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Research paper on
Retail Debt market in India

Financial Institutions Reforms and Expansion (FIRE) Project

May 31, 1996

Financial Institutions Reform and Expansion (FIRE) Project
US Agency for International Development (USAID/India)
Contract #386-0531-C-00-5010-00
Project #386-0531-3-30069

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Objective: To identify the retail market potential for debt and develop a long term strategy to develop the secondary debt market in retail so as to mobilize household savings for the purpose of investment.

Scope of the study:

1. Drawing of investor profile on the basis of the retail investors' background in terms of his occupation, educational qualification, age and income.
2. Identify potential demand for debt and concentration of retail funds in each investor group.
3. Devising a strategy for marketing of debt instruments and development of secondary market in debt so as to eliminate the liquidity risk for an individual investor.

Methodology:

The methodology used for the project is as follows:

1. Literature survey to determine the extent of development of the Indian Debt Market.
2. Interview the Industry experts to get their views on the market and suggestions for its development.
3. Administer questionnaire to and interview the brokers and the sub brokers in Bombay to know their perception of the retail investors' mood and impediments to development of secondary debt market in retail.
4. Administer questionnaire to investors in Bombay and Calcutta to identify their appetite for debt instruments and the reasons for them shying away from secondary market in debt instruments.

Schedule:

April 08 - 12 (1 week):
1. Basic study and getting grasp of the subject.
2. Preparation of Project Proposal and getting it approved by the project guide.

April 15 - 20 (1 week):
1. Literature survey to study the history of Indian Debt Markets, various debt instruments at present and their performance and operational impediments to development of secondary debt market.

April 22 - 26 (1 week):
1. Prepare the broker and investor questionnaire and discuss with the project guide for his

suggestions.
2. Incorporate the suggestions and prepare the final questionnaire.

April 29- May 17 (3 weeks):
1. Interview industry experts to get their views on the Indian debt markets.
2. Meet brokers of NSE, BSE and OTCEI with the questionnaire and also interview them.
3. Meet the investors in Bombay with the questionnaire and get their responses.

May 20 - 24 (1 week):
1. Survey investors in Calcutta.
2. Analysis of the questionnaire responses.

May 26 - 31 (1 week):
1. Report Writing

INTRODUCTION TO FIRE PROJECT

The Price Waterhouse Financial Institutions Reform and Expansion (PW-FIRE) Project is a United States Agency for International Development (USAID), Government of India funded project. The purpose is to provide technical assistance consultancy. The core objective is to assist the formation of transparent and efficient systems for trading, surveillance, supervision and regulation. The result will help attract portfolio investment from international investors, as well as, to mobilize domestic savings to finance investment in industry and infrastructure.

In India, USAID has contracted the administration assignment to Price Waterhouse LLP (USA). Price Waterhouse is working with financial client agencies and utilizing its global and local resources to provide training to market participants, consulting expertise in restructuring existing processes and establishing new institutions where required.

The first tier agencies working with Price Waterhouse include:

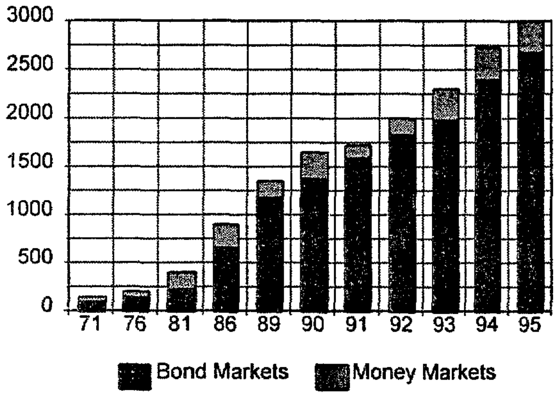
- The Securities and Exchange Board of India (SEBI) to strengthen technical, regulatory, supervisory and surveillance capabilities.
- The National Stock Exchange of India Limited (NSE) to strengthen its operating systems and provide technical assistance for a derivatives exchange and a share depository.
- The Over The Counter Exchange of India (OTCEI) to strengthen operating systems and procedures.
- Stock Holding Corporation of India Limited (SHCIL) to strengthen national custodial services and assist the planning of a national share depository system.

In 1996, PW is contonuing to work with the first tier clients and expand activities with training programs to market intermediaries countrywide such as regional exchanges and professional associations like Association of Mutual Funds in India (AMFI), Institute of Chartered Accountants of India (ICAI), etc.

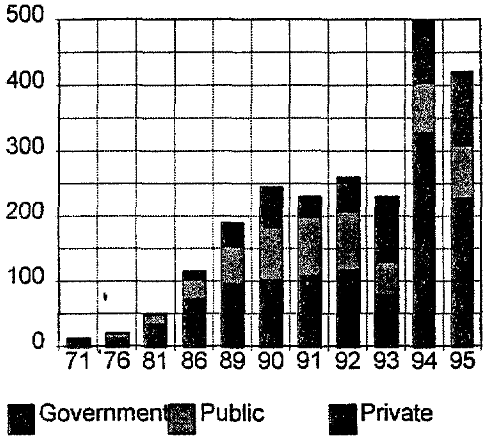
CHAPTER 1: INTRODUCTION

The Indian bond market in size would be next to only the Japanese and Korean bond markets and has an approximate size of Rs.300,000 crores or Rs.3000 billion as of the 31st of January 1995. The government issue of debt would account for more than 50% of the market, with the rest taken up by the public and private sector.

Growth of the Indian Bond Market
(in hundreds of crores of rupees)



Primary issuances of debt instruments
(in hundreds of crores of rupees)



*The figures indicated are as of the 31st March of the year.

- **Government Securities**

While the size of the Government debt is determined by fiscal policy, its composition is determined by debt management policy. Therefore the role of the RBI, given the amount of money to be borrowed by the government, would be to try and optimize the maturity and the cost of servicing this debt. Historically the government used to undertake borrowing at rates of interest which were way below market rates and this resulted in large monetisation, a spinoff of which, was the prescription of high reserve ratios, which in turn led to banks prescribing to high lending rates in certain segments, coupled with comparatively lower rates on deposits. This led to a regime wherein the government in an attempt to control the nominal rate of interest offered large fiscal concessions. The government thus ended up paying a far higher price than what would be necessary had it moved over to a market related system of borrowing.

The RBI therefore recommended a moveover to more market related rates and since 1992-93 the government borrowing program has been taking place at rates which are market related. This has been facilitated by the center's decision to move over to the auction system of issuance from the earlier system of pre announced coupon rates. The government presently undertakes its borrowing program via the use of the auction system as well as pre announced coupon rates. The European style multiple bid system is used with bids in terms of discounted price for T-Bills and yield to maturity for the term securities. The competitive bids are accepted at par or premium if below the cutoff rate with non competitive bids being accepted at the weighted average price of the successful bids and the remainder devolves on the RBI.

The Hobson's choice for the RBI arises due to the situation wherein they have to decide the level of interest rates for the government to borrow at. If interest rates are to be depressed then the RBI has to maximize its participation by setting the cutoff to lower rates but this leads to devolvement of a lot of the securities on the RBI leading to an abnormally high figure of Rs. 15,882 crores of monetized deficit as on July 1 '95. On the other hand a large participation by the market players would entail the offer of a higher cutoff rate, thus increasing the cost to the government.

Last year the September agreement signed between the RBI and the center limited the ad hocs to Rs. 6000 crores and placed a ceiling of Rs. 9,000 crores on ad hocs for 10 consecutive days. The RBI would therefore automatically issue term securities to fund the government, automatically bringing down the level of ad hocs to the prescribed limits. This year no such agreement has been signed and the net credit of the RBI has been alarmingly high. With the government borrowing program this year targeted at a gross figure of 41,000 crores the RBI's action plan would be aimed at raising a large portion of this through the market route. The government and the commercial sector are necessarily tapping a common sector of available resources and the government being the major borrower has had to pay a higher interest rate and has also resulted in the absistence from the market of the other borrowers.

The use of the ad hoc treasury bills as a method of financing the government's requirement is sought to be totally phased out over the next two years. The timing of the government approaching the market is also very important to the response it can get and the rates it can offer. However the market players have to find a perfect trade off in a rising interest scenario as the increase in the offer rate would also mean depreciation in their present portfolio.

The instruments issued by the Central Government are:

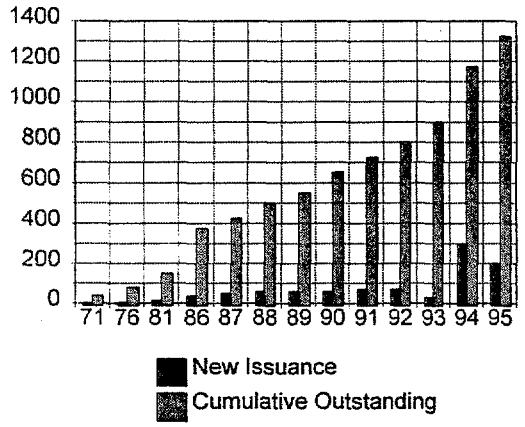
- **Central Government Dated Securities**

These are dated securities with a maturity structure varying from 2-10 years. Earlier the government used to issue longer term securities but taking into consideration market sentiment, it has discontinued issuance for a maturity structure of more than 10 years. These are registered with the

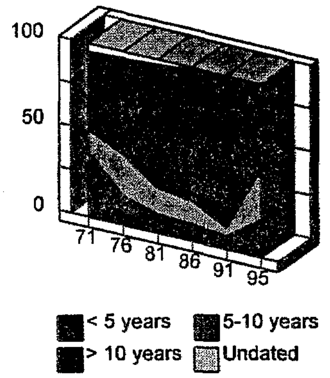
PDO (Public Debt Office) at the RBI in the Securities General Ledger or can also be held in the form of certificates. These are issued by the RBI on a random basis as and when the need arises and the announcement of an issue is only made two days in advance through a press release. Issue amounts would ideally vary between Rs 200 to 12000 crores.
As on the January 31, 1995, there were 90 issues outstanding with a total face value of Rs 1,30,500 crores which had a depreciated market value of Rs. 1,15,000 crores.

