461.46 crores were listed on NSE and BSE platforms in 364 issues.

Government Securities (G-Sec & SDLs)

The Central & State Government raises resources to fund their fiscal deficit by way of market borrowing. This activity is facilitated by Reserve Bank of India (RBI) by way of auction of these securities through an electronic platform called E-Kuber, the Core Banking Solution (CBS) of RBI. Investors place their bid in the auction through this platform. The allocation is done on either Uniform Price basis or Multiple Price basis. In an endeavor to facilitate wider participation and retail holding of G-Sec, retail investors are allowed to participate in auction on non-competitive basis.

There is an active secondary market for G-Sec also. The securities acquired through auction are bought/sold in secondary market either through Negotiated Dealing System – Order Matching

[1] *SEBI Consultation Paper Designing a Framework for Enhanced Market Borrowings by large Corporates dated July 20,2018*

> With this understanding the investors many times treat investment in a debt market security as a risk free investment. However, the recent turmoil in the debt market triggered by the securities of major players such as IL&FS, DHFL etc. was an eye opener for all investors.

(NDS-OM) – an anonymous electronic trading platform or traded over the counter and subsequently reported on NDS-OM. Some secondry market activity in G-Sec is carried through stock exchange also.

Risks associated with debt market

Now that we have discussed the What, Who, How and Where of the debt market, let us understand the risks associated with the debt market. From the earlier discussion we had concluded that effectively the debt instruments issued in the market offer fixed or floating interest rate. With this understanding the investors many times treat investment in a debt market security as a risk free investment. However, the recent turmoil in the debt market triggered by the securities of major players such as IL&FS, DHFL etc. was an eye opener for all investors. Hence, it's prudent to understand the risks associated with debt securities.

The following are the risks associated with debt securities:

- Interest Rate Risk: The primary risk of investing in any debt security, irrespective of the nature of the security, is the Interest Rate Risk. Price of a debt instrument is inversely related to the movement in risk-free rate of interest, say yield of Government securities. Therefore, as and when interest rate increases, the price of bond is expected to fall, leading to a loss for the holder of the security.
- Default Risk/Credit Risk: This can be defined as the risk that an issuer of a bond may be unable to make timely payment of interest or principal on a debt security or to otherwise comply with the provisions of a bond indenture and is also referred to as credit risk. Credit risk in bond investment includes Credit Spread Risk and Default Risk. Credit spreads reflects the credit worthiness of corporate borrowers, and depend upon the credit rating provided to the corporates by external rating agencies. The value of a corporate bond not only depends upon the risk-free rate, but also on the credit spread of respective securities. Poorer the credit quality of a corporate bond issuer as reflected through a lower credit rating, greater would be the credit spread, leading to fall in bond price. Therefore, credit spread risk is the risk of fall in bond price due to migration of issuers' credit rating from higher to lower level, say from AAA to A, and therefore rise in risk premium.
- Reinvestment Rate Risk: This can be defined as the probability of a fall in the interest rate resulting in a lack of options to invest the interest received at regular intervals at higher rates at comparable rates in the market.

The following are the risks associated with trading in debt securities:

- Counter Party Risk: is the normal risk associated with any transaction and refers to the failure or inability of the opposite party to the contract to deliver either the promised security or the sale-value at the time of settlement.
- Price Risk: refers to the possibility of not being able to receive the expected price on any order due to an adverse movement in the prices.
- Liquidity Risk: Liquidity Risk is another type of risk that bond investors may face. Liquidity risk arises from the illiquidity of a debt issue in the secondary bond market. In other words, whenever an investor fails to sell a security at a fair price due to lack of sufficient demand, the market is said to be illiquid for that security, and creates liquidity risk for the investors.

Pricing of a bond

Pricing of a bond is essentially determination of yield on that debt instrument and resultant absolute price. From an investor perspective it is important to understand how the yield (corresponding price) is determined in the debt market. The yield of a bond in the markets is determined by the forces of demand and supply, as is the case in any market. Other than this the yield of a bond in the marketplace also depends on a number of other factors and will fluctuate according to changes in:

- Macro Economic conditions, both domestic and relevant global ones.
- General money market conditions including the

state of money supply in the economy.

- Risk On or Risk Off situation. Interest rates prevalent in the market and the rates of new issues.
- Future Interest Rate Expectations.
- Inflation expectation based on both domestic prices and global commodity prices viz. Crude etc.
- Credit quality of the issuer.

Yield refers to the effective rate of interest paid on a bond or note. There are many different kinds of yields depending on the investment scenario and the characteristics of the investment.

Yield To Maturity (YTM) is the most popular measure of yield in the Debt Markets and is the percentage rate of return paid on a bond, note or other fixed income security if you buy and hold the security till its maturity date.

Current Yield is the coupon divided by the Market Price and gives a fair approximation of the present yield.

Therefore, Current Yield = Coupon of the Security (in %) x Face Value of the Security (viz. 100 in case of G- Secs.)/Market Price of the Security

Eg: Suppose the market price for a 10.18% G-Sec 2012 is ₹ 120. The current yield on the security will be (0.1018 x 100)/120 = 8.48%

The yield on the government securities is influenced by various factors such as level of money supply in the economy, inflation, future interest rate expectations, borrowing program of the government & the monetary policy followed by the government.

> The two major regulators regulating the debt market are the RBI and SEBI.

Regulatory Framework

The overall debt market can be divided in terms of issuers of debt securities: government, financial institutions including NBFC and corporates. The two major regulators regulating the debt market are the RBI and SEBI. The areas regulated by respective regulators are as under:

RBI: it regulates and also facilitates the government bonds and other securities on behalf of the government. Further, RBI also regulates the debt securities issued by financial institutions and NBFCs

SEBI: SEBI regulates all corporate bonds, both PSU and private sector. Further, any debt security listed on a stock exchange either by government or financial institutions are also regulated by SEBI in addition to the RBI.

MCA: The Ministry of Corporate Affairs regulates the unlisted debt securities issued by a corporate.

The list of some of the major regulations for the debt market is as under:

RBI :

- Master Direction on Money Market Instruments: Call/ Notice Money Market, Commercial Paper, Certificates of Deposit and Non-Convertible Debentures (original maturity up to one year).
- Master Direction - Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 (Updated as on February 22, 2019).
- RBI Guidelines on Private Placement of NCDs for NBFCs.

SEBI :

- Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008.
- SEBI (Issue and Listing of Debt Securities by Municipalities) Regulations, 2015.

Following the announcement in Union Budget 2018-19, SEBI has recently on November 26, 2018 issued guidelines on 'Fund raising by issuance of Debt Securities by Large Corporates' which mandate a large corporate to raise at least 25% of its incremental borrowings by way of issuance of debt securities. The above mandate is effective from April 01, 2019.

Conclusion:

Recent turmoil in debt market has made many investors risk averse and forced them to look for other safer avenues to invest their funds. However, recognising the importance of the debt market and dependence of major players in the economy on debt market as a primary source of fund, the regulators have been actively engaging in correcting and regulating the debt market. Even after 2018 being a year of turmoil for the debt market largely due to uncertainty in policy of RBI and the credit risk in the market due to defaults by IL&FS, data shows that in many cases debt returns have outperformed equity markets in debt mutual fund categories. Hence, the overall awareness about the opportunities and risks associated with the debt market and better regulations will result in an even higher growth in the debt market of India which lags far behind in terms of market share as compared to other developed economies. ■