The major investors in GoI securities are the commercial banks, insurance companies and the RBI on whom the securities devolve if not subscribed. Provident funds used to be major holders but due to regulatory reasons have now shifted their focus to state government securities. A look at the ownership spectrum across the years indicates the growing participation of the banks in the government securities due to the fact that these are the most liquid securities in the secondary market.

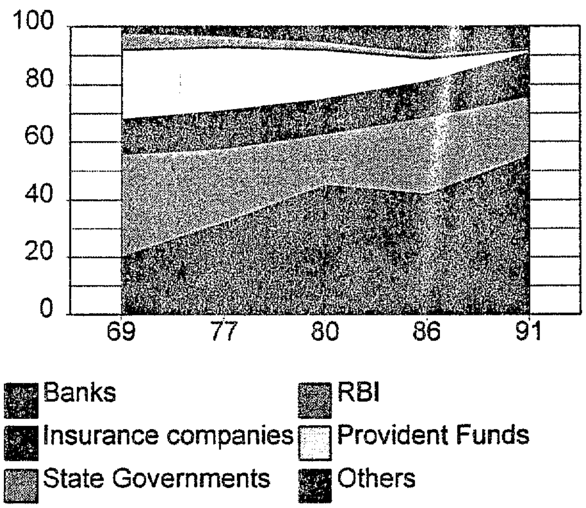
GOI dated Securities Issuance and outstanding Securities
(in hundreds of crores of rupees)



Maturity patterns of GOI dated Securities
(in hundreds of crores of rupees)



Holding spectrum of Central Government Securities



- **Treasury Bills**

Treasury Bills are basically short term (3 months -1 year) obligations issued by the RBI on behalf of the government. The RBI presently issues two types of T-Bills, having maturities of 91 days and 364 days. Issuance is through the European type of competitive bidding with all bids above the cut off price being accepted. The 91 day T-bills are issued on a weekly basis with a notified amount, whereas the 364 day T-Bills are issued on a fortnightly basis with no notified amount or RBI participation. The use of the ad hoc T-Bills as mentioned earlier is to be phased out by the government by March 1997. The government also used to issue 182 day T-Bills but has discontinued the use of this instrument. Issue sizes in the case of the 91-day T-Bill would range from Rs. 100-500 crores and Rs. 300-1000 crores for the 364 day T-Bills. The T-Bills are issued in the form of promissory notes or by credit to the SGL account if available.

- **State Government Securities**

These are securities which are issued by the RBI on behalf of the states on an annual basis. All the state government securities to be issued during a year are clubbed together and carry identical coupon rates and maturity structures. The RBI does not participate in the auction system for these securities but acts as a depository and offers a book entry system. The state borrowing program is conducted before the central borrowing program swings fully into action. There have been several complaints of forcible allotment of some state's securities when the one's bid for have been oversubscribed. The logic offered by the RBI is that since all these are guaranteed by the central government it should not make a difference. There however should be a move toward the states marketing themselves and handling their own borrowing program as this would definitely make them more competitive.

- **Government guaranteed Bonds**

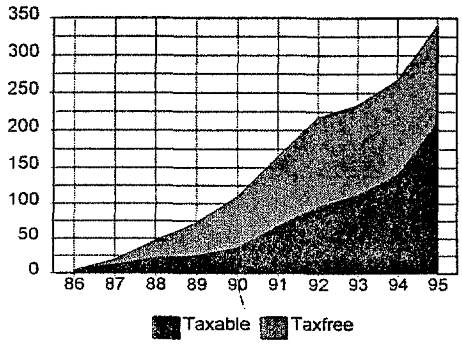
These are medium to long term debt securities issued by PSUs, state owned utility, transport and housing finance companies and guaranteed by the central or state governments. Outstanding issues aggregate Rs. 40,000 crores but this is on the wane due to the delinking of the PSU finances from the central budget. The securities are mostly available in physical form, but some issuers may also offer book entry facilities to investors.

- **PSU Bonds**

Public Sector Units have been issuing these bonds which are medium term obligations. The use of these instruments is on the increase with approximately Rs.6,000 crores worth of PSU bonds being issued in 1994-95, taking the total outstanding amount to Rs.33,000 crores. One of the main unique selling points of these bonds has been the offer of tax-free bonds by the infrastructure related PSUs like the railways and the power sector. Earlier the interest rates being offered were regulated by the Government to a maximum of 13%. However, with the removal of the ceiling coupon rates have gone up to 18% at times. The current guidelines governing issue of PSU bonds are:

i. Minimum maturity for taxable bonds is 5 years, while that for tax-free bonds is 7 years.
ii. Floating rate or deep discount bonds can also be issued.
iii. PSUs are allowed to retain over subscriptions to the extent of 25%.
iv. New issues need to be listed on a stock exchange.
v. In the case of public issues credit rating has been made mandatory and this may further be regulated to make dual rating a compulsion.

Issuance of Public sector bonds
(in hundreds of crores of rupees)



In the last few years most of the bonds have been issued through the private placement route with large institutions or the banks. The reasons being mainly the issue costs involved in private placement are less than 1.5%, whereas a public issue would cost anywhere between 4.5% -6% and the fact that they can be customized by embedding put/call options. They are transferable by endorsement in some cases, but in the case of higher interest bearing bonds registration has to be done with the issuer. Another sop offered by these bonds is that interest income qualifies for tax exemption for individual investors. Although earlier this was a different breed of animal, today the only feature differentiating it from the corporate debentures is the exemption of stamp duty on transfer of PSU bonds.

- **Corporate Debentures**

The corporate debenture is a short to a medium term instrument issued by corporates and PSUs. The typical maturity would vary from 3-12 years with issue sizes varying from 5-200 crores. Debentures could be secured or unsecured; partly, fully or non convertible into equity depending on the issuer. The conversion could be at market related or predetermined rates and optional or mandatory. In the case of convertible debentures the non convertible part if any is normally taken up by the institutions and referred to as the khokha. Public issues of debentures of maturities greater than 18 months have to be mandatorily rated by one of the rating agencies. One of the main problems is that transfer of ownership has to be registered with the issuer.

One of the innovations has been the issue of floating rate bonds by a few financial intermediaries and private corporates in 1994-95. These have been privately placed with put/call or floor/cap options in some cases and almost all are listed on the NSE. The outstanding face value is Rs.2,600 crores with a typical maturity period of 3-5 years.

The use of the private placement route has been preferred as compared to the public issue route due the costs attached to the later. A look at the typical issuance costs would only reinforce this decision as seen from below

Issuance costs for issue size of Rs. 100 crores
(Rs. tens of lakhs)

Corporate Debentures	Public Issue	Private Placement
Trusteeship fees	.20	
Issue Management fees	5.00	5.00
Rating	2.00	
Stamp Duty	0.20	0.20
Listing Fees	0.03	
Registrar for transfer	5.00	
Brokerage fees	15.00	
Postage, printing, refunds, travel, advertisements and other expenses	35.00	1.00
Total	62.43 (6.2%)	6.20 (0.6%)

- **Commercial Paper**

The CP is a short term unsecured negotiable promissory note issued by private and public sector manufacturing companies at a discount to the face value to finance their working capital requirements. The maturity period varies between three months to a year. Trading levels in this extremely popular instrument had climbed during the last two years, but have been depressed since the RBI's decision to not automatically restore bank finance limits and withdrawal of standby guarantee facility by banks. An automatic arbitrage opportunity for issuers has thus been plugged.

- **Certificates of Deposit**

These are unsecured negotiable promissory notes, transferable by simple endorsement and delivery made with commercial banks and development finance institutions in the form of deposits. CDs issued by the banks are normally discounted bills. CDs have basically been used as deposits and though issuance had picked up toward the end of Dec. 93 and the outstanding issues are now estimated at Rs. 3,000-3,500 crores.

CHAPTER 2: HISTORY OF THE INDIAN DEBT MARKET

The pre - liberalization era and the role of RBI

The Indian bond market has traditionally been dominated by government securities and the main players have been the commercial banks which have had to invest in these to satisfy Statutory Liquidity Ratio (SLR) norms. Also, prior to economic reforms of 1991, the coupon rates were determined unilaterally by the government and thus there was little volatility in interest rates. In such conditions the market had only one view and hence any trading in the secondary market was purely with the objective of balancing cash flows. Active management of the treasury portfolio was hence never necessary.

When the economic reforms were initiated in 1991, the government of India decided in principle to bring down SLR to 25% of deposits over the years. This had become necessary as the various public sector commercial banks had been showing consistent losses as a result of the pressure of priority sector lending at lower than economic rates, losses resulting from the loan write offs by the National Front government of 1989-90, the large SLR and CRR which left little funds for discretionary lending and the regulated interest rates on the assets side which did not allow for an economic spread between the net cost of borrowing and lending. The progressive lowering of the SLR resulted in a reduced demand for GoI securities and this lead to the government's decision to increase coupon rates and eventually move to a market related rate for financing fiscal deficits.

In the post liberalization scenario the RBI defines its role as:

- the merchant banker and underwriter to the GOI for its issue of debt
- the agency for the issuing govt. Debt at rates decided in consultation with the GOI depending on market demand
- optimizing the maturity structure of government debt
- using monetary policy to stimulate industrial growth and control inflation

The Securities Scam of 1991 - 92

An increase in coupon rates meant banks, specially the relatively newer foreign banks, which were not holding securities issued in the 1970s and early 80s at very low coupon rates, needed to reshuffle their portfolios to lower maturity securities so as to prevent a depreciation of their portfolios in a scenario of rising interest rates. Thus, this period saw a phenomenal increase in secondary market trading. The volumes reached proportions which could not be handled by the RBI's manual accounting systems designed for the market of yesteryear.

Now, the equity markets were also booming in the wake of expected gains to industry from liberalization. In the confusion resulting from the enhanced activity in the debt markets certain individuals, mostly intermediaries in the financial markets, saw an opportunity to channel money from the SLR securities to the equities markets. They enlisted the cooperation of the commercial banks by convincing them that they could reduce substantially the losses accumulated, and resulting from their commercial lending activity by investing in the equities markets. However, banks could only invest up to 1.5% of their deposits in each corporate debt and equity. This necessitated the transfer of funds to the intermediaries for investment. The mechanism used was the Repurchase Option (REPO) allowed on trade in government securities.

The REPO allowed an investor sell a security on the condition that he will buy it back later. Now, banks did REPOS with other banks and at the end of the transaction both parties showed the security in their books as part of their SLR portfolio. Thus, the total holding of SLR securities of the banking system reduced and, in consequence, funds were released for discretionary investment. Since, as stated earlier, banks could not invest all these funds in the equities' market on their own, they did REPO transactions with financial intermediaries and these securities were transferred to them. On the strength of these assets the intermediaries raised funds and channeled these into the equity markets. In fact, at one time we had a situation where the Indian markets were booming when all around the world markets were taking a beating and this, in a situation of stagnant industrial growth which had resulted due to import compression in the wake of the balance of payments crisis.

On May 1, 1992, the irregularities in the securities transactions on REPO were detected. When the news hit the equities' market, the scrips whose prices had been propped up artificially through creative market making using the large quantum of funds channeled from the GOI securities crashed. In a market driven largely by sentiment in the short run the cancer spread to all scrips in the market and the BSE sensitive index fell to around 1900 points from a high of 4500+ points. In the legal action that followed, securities worth some 3000 to 5000 crores in the name of Harshad Mehta and the other intermediaries involved, were impounded. Now, these securities had been sold to the intermediaries by the banks as REPO transactions for which payments had not been made. The REPO is defined such that these securities are defined as owned by the purchaser and the seller have civil claims against the purchaser for the amounts outstanding against the payments of such securities. Since the equity portfolios of the intermediaries depreciated considerably in the aftermath of the scam they were unable to settle these claims and many such claims are still pending in the courts. Thus the total loss to the banking system, excluding claims settled, was 3000 to 5000 crores.

There has been much debate on the scam and the facility of the REPO which was seen as the main weakness from which the scam resulted. However, in hindsight, we believe that it was not the REPO that was responsible but the inadequate clearing and settlement systems at the RBI which were just not designed to cope with trading volumes in the scam period. The REPO, as defined, is an outright sale till such time the transaction is reversed and, as such, it is illegal for the bank selling the security to show it as an SLR asset in its book of accounts and such activity amounts to an outright fraud and the party involved are liable to criminal prosecution for the same. In light of this the RBI's decision to the ban on REPO transactions in a scenario where it has computerized the SGL accounts and is in the process of doing the same for funds clearance in the current accounts, is no longer relevant and is seen by market participants as excessive caution in dealing with a subject where the RBI is still not sure of its expertise.

Fallout of the Scam

- The most important negative consequence of the scam, and the source of all the restrictions that followed, was that the public, the press and the parliament wanted some specific body held accountable and also, they wanted heads to roll. The body picked on was the RBI. This made the RBI too cautious to undertake any subsequent reform in the debt market and also caused it to impose severe restrictions on securities trading.
  The scam was not the fault of any loopholes in RBI's policies or laxity in its administrative vigilance except to the extent that it lacked the infrastructure to handle the sudden surge in securities trading and hence took time to discover the scam. Aside of this, the scam was an outright case of fraud and criminal activity and should have been treated as such. Once discovered it was not a responsibility of the RBI but a job for the law enforcement and investigation agencies and they should have focussed on prosecuting all those involved in the scam, either directly or through collusion, and not wasted time and effort in attempting to affix responsibility.

- REPO transactions were banned except amongst the banks and RBI and that too only in very few securities. This has had the effect of reducing liquidity in non repoable securities and has also increased the volatility in the call money market whenever there is even a slightly excessive demand for money as funds can no longer be raised against REPOS.

- There is the fear of removing CRR on inter-bank borrowing as banks may build long term assets using short term call money funds and also, this channeling of funds out of CRR would amount to another scam.
  CRR on inter-bank borrowing results in volatility in the call money market which in turn has a strong influence in the money market.

- Nationalized banks have become excessively cautious and taken away power to take decisions at the dealer level and thus active secondary market trading on such accounts has reduced considerably.

Also, the fear of CBI inquiries has often resulted in dealers of such banks transacting with the RBI at say Rs.99 when they could, if allowed greater decision making power, have got Rs.101 in the market.

- On May 1, 1992, DFHI started trading in GOI securities. In market circles it is perceived that the end of the day they found that all their transactions were fronts for Harshad Mehta, the chief accused in the securities scam and so they since then they have stopped trading in these securities or at best their participation has been minimal.

- Post scam the RBI does not allow a broker to net off his position in a particular security on the same day. Since there is only limited availability of finance for broker this makes it very difficult for them to offer 2-way quotes and provide liquidity to the markets. The RBI did this because in the scam and the post scam period the public debt office (PDO) of the RBI did not have systems to handle peak trading conditions. However, the systems of the PDO have been improved since then and this may not have the same relevance now.

- As a result of the broker-bank nexus that was the basis of the scam the RBI imposed conditions which limited the transactions that a bank could channel through one broker to 5% of total transactions. Now, many banks do not even have 20 empaneled brokers and what is more important, some very large transactions would result in this limit being transgressed anyway and in such a situation banks prefer not to go through brokers and hence the NSE and do deals directly. This has the dual effect of reducing volumes on the NSE and reducing transparency from the point of view of information on trades available in the market.

Fiscal Discipline in the Pre and Post Liberalization Period

In the 1980s the government decided to go for a faster pace of growth and at that time India still had a planned economy and hence this growth was supposed to be lead by the public sector as in the past. However, the financing required for such growth was not available through internal resources and hence the government had to go for large internal and external borrowing to finance the fiscal deficits resulting from such planned investments.

At the same time the government's revenue expenditure was also getting out of control as a result of an increase in the number of government and public departments, support to the public sector enterprises and populist schemes in the wake of increasing political competition as India moved away from what till then had been de facto a single party rule. Thus started a series of fiscal deficits which were financed both by borrowing and monetization which lead to rapid growth in money supply as compared to yesteryear. This had the effect of depreciating the market value of the rupee and in time the dual assault of fiscal indiscipline and a weakening rupee lead to India's external debt rising to a very high percentage of GDP

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Imports were also growing much faster than exports specially as a result of the burgeoning oil import bill as the rapidly - as compared to earlier - industrializing economy demanded more and more energy. The external borrowing had to be serviced and unlike the internal borrowing this could not be done simply by monetization and so India had to borrow short term funds and also such borrowing was different from the soft, low interest bearing loans that the country had availed of earlier. The result was that by 1991 India was in the grip of a balance of payments crisis and as its credit rating got down graded it found it more and more difficult to raise external loans to service the short term borrowing which had started to mature. The BoP crisis was further exacerbated by the flight of non resident Indian deposits as fears of an external payment default mounted. Also, the interest payments on internal and external debt had reached 50% of revenue receipts (it dropped 45% from 1990-91 to 1992-93 but since then has again risen to 50%) and in consequence the government was left with little space to reduce revenue expenditure as the component of the non discretionary expenditure reached alarming proportions.

When the Narsimha Rao congress government came to power there was just enough foreign exchange left to finance three weeks of imports. The only recourse was to go to the International Monetary Fund (IMF) for loans as part of a macro economic stabilization program. This aid however, did not come without conditions. The IMF realizing that unless structural adjustment measures were taken the crisis would recur in a few years, linked the aid to fiscal discipline, movement to a more market driven economy, opening doors to foreign investment and privatization of loss making public sector units. The terms were not unreasonable and it was thus that the process of economic liberalization started.

In the post 1991 period measures such as reduction of the fiscal deficit to 5.9% of GDP in 1991-92 and 5.7% in 1992-93 as a result of expenditure cuts on subsidies and non productive populist schemes and increase in revenue realization by optimizing direct tax rates so as to maximize collection by using the principles of the Laffer curve. This was done despite corporate tax revenue loss due to a slowdown in industrial growth as a result of a tight monetary policy and import compression and also loss in customs revenue due to the same. However, PSU disinvestment, which strictly speaking should come under capital receipts, was used to finance revenue expenditure instead of retiring public debt and hence the fiscal performance was some what exaggerated.

Thus, in the following year the fiscal deficit overshot the target of 4.7% of GDP and touched 7.7% as a result of expenditure overruns, stagnant industrial production and lower than expected PSU disinvestment. In 1994-95 the government keeping the necessity to stimulate industrial growth, set a more reasonable target of 6% of GDP and achieved 6.7%. The 1995-96 budget envisages a fiscal deficit of 5.5% of GDP. It expects greater PSU disinvestment (to the tune of 0.2% of GDP) and a reduction in non interest expenditure by 1.3% of GDP mainly through cuts in subsidies (0.2% of GDP), defense (0.2%), state lending (0.4%), non defense capital expenditure (0.2%). Implicit assumptions are that nominal GDP will grow by 15%, import growth will offset the effect of tariff reductions and improvement in tax administration and compliance will offset the impact of lower excise rates. It is however, unlikely that the above target will be met. Firstly, greater PSU disinvestment had assumed an investment climate of the previous year. This year primary issues are not attracting the same premium and subscription as compared to last year as a consequence of a depressed secondary market. Secondly, the expenditure cuts envisaged will be offset by certain populist schemes announced recently due to the political compulsions of an election year. Even interest payments on treasury bills issued and maturing this year will rise though this, in its quantum will be nominal

The government has budgeted a gross market borrowing programme of 28,000 crores excluding treasury bills and with them about 32,000 crores. The net borrowing is to be 22,000 crores. At the same time the RBI is committed to using monetary policy to control inflation and hence limit monetary expansion. This makes the borrowing programme difficult and it is expected that a large portion of government debt will devolve on the RBI. The RBI is trying various tools at its disposal to make a success of the borrowing programme given the constraints, e.g., the RBI has offered to convert certain treasury bills into repoable securities maturing in two years. However, there are many factors working against the RBI besides those mentioned. These are:

1. FIIs have reduced investment in India and this has reduced the injection of high powered reserves and hence reduced the liquidity in the system.
2. In the high liquidity days of last year banks had excessive funds which they invested in long dated securities for the extra spread available on these. Their cash flow requirements were however short term and hence they are stuck with securities they cannot get out of without taking huge losses considering the rise in interest rates from last year to the current year. Thus, they cannot release funds for fresh investment in GoI securities even though the interest rates are very attractive.
3. Banks are already holding securities in excess of SLR norms.
4. High call money rates in the last few months have made investment in dated securities a risky investment.

On the positive side we have:

1. The RBI has picked up a substantial chunk of government borrowing so far and once this money returns to the system there should be some monetary expansion and this will ease the pressure on the supply of money.
2. Also, the last few weeks have seen lower and more stable call money rates and this has to

some extent reduced uncertainty in the money market.

3. The FIIs are also beginning to return to the markets and this means further monetary expansion.

According to the September agreement of 1994 the government cannot take recourse to borrowing using the automatic monetisation facility of the issue of ad hoc bills by the RBI for an amount greater than 5,000 crores for the year and greater than 9,000 crores for a period extending beyond 10 consecutive days. In the event this happens the RBI reserves the right to issue government securities in the market and bring down the level of ad hoc bills. It was also agreed in principle to phase out recourse to ad hoc bills by 1997. However, the government has not extended the agreement this year and the level of ad hoc bills have already exceeded the limit agreed upon earlier.

CHAPTER 3: THE PRESENT SCENARIO

The Indian Debt market is characterized with a phenomenal amount of segmentation in terms of the regulations governing the different players in the market. Therefore when a look has to be taken at the accounting practices of the various players, we need to understand the regulations governing them and the motivations for them to follow the mentioned accounting practices. A look at the different major market players would indicate to us the various accounting practices followed by them in valuation of their portfolio. What one also needs to put into perspective is the historical pattern of debt financing in the Indian scenario.

The Reserve Bank of India had historically been using the direct instruments of monetary policy (i.e., reserve requirements, administered interest rates and credit controls) and the government had also been issuing this paper at non market related rates. The institutions have thus been holding securities in their portfolio which were issued at coupons of around 6-6.5% in the mid eighties. The coupons on paper issued by the Govt. have progressively been increasing through the years and it is today almost three years since the Government of India has accepted the principle of market related rates of interest on Government paper.

It is in the light of these developments that we need to address the issue of valuation of their portfolios by the different participants in the market.

Banks

The reserve requirements specified by the RBI have made it mandatory for the banks to hold government or other specified securities to match their SLR requirements. Therefore the banks have traditionally been buying these securities through the years and had been valuing them at cost. Subsequent to the government's decision to start borrowing at market related rates it has been felt that the banks should move gradually toward marking their portfolio to market.

The valuation norms for the banks when introduced in 1992 required the banks to mark 30% of their portfolio, which was the current portfolio to market and the remaining 70% which was the permanent portfolio could be marked to cost. However the central bank feels that this is too low a proportion, taking into consideration the fact that it is almost three years since the government has accepted the principle of market related interest rates on its borrowing. The percentage of securities bearing high interest rates has been increasing and therefore the proportion of current category will have to rise in the future. It is pertinent to note that the securities portfolio of banks acquired after 1992 accounts for around 40% of their portfolio and therefore it would not be unreasonable to raise the stipulated ratio between current and permanent categories of investments from 30-70 to 40-60, which the RBI has already done. This ratio is only expected to rise in the future as it has an important bearing on secondary market trading as the banks are the largest holders of debt securities. The valuation necessarily needs to be done on the balance sheet day at actual market prices and in case of securities which are not actively traded the RBI issues the indicative YTM rates which have to be considered for valuation. Also, the presence of small transactions at deliberately depressed yields would also not be acceptable for purposes of valuation. If and when a security has to be switched from the current to the permanent portfolio, it can be done only by approval of the board of directors in the case of the scheduled banks.

The private sector banks which have been established in the last two or three years do not have a very serious problem of erosion of their portfolio and hence most of them mark close to 100% of their portfolio to the market.

The existing provisioning norms for scheduled banks allow for setting off of gains and losses within a particular category of investments but not across different categories. The RBI plans to introduce these norms even within categories, wherein the banks would have to ignore the market appreciation for segments within an investment category. This coupled with the change in the portfolio proportion will definitely force the public sector banks to be more competitive.

Institutions

Insurance Companies:

The Insurance companies have been in the securities market principally for the purpose of investment and not trading. Therefore the role of the treasury traditionally has been to match the asset liability flow and not as a profit center. The investment pattern of the companies is highly skewed, with as much as 50% of the portfolio in government securities out of which the majority would be in long term security with only a small amount in short term securities, to the extent of matching the cash flows and the total portfolio is valued at cost as the securities are normally held to maturity.

The investments of LIC and GIC in Govt. and other approved securities were to the tune of Rs. 28,577 crores as of March '94 which constituted 50% of their total portfolio.

Earlier most of the assistance sanctioned was in the form of loans. However, lately a larger component of the assistance is going in the form of debentures and equity thus implying a change to more marketable or tradeable forms of debt. The operations of LIC and GIC differ a little as the latter would definitely have much shorter term liabilities. However, for accounting purposes the book value method of accounting is prescribed by the insurance act of 1938.

Unit Trust of India:

The UTI is possibly the largest non banking institution which targets the retail investor with 58 schemes in operation at this moment of time. It is a long term investor in the markets, with most of the investing done to balance maturity matching. The portfolio used to be marked at cost but they are slowing moving toward a more rational accounting policy with the trading portfolio being marked to market, whereas the holding portfolio would continue to be marked to cost. This also indicates a move toward the enhancement of trading actively in the secondary market.

The UTI held close to Rs. 8050 crores worth of government securities as of March '94 and this is marked to cost. The percentage of assistance given in the forms of term loans is definitely on the decrease and assistance is now forwarded in the form of either debentures or subscribing directly to the equity.

Provident Funds:

The provident funds have been set up as trusts and the basic nature of the fund is such that it necessarily dissuades trading in the securities held. The guidelines do not allow a provident fund is not allowed to sell an investment if it means booking a loss and therefore provident funds have necessarily been long term investors and have thus always valued their investments at cost. They normally participate in primary auctions as non competitive bidders and are statutorily forced to hold 30% in government securities and 30% in state and central government guaranteed bonds.

Non Banking Finance Companies:

In lieu of the permission given to the NBFCs to raise deposits equal to their net owned funds as recommended by the Shah committee report it was felt that they be required to maintain liquid assets to the extent of 10 percent of their deposit liabilities consisting of deposits from public and shareholders, intercorporate deposits/borrowing, money raised through issue of bonds and debentures. It was further specified that at least one half of the liquid assets would have to be in the form of Government securities and/or Government guaranteed bonds. This is called the LAR and has further been hiked to 15% as of 1 July '95.

The guidelines on investments in securities stipulate a bifurcation into current and long term investments. The current investments would be those that would be easily realizable and are intended to be held for a period not exceeding one year from the date of such investments having been made. The current investments would have to be valued at the lower of cost and market value for each investment individually.

The long term investments would be valued at cost but diminution would have to be made to recognize a decline, other than temporary, in the value of long term investments, such reduction being determined and made for each investment individually. In the case of treasury bills and commercial papers they would be valued at carrying cost.

The accounting and valuation procedures adopted by the different institutions definitely point to a rationale between the accounting norms and the business policy of the institutions. However with the changing scenario in terms of both macro as well as micro economic transformations taking place the standards in some cases need to be reviewed and aligned with the emerging securities markets scenario.

Impact of taxes on the willingness of institutions to trade debt securities.

The segmentation of the different players does not exist only in terms of the accounting practices followed but also in terms of their tax liabilities. This again is due to the diverse nature of the institutions with a few of them like the provident funds being set up as trusts and basically non profit making in nature. The tax implications play a significant role in trading in some securities because of the nature of the securities and the parties to the trade.

In the present system of TDS (Tax Deductible at Source) the tax is deducted automatically from the interest payments by the central bank at the time of declaring the same. The trading in the security would therefore also be a function of the tax deductible on the interest coupon. Also, in the presence of tax free bonds issued by PSUs one needs to inspect the impact of taxes on the trading of these bonds.

Voucher Trading:

By virtue of the fact that certain securities attract a differential tax rate in the hands of different institutions, there is an arbitrage opportunity available wherein the institution holding the security, if it's tax liability is high, sells it to an institution who can avail of a lower tax deduction or no tax deduction at all just before the date for accrual of interest and buys it back later, leading to a situation wherein both gain. This activity known as voucher trading is a favorite tool of certain institutions to lower their tax liabilities.

Stamp Duties and Transfer fees:

The indirect form of taxation in terms of the stamp duties and transfer fees has always been a thorn in the side of the market players. The gross emoluments to the government have not really been high in terms of volume of money collected. However, the imposition of stamp duty and transfer costs have definitely affected the willingness of the players to trade. The market players have therefore devised ways and means of getting around the hurdle of having to pay stamp duty or transfer fees.

The parties transacting on the NSE in addition to the stamp duty would also have to undergo a transaction cost. Therefore the larger deals are definitely not routed through the NSE as this raises the cost of the deal.

The Latest Scenario : Finance Firms touch off bond rate war

A rate war has broken out among finance companies raising funds from debt instruments. GE Capital, which set the ball rolling by offering a yield of 21% for a two year paper, has forced Kotak Mahindra and Twentieth Century Finance to offer high returns on their debt instruments.

Twentieth Century Finance is raising Rs. 75 crore through a non-convertible debenture issue which it plans to place at 20.5% levels. The instrument has been divided into two parts. The regular income bond will carry an interest rate of 17.5% and interest will be payable half yearly. The paper matures in three years. The other is the cumulative income scheme. Under this, the investor will not be paid interest after six months, but after two years. The annualised yield works out to be 20.5%. The company has been assigned an AAA rating by ICRA.

Kotak Mahindra is tapping the debt market through a private placement. The issue size, which has been fixed at RS. 25 crore, will open for subscription soon. The coupon rate has been fixed at 17% and the yield to maturity works out to 20%. The debt instrument has received the highest possible rating.

Sundaram Finance has been placing its bond issue at 23% yields. The Rs. 25 crore issue was managed by JM Financial and the instrument carried an interest rate of 18%. For the 1 year paper, the annualised yield worked out to 19.25% while the 3 year paper carried an yield of 23.19%.

The following table gives the yields offered by various issuers. The high interests being offered by finance companies are surprising as, last year, when the liquidity situation was very tight, they offered lower rates. But after the RBI slashed the CRR in two phases, liquidity in the system has eased substantially.

Finance Company	Issue Size (Rs. crore)	Yield (%)
Sundaram Fin	25	23
GE Capital	60	21
Twentieth Century Fin	75	20.5
Kotak Mahindra	25	20
Anagram Fin	50	20.08
Apple Industries	50	18.81

CHAPTER 4: SECONDARY MARKET TRADING IN DEBT SECURITIES

The basic requirements for a smooth functioning securities market are first an institutional structure would have to be in place and market participants should have different interests, which would entail different perceptions, liquidity with a mature system of price determination, a transparent system of trading and a secure system of settlement. Let us now look at the secondary market that exists in the context of the above-mentioned points. The very fact that the average daily traded volume of Rs.200 crores is but 0.07 % of the total outstanding debt in the market is a clear enough indicator that there is an absence of a well-developed secondary market in debt.

Government Securities:

The major holders of debt securities in the Indian scenario have been the banks and the larger institutions and they have been forced to do so due to the reserve requirements imposed on them by the RBI. The banks have traditionally been the largest holders of government debt and forcibly continue to be so till reserve requirements are drastically brought down. In the scenario of non market related rates of borrowing by the government the banks used to buy the securities and hold them to maturity. Add to this the fact that even today when the government has accepted that it is going to borrow at market related rates since 1992-93, only 30% of the portfolio of most of the public sector banks is in the current category. The treasuries of the banks have traditionally been never looked upon as profit centers and therefore simply have lacked the concept of risk management. When you add to this the fact that the largest deposits for the banks have been their savings accounts on which interest payable is just 4.5 to 6%, and the maximum deposit rates are now at 12%, the average cost of funds to the banks comes to about 8-9% building in for the priority sector lending they have to do. Therefore, by just buying and holding debt securities to maturity a clean spread of around 4-6 % is available to the banks. However the RBI has been giving active signals to the banks that they would have to progressively mark their portfolios to market and this has prompted the banks into some kind of action.

A possible solution that could be investigated would be for the RBI to work out with the banks and investigate the possibility of swapping the low interest bearing securities that the banks were forced to buy in the 1970s and 1980s with securities bearing coupon rates prevalent in the market with the costs attached to such a transaction being borne by both the parties in a predecided ratio. The purpose served here would be two fold as by doing this it would become progressively easier for the banks to mark more of their portfolios in the current category, thereby infusing a large quantity of tradeable stock into the market which today lies with the banks and is not available for trading.

Also in the aftermath of the scam the internal guidelines at the public sector banks have now been tightened to an extent wherein trading has been made very restrictive and the dealers themselves have no authority to make trades.

The very nature of the banks and the institutions which hold large quantities of debt in India is such that their views on the long term match and therefore in the absence of diverse players and views the mentality that is very clearly seen is a herd mentality with all the institutions either wanting to buy or sell at a particular period of time. This herd instinct among the major players needs to be removed and this can only be done by improving the depth of the market. The RBI has taken a positive step in terms of promoting the primary dealership system which would definitely add and allow a larger number of players to the market, which brings us to that very debatable question of the role that the retail investor has to play in terms of the market for government debt. Let us not therefore forget that the retail investor was the main stay of the market in the 1940s.

The investor has not been able to enter the market because there has been no facility offered to him in terms of holding smaller security sizes as the minimum lot size has been Rs. 10,000. The banks with their wide network of branches are in an ideal position to access their securities to individuals and corporates and this would only go a long way in making their portfolios more liquid. In the era gone by it was considered to be a conflict of interest for the banks to promote the government securities through their secondary trading accounts but with the changing scenario if they do not act fast then someone is definitely going to tap this vast resource base very soon. The 81,000 crores worth of household saving in 1993-94 itself, is just an indication of the tremendous potential that exists in this sector and if the banks do not react proactively they are sure to lose out on this investment base.

The route also available to the individual investor should be through the money market mutual funds. There are no money market mutual funds in existence though the income schemes of the mutual funds do temporarily park the collected funds in money market instruments for the initial months of the scheme till it can be properly placed. The non existence of any money market mutual funds in the presence of guidelines issued by the RBI for the setting up of the same, and market participants with the required expertise, points to the fact that the guidelines might need a review and the RBI would do well to have a look at the same as the household saving could contribute in a large way to the debt markets.

The market as it had existed prior to the conception of the NSE last year was purely a telephone market and largely continues to be so in the presence of a limited number of players. Most of the participants in the market are really aware of whom the counterparty is and although this helps in reducing the counterparty risk the opportunity for market determination of price is lost. The NSE system on the other hand which is an order driven system imparts total transparency to the system and the identity of the counterparty is not known, therefore letting pure market mechanics do the price fixing. A couple of issues that can be addressed to in the trading system of the NSE is the possible introduction of 'wildcards' in specifying the order which would lend more flexibility to the system without transgressing on the transparency or the security in terms of counterparty risk. This would also in a larger sense mean that the system technically could now also operate as a quote driven system if a wildcard specification was given on the order amount.

The system as it exists does not encourage one to go out and take a risk and the prevalent psyche is to wait for an order to flash and then hit it, but due to this, the true level of the market is not discovered and the system does not really act as an on screen-based system. What however happens is that deals are pre negotiated on the telephone and put through the NSE and this is typically true for the banks, who if they deal through a broker have to necessarily deal on the NSE. However with the number of players increasing on the NSE, which already has 375 members, and is slated to increase to 900 by the end of the year the depth in the market should definitely emerge as the number of players increases.

Monetary policy control, as has been proved the world over has always been more efficient using the indirect instruments of monetary control through open market operations. The purpose served here is two fold as in addition to the government being able to control monetary policy, it would also entail a development of the secondary debt market. The institutional structure for facilitating such a system is also being simultaneously developed with the formation of the DFHI and STCI and the development of a system of primary dealers.

The very effectiveness of the OMO can be gauged from the fact that in 1993-94 the RBI undertook OMO to a tune of Rs. 9,000 crores and this would have been equivalent to a CRR increase of 2.8 percentage points. The effectiveness of the OMO would be dependent on the time the operations are conducted, the securities that are traded and the bid and offer rates made by the RBI.

The concept of market makers who would be facilitators is just a concept of having a platform for a multiplicity of people having a multiplicity of views and expressing them. This has been lacking in the Indian scenario due to the following constrains

- The system inherently does not reward a person taking a view, as all the players have a herd mentality.
- Little standardization of instruments which makes rating that much more difficult.
- Segmentation of the market in terms of accessibility of certain instruments to certain people.
- Most important, movement of money within the debt market is restricted, as the regulations limit the exposure to certain instruments.

Primary Dealerships

The RBI in the pursuance of its system of shifting toward indirect forms of monetary control has recently announced the PD system and applications for the same have been invited. The PD as proposed is not going to be a final repository but a transient holder of securities who will help investors to buy and sell securities. The rationale in prescribing a minimum net owned funds of Rs. 50 crores is that they necessarily have to deal in large amounts and therefore a low capital base would necessarily constrict their activities. However the market perception is that a capital base of Rs. 50 crores would not be enough to finance the operations and since clear guidelines on the financing of the PDs are not encapsulated there is a feeling of uncertainty.
In the primary segment of the government market the PD would have multiple roles to play in terms of being a bidder for as well as underwriting a portion of the issue.
He would have to commit to aggregately bid for specified amounts of government of India dated securities and treasury bills on an annual basis and achieve a minimum success ratio of 33.33% for dated securities and 40% for treasury bills. The PDs will also have to collectively underwrite a part of the gap between the notified amount and subscribed portion in the case of a predetermined coupon and between the notified amount and the amount accepted at the cut off in the case of auctioned securities. In the case of devolvement the collective underwritten portion by all PDs will be 25% for dated securities and 20% for T-Bills in the present scenario, with this percentage rising further in the future so that the RBI will gradually shed these functions.

The PD would have to play a major role in the development of the secondary market and giving it depth in terms of increasing the number of players. A primary dealer would have to give a firm two way quote either through the telephone market or the NSE and deal in the secondary markets. What is suggested here is that not all the PDs need to hold all the securities, but they could have an inter- dealer network whereby a primary dealer could give a quote in a security he would not be holding but would be able to source it from another dealer. This would substantially reduce the inventory holding of the PDs as they would not have to stock up on all securities. The future of the PDs looks at placing the entire debt in the market but this would automatically come about by the presence of satellite dealers linked to each PD, who in turn would have sub- brokers attached to them thus spreading the market chain downwards and ensuring the presence of players with different views. The PD will further have to ensure that his annual turnover in a financial year will not be less than 5 times in case of govt. Dated securities and 10 times in terms of treasury bills.
The turnover will be calculated as follows:

$$\frac{\text{Total purchases and sales during the year}}{\text{Average of month end stocks during the year}}$$

The primary dealers would therefore play an important role in the development of both the primary as well as secondary markets for debt. The financing of the dealers though has been an issue of contention. The primary dealers would have access to the call money markets and repo operations with RBI in central government dated securities and treasury bills to an extent of 16.67% and 10% for commitments made for tendering aggregate bids in dated securities and government bills. The RBI has further clarified that it might provide very short term support for a few days but it would definitely not fund activities over a longer period of time.

The perception of the marginal players in the market is that in the shorter term what the PD system entails is that as far as privileges go, the PDs would be on par with the banks but the duties would be far more onerous.

The DFHI and STCI were developed to enhance trading in Govt. Securities with the intention of them being market makers with the former being at the shorter end and the latter at the longer end of the market.

The DFHI has been given an access to the call money markets and in addition can avail of the ready forward facility available with the RBI. However, in the case of non-repoable securities it just adjusts its portfolio to limit the losses. The unidirectional flow of money in the market only makes it easier as the nationalized banks are big borrowers and the foreign banks are big lenders and they find the DFHI an effective institution to channelise their funds.

The STCI which has a net worth of around 500 crores got its capital during a period wherein the markets were quite liquid and therefore today in an increased interest rate scenario the portfolio would have depreciated thus warranting financing through other means. As of 28 June '95 the STCI has been giving two way quotes for government papers and T-Bills, with a ceiling of one crore on each deal in case it is a buyer. This clearly reflects the one sidedness of the market with most of the players being net sellers as also the limited quantum of funds available with the institution.

The STCI and the DFHI are two institutions who have applied for primary dealerships and therefore seem to be gearing their activities toward preparing themselves for the roles they would have to play in the developing market.

The DFHI and the STCI have been dealing so far only on the telephone market and what the NSE could possibly look at is their inclusion into the fold of active players on the NSE floor.

PSU Bonds:

This segment though more liquid than the state government securities does not see a great amount of activity and deals of small volumes take place between banks and other financial institutions. Trading is normally done through brokers with a daily turnover in the market being Rs. 5 crores.

Corporate Debentures:

The holders of these securities are the insurance companies and the mutual funds and they prefer holding the securities to maturity. Therefore, in spite of being listed on the BSE as well as the NSE trading volumes are very thin. The FRB market sees some trading due to the presence of market makers giving two way quotes but the volumes are again only Rs.20-30 crores a month.

A REVIEW OF OPERATIONAL SHORTCOMINGS OF SECONDARY DEBT MARKET

Clearance and Settlement systems and costs for debt securities

One of the basic requirements for the development of an active secondary market for debt is the removal of fear from the minds of the investor of the uncertainty involved in settling his deal. The need of a proper settlement and clearance system becomes very important in the light of a high number of bouncing of SGL forms issued by banks and other FIs in the case of government securities. The present state of the system a selected number of players an access to the SGL facility at the RBI.

One also needs to realize that cross directional flows across securities are practically impossible as the differential in time required to settle in government securities and PSU bonds or corporate debentures is so large that money flow across the different segments is next to impossible. A look at the settlement system that existed at the PDO prior to the present DVP system indicated that there was no reconciliation on line to see that a default was not made on the securities side of the transaction or on the current account. It would therefore be interesting to study the DVP system as introduced by the RBI from the 17th of July 1995.

Delivery vs Payment (DVP) System

The strength of securities clearance play a very important role, as an inefficiency in this could cause a great deal of discomfort to the entire functioning of the market. Under the system, the seller will deliver the securities at the same time in which the buyer transfers the funds. An important prerequisite for the DVP system is that the transferor as well as the transferee have to maintain a SGL and a current account with RBI. Under the present guidelines the facility of maintaining such accounts is only available to some specified categories of institutions. This is in place because undertaking retail banking activities for a large clientele would not be in conformity with the role played by RBI as the central bank.

In the DVP system, the revised SGL transfer form duly signed by both the parties is submitted to the PDO or PAD on the same day or the next working day. Subject to compliance of norms and there being sufficient balance in the seller's SGL account and buyer's current account, the RBI will put through the deal. Bouncing of the form could lead to very serious repercussions to the parties involved. A hybrid form of the SGL account is maintained by certain banks so as to allow their clients to access the SGL facility. These accounts are linked by the bank to their main SGL account with the RBI. The banks will also conduct DVP transactions for their constituents. These banks will be designated for the purpose. The transactions between the SGL accounts 1&2 of the same bank would be reflected in the books of transfer without any fund flow.

Broad guidelines for transactions to be followed for securities accounts maintained by the banks for their constituents are available.

A market suggestion is that the DVP system should be extended till the end of day and not at the spot as is proposed because this will give the investors to arrange for the funds or money during the day. This suggestion mainly stems from the low net worth players as the banks would have sufficient funds available in their current account and securities in their SGL but the brokers who are not high net worth individuals would definitely have a problem with the system as it does not allow them to net off their positions at the end of the day.

The DVP system at the RBI is not totally computerized as the process of checking up if there is enough money in the account or securities in the SGL is going to be a semi computerized and not automated, however the RBI should really work toward achieving this objective and this would definitely enable online monitoring and trade for trade settlement.

Although the DVP system at the RBI is a gross system, when two or three banks are appointed as clearing banks and allowed to maintain their own SGLs for their clients they may offer their clients a net settlement system by charging them an interest rate or whatever on the overdraft in terms of cash or securities. This is just providing them an intra day facility to play around and the bank can also set a cap on the amount of exposure it will allow the party.

The presence of a Bank Net which is the basic infrastructure that is in place can if properly utilized provide a phenomenal launching pad to integrate all the players. The RBI net is a net which sits on the banknet and the NSE has already got an access to this facility. The two institutions can definitely work toward a system wherein data flow would be available between the trades conducted and those settled.

A long term perspective is the possibility of having online trading and settling, and having the infrastructure in place this should not prove to be too difficult.

The possibility of the NSE setting up its own clearing house or settlement system seems really remote as this would mean that they would either have to float a bank or form an FI which is highly unlikely and the RBI only allows these two entities to become a clearing house. What they could possibly do is tie-up with a bank which can offer a clearing house service and this would definitely be acceptable to the RBI. This system would go some way in providing a settlement and clearing system that would be dedicated to the exchange.

The depositories' act is presently under legislation in the parliament and the Government plans on introducing this in the monsoon session. The depositories act, when passed will mark a watershed in the area of clearance and settlements, as a national level depository for all kinds of debt instruments would mean a total scrip less trade. However the process of transformation from the present day system to an ideal state would not be an overnight one as the immobilization and subsequent processes would have to be achieved over a larger period of time.

What, however should be stressed is that the depository when introduced should be for all the debt instruments as this would then facilitate inter-segmental flows by making the settlement and clearance procedures for all the kinds of debt instruments and all the players the same thus ensuring a level playing field.

The costs associated with trading in debt securities vary on the channel through which the trading is done and are normally borne by the brokers. If the deal is put through directly on the SGL then the only transaction cost that will have to be borne would be the stamp duty. The stamp duty for Govt. Securities is Rs.1/Rs.1000 transacted, limited to a maximum of Rs. 1000. However in the case of PSU bonds the stamp duty payable is pro rata to the transaction.

In the case of transactions taking place on the NSE, in addition to the above-mentioned costs the broker would have to bear a turnover tax of 5% on income and an additional SEBI registration charge which are yearly charges. In addition to this he would also have to pay a transaction charge on the NSE at the rate of Re 1/Rs.1,00,000 transacted at either end of the deal. In the case of the same broker getting the buyer and seller together the transaction costs are reduced to half at each end of the bargain so that he ends up paying the same amount as if he transacted just one end of the bargain. The broker has to recover all his costs he incurs in the form of brokerage from the principals.

The problem faced by the brokers is that most of the banks just refuse to pay them brokerage and therefore they are forced to bear the cost themselves or recover it from the other end of the bargain. The NSE as an exchange needs to address this issue as the brokers are its members and therefore it is in its own interests to solve this problem as the brokers would then be encouraged to get more business on the exchange. What happens today however is that players avoid the costs wherever possible by not issuing contract notes. Also higher volume deals are transacted directly as it proves to be beneficial to all the players involved.

Trade reporting and quote dissemination by the screen based and over the counter market for debt securities

The primary requirement for the development of trust between an interacting group of people is the transparency of operations. A fair degree of transparency in debt market operations has been achieved due to the publication of the SGL accounts of the RBI and the transactions on the NSE. Thus, the prices and yields prevalent in the secondary market are easily known to all the participants. However, the two systems need to be studied in tandem to understand the impact of the systems of trade reporting and actual settlement.

The volumes of settlement taking place on the SGL are a reflection of the total deals transacted in the government securities market via the over the counter market (telephone market) as well as the NSE. The deals on the NSE need not get reflected on the same day that they take place, as the SGL reflects the deals that are settled on the particular day whereas the deal that is reflected on the NSE may not be for settlement on the same day. The facility for settlement on the NSE is available for trade day plus five days and on the SGL directly would be trade day plus thirteen days.

The NSE system has gone a long way in adding transparency to the market in terms of information dissemination to the players. An area that needs to be looked at is in the case of last traded price is that the trade may have taken place an indefinite amount of time ago and thus this would not be an accurate reflector in terms of market sentiment in the particular scrip and also on the whole.

The telephone market in its inherent nature would provide an ideal opportunity for players to have arbitrage opportunities based on the fact that information would not be available to all the players. Also there exists the possibility of misinformation being used by some of the players to arbitrage and make gains which would not be available in the case of a transparent system.

The NSE infrastructural support to the market players in terms of dissemination of available information therefore makes the market players compete on an equal level. In this changing scenario the breed of the traditional broker is really threatened as anyone possessing a screen would be able to trade on his own account. Therefore the role of a broker in terms of value addition would now be very limited and he would have to reposition himself in this changing scenario. As of now the largest players in the market, i.e., the banks are not allowed to become members of any stock exchange and except for direct interbank deals they have to deal through brokers on the NSE.
There is no reporting structure in place in the case of deals done with direct delivery or spot delivery. Another component of the market that goes unreported is the ICD segment wherein the deals are basically arranged by an inter-broker network.

The Indian markets on their path toward sophistication are presently having their first brush with bond indices. The long felt need for a benchmark would be addressed by the development of a representative bond. This however has not happened so far due to the inconsistencies in terms of trades in the Indian market. The bond index could be used to serve the purpose of a benchmark as the derivatives market develops in addition to being an indicator of the performance of the market.

The problems faced at the moment in the composition and valuation of the index are

- The absence of sufficient activity in the secondary markets
- The absence of a yield curve extending beyond three years

Hedging vehicles and other methods of managing interest rate risk.

Players with multiple views and perceptions are the cornerstones of an active trading market in any security or commodity. This being in place there would be people who want to sell or buy depending on their perception of how the parameters affecting the market would move. In the case of a debt market the movement of interest rates would be the parameter. Further to this it would also be essential for the player to be able to cover the risk he is taking in taking a long or short term view, with the help of certain risk management instruments.

In the Indian scenario, with movements in interest rates being volatile and the prediction of future interest rate movements being unsure, the necessity of such hedging instruments becomes an absolute necessity. In the absence of such an instrument for any player to take a long term view and position could prove to be extremely fatal as an incidence of unforseen circumstances would totally depreciate his portfolio.

One of the most basic instruments used by market players all over the world is the ability to sell short or buy long with a specification of a certain limit. This however does not exist in the Indian scenario and in the aftermath of the scam the possibility of induction of the same in the near future would be a difficult proposition to undertake.

However, what one can look at, is the emergence of a floating rate instrument which could actively be used as hedge against volatile interest rate movement. The floating rate bonds are not instruments that are totally alien to the Indian market. There were floating rate bonds issued by certain institutions. However the prerequisite of a floating rate instrument is the presence of a reliable benchmark on which the floating rate instrument would be based. The 364 and 91 day T-Bill auction rates were used as the benchmarks but the volatility of the same has rendered the instrument useless with the subscribers to the same not at all satisfied. The basic reasons for the failure of the floating rate bonds have been

- The regulation of interest rates
- The feeling in the investors that the issues were wrongly priced
- As the banks are only allowed to invest 5% of their portfolios in shares and debentures, they naturally tend to compare the yields on the FRBs to those on equity.
- The absence of differential pricing between the various FRBs.

A recent addition to the instruments available would be a rupee derivative being launched by Standard Chartered bank which would enable customers to convert their fixed rate liability to a floating rate liability in what would essentially be an interest rate swap. The benchmark decided for the same has been the call money rate but in restricted cases the 364-day T-Bill would also be used as a benchmark. The bank feels that there was enough demand in the market for the instrument and therefore in the final analysis it would be the market that would decide upon the worthiness of the instrument.

The absence of a stable interbank borrowing rate would facilitate a structured system wherein this would act as the base rate with all the other rates being derived from this.
Given the absence of an active long term debt market there exists a chronic asset liability mismatch. The hedging vehicles in use over the world for managing interest rate risk have futures, interest-rate swaps and options. Also, in the absence of capital account convertibility the ability to hedge in foreign markets is restricted.

The rationale behind the absence of all these instruments is fairly simple, as the treasuries of the banks in a regulated scenario never had a perception of what interest rate risk management was all about. They would just have to buy a security and hold it to maturity and they would be making a clean spread of 4-5%. This scenario is however fast getting outdated and the market will definitely have to look toward the development of some hedging instrument to manage interest rate risk.

Credit information and systems support for the control of counterparty credit risk

A latent advantage that the telephone system has over the screen-based system of the NSE is that one knows the devil being dealt with. Counterparty credit risk exposure has always existed even in the telephone market though not in a documented form. On the NSE the counterparty credit risk exposure can be set as a buyer and not as a seller and the rational for the same being that the buyer used to normally make payments in the form of a banker's cheque and there was no question of this bouncing except under extra ordinary situations wherein a bank itself defaulted. On the other hand the buyer had to carry a risk of the SGL transfer form bouncing due to non availability of securities.

The advent of the DVP system has however evened out the playing field and therefore it would now be advisable for the exchange to incorporate counterparty limits even for sellers of securities. This is also necessary as a particular participant might not want to trade with some other participant under any condition. Apart from this the credit risk as such does not exist as the transaction would not be put through in case of a default in terms of respective balances of both the parties in their cash or securities accounts.

A crisis of confidence has however erupted in the market for the Inter-Corporate Deposits due to the occurrence of defaults now on a regular basis. Trust was one dimension on which this market used to thrive in the absence of any legal recourse which will yield results in a reasonable time frame, because the ICD as such is a very unstructured and mostly an unsecured loan. In this context the kind of credit information available to control counter party risk becomes very important. The only credit rating company that rates companies for ICDs is CRISIL. Also since the rating is not mandatory most people do not go in for a rating.

In the absence of any such ratings lenders decide the borrowers credit risk in terms of his cash flow generation, solvency ratios, its past payment record, the management of the company, the business practices followed and several other factors inherent to the company. The reliance on internal guidelines therefore is extremely high when setting limits on counterparty exposure in the Indian scenario.

The Quality and availability of credit information about the corporate issues

In an increasingly market driven economy the investor would be exposed to two risks, i.e., the business risk associated fundamentally with the business and a payment risk in terms of the ability of the issuer to meet his liabilities. The investor would not have the time and the expertise to look into the financial soundness of every corporate or instrument that he wants to invest in. This gives rise to an industry which is hardly eight years old in the Indian context. The role that the rating agencies play in market is of extreme significance as this is the guiding factor for an investor to gauge the risk involved with the instrument.

There are three credit rating agencies, i.e., Credit Rating Information Services of India Limited (CRISIL), Credit Analysis and Research Limited (CARE) and Investment Information and Credit Rating Agency of India Limited (ICRA), who collectively amongst themselves have rated more than 2000 instruments of debt from approximately 1200 issuers of debt.

The mandatory rating of some of the instruments of debt like fixed deposits of companies, commercial paper and certain categories of debentures has made this an industry driven more by the issuers and not the investors. One of the issues being raised is the possible playing of one rating agency against another by issuers in the process of pressuring them to give a higher rating. The rating agencies are paid in advance and the issuer has a right to either accept or reject the rating of the agency.

The rating may further be published only if the issuer accepts it. Therefore this definitely does not entail a totally transparent system as the issuer may publish only the higher rating. It would therefore be in the interest of investor protection to make double rating mandatory as this would give a clearer picture.

The source of information for a credit rating agency today is the company itself and the primary outlook is the ability of the issuer to service the debt. The factors looked into to ascertain this are the cash flows, profits, asset quality, resource pattern, business risk and other associated areas. The rating is generally instrument specific but companies are also rated on the whole for their ability to service debt and this is a continuous process with a review being conducted every three months to access the effect of changes in the market scenario on the company. The disclosures made by the company are also in some cases suspect as the entire concept of an audit in India is statutory and not proprietary and there have been several cases of non disclosure. In the case of diversified companies it is often found that they are not very willing to disclose a stream wise breakup as this may indicate the unhealthy state of one of the streams. Balance sheets are often reconstructed by the rating agencies to get a clearer picture of the finances of the company.

The sensitiveness of investors to credit ratings has gradually increased over time but even in the present day scenario investors go more by name recognition than by rating. On the other hand the institutional investors do look at the ratings but they have their own elaborate internal credit analysis. The sensitiveness even of the sophisticated investor has not come in terms of pricing the differential credit risk and anything below a AAA would be considered equal as long as it is investment grade and would be able to command the same level of interest. Thus, there are no interest rate bands for certain ratings of securities and the market does not really price the differential credit risk of the instruments.

The credit rating agencies are now making forays into different businesses like providing industry reports or emerging scenario perceptions. Although credit rating was initially promoted by the institutions by making it mandatory for the issuers, it will have to be sustained in the longer run by the investors who would envisage a need for independent and professional analysis in aiding their investment decision. In such a scenario credit rating would truly become an objective exercise in evaluating an issuer's true worth. However, this also has to be supported by stricter disclosure norms, thus making the entire system that much more transparent.

Types and availability of financing for dealer inventories

The oft heard complaint for a sluggish secondary debt market in India has been the lack of liquidity in the markets. However, on investigating the source of this liquidity crunch one comes up with some interesting opinions about the causes of the lack of liquidity in the system.

One of the principal drivers of all activities in the secondary market for debt would be the interbank call money rate. The interbank call money market by its very nature is not purely an interbank market but also has the participation of some of the institutions as either only lenders or borrowers as well as lenders. The market is essentially an overnight market and not a term market due to the slapping of reserve requirements on call money. The market is cyclic in nature due to the fact there is almost no borrowing on every alternate Friday, which is the reporting Friday. The market sees a great amount of volatility and in extreme cases has gone up to even 60% but normally rules around 10-13% which in itself is quite a wide margin. This is due the very nature of the participants wherein

some of them are perennial borrowers while others are perennial lenders. E.g., the State Bank of India is a perennial lender and in its absence from the market ICBM rates flare up.
One of the major complaints that the banks have regarding the call is that the CRR has to be maintained by the borrower, and this they feel is unfair as the money is not going out of the system and therefore there is double reserve imposed. The RBI's logic is that the banks should not borrow from the IBCM to for their commercial lending and as a deterrent has imposed reserve requirements on the inter-bank borrowing. This is further strengthened by the logic that one cannot build long term assets using short term liabilities. This has led to a standoff between the banks and the RBI and therefore a term money market has never developed. A suggestion that could be put forward would be to have reserve requirements on the assets and not on the liabilities as liquidity is basically associated with assets and the capital adequacy norms too are on the assets.

With the exception of one off transactions, most of the trading is at the shorter end of the market. Last year people bought long term securities because low calls brought the short end down and this in turn brought the long end down. Then the RBI, with the objective of reducing volatility in the call money market, came out with the rule for maintaining 85% of CRR on a daily basis and 100% on the reporting Friday. The effect, however was quite the reverse as the flexibility that borrowers enjoyed in deploying their funds and also the mobility of funds was reduced considerably. The result was that liquidity and trading in the market reduced and in consequence interest rates began to rise.

Debt markets throughout the world have 96% of their transactions through the Repo or the repurchase option or the ready forward and as of 1991-92 90% of the deals in the Indian markets were made through the Repo too. Therefore it is in this context that the total banning of the Repo by the authorities and only its partial reintroduction has really left some of the players in the market hamstrung. One needs therefore to define the Repo as a particular breed of animal and regulate it instead of simply going ahead and banning it.

The Repo is the main tool available for dealer inventory financing throughout the world and the very nature of large volumes in an active debt market warrant the requirement of financing for the short term. What needs to be understood is that for a player to be active in the market even a capital base of 50 crores leveraged ten times which would mean a fund base of 500 crores, which the STCI has in terms of its net worth and it still finds it difficult to operate. Add to this the fact that they have a refinancing window open with the RBI in terms of reverse Repos they can perform with the central bank, but they still find it difficult to finance their needs.

Repos are today allowed inter-bank and between the banks and the RBI only in select securities, the T-Bills and six specified dated securities which are securities that have basically been converted from T-Bills. The RBI is using the facility of the Repo as an added incentive to get new government paper subscribed as was very apparent from the facility being offered on the latest conversion of government stock maturing in October. The playing field therefore seems to be very skewed in the favor of the banks, as the non banking finance companies and the brokers have a limit to the funds they can raise through the fixed deposit route and they do not have an alternate source of financing available.

The route out seems to be for the RBI to define the instrument and therefore set broad guidelines around the regulation and the working of the instrument after gradually introducing it for all the market players. The environment for the re-introduction of the ready forward seems to be conducive as the Ministry of Finance has already cleared ready forward trading and as of the 27th of July SEBI has also introduced ready forward trading on the stock exchanges though in a regulated manner.

Registration and disclosure requirements and costs for corporate issues of debt securities.

The age of the investor has definitely arrived in the securities market and therefore the investor would today like to have detailed and correct information from the corporates he plans to invest in. It is in this light that the Malegam committee report, although on the disclosure requirements for the primary issues in the capital markets gains importance. The provisions being made for reporting of past income as a foreteller of future events in terms of specifying the details of other income in case it exceeds 20% of net profit, the accounting practices being followed and future projections of profits is laudable and definitely a step in the right direction. In the securities market areas the disclosures that the corporates need to make to the credit rating agencies need to progress on the same lines as mentioned above.

One perceives a definite need for the SEBI and the Institute of Chartered Accountants to work together toward evolving a rigid code of generally accepted accounting practices that the corporates need to follow on the disclosure requirements as this would then lead to the removal of misleading information provided by the issuers. This would also lead toward the evolvement of a more transparent system of accounting standards being developed.

There exists a segmentation in the market even in terms of the instruments that need to be rated. The shorter term instruments like the commercial papers necessarily need to be rated and the rating process here is a continuous one with the review of the same being done on a continuous basis. The fixed deposits of the financial companies, i.e., normally the NBFCs need to have their fixed deposit program necessarily rated and a minimum rating would be essential before entering the market.

The long term instruments that are not convertible do not necessarily have to be rated but partly convertible debentures, with a conversion period of more than 18 months need to be rated compulsorily. A loop hole available to the issuer is to simply restructure to make the instrument convertible or renewable within 18 months so that they do not have to disclose the rating. Another route available is the private placement of the instrument and this is becoming an extremely popular route as the costs attached to placing an issue privately are only 0.5-1.5% whereas the public route would cost him close to 5% as issue costs. The PSUs are major players in the private placement market getting a lot of paper placed through this route.

The registration and transfer of ownership in case of corporates takes place at the company itself and there are a lot of problems involved due to this. The problems here arise due to the fact that the holding of the security is in terms of certificates, and there are lots of problems as these would have to be sent to the company for transfer and the process would have problems in terms of loss of certificates or signature problems and the entire process could take as long as three to four month.

CHAPTER 5: MINUTES OF MEETINGS WITH INDUSTRY EXPERTS

Meeting with Mr. Amar Kumar, DSP Financial Consultants Ltd.

1. In India, the risk free return in risk - return curve is taken as the return on GoI borrowing (T-bills, dated securities), although in international markets, it is not viewed as risk free. In fact, GoI securities have been rated BB+ and Baa3 by Moody's and Standard and Poor respectively. Hence GoI can borrow domestically at lower interest rates. Hence, there is an urgent need of developing the Indian debt markets to fund investment needs.

2. Any investment involves three risks, viz., issuer's risk, interest rate risk and liquidity risk. Through development of active secondary market, liquidity risk can be minimized. This will shift the yield curve downwards, implying that investors will demand lesser returns on the same security.

3. IDBI issue, for which DSP Financial Consultants were the Lead Managers, was discussed at length. Following points were made:
   (a) 60% of the issue was subscribed in Deep Discount Bond (DDB), which was offering Rs. 2 lakhs after 25 years on an investment of Rs. 5200. This shows that investors have not seen the interest rates but the final figure keeping in mind any commitments that they have after 25 years, e.g., marrying the daughter. These kind of investors, are unlikely to trade with these securities. 20% of the subscription went to Retirement scheme which again emphasizes the fact that investors are not willing to trade. Only 20% was subscribed in Regular Return Bonds (RRB) and Easy Exit Bond (EEB).
   (b) Generally, investors' preference is for short term securities while IDBI is a long term lender. This anomaly would not have caused any problem in the presence of active secondary markets where investor could have off loaded his security as and when required. But in the absence of same, IDBI has offered an 18 month put option on EEB for which it is charging the investor (EEB is offering 15.5% as compared to RRB's 16%). Hence investor is paying the price for illiquidity.
   (c) IDBI also has a call option, which it is unlikely to exercise for fear of loss of credibility in the market.
   (d) In future, IDBI intends to try market making in its issue through some intermediaries. The two way quotes given would be determined by demand and supply (as against the NAV rule used by UTI) and any losses/ gains will be borne by IDBI. IDBI will also offer a line of credit to these intermediaries. This would be the first step in development of active secondary debt market.
   (e) 50 - 60% of the issue was subscribed in Bombay region. This was followed by Delhi, Calcutta, Ahmedabad, Rajasthan and UP (in descending order). This gives an idea of concentration of funds in different geographical regions of the country.

(f) The issue was successful in the retail market mainly because of depressed equity markets. In future, even when the equity markets pick up, the investors would not experience the same extent of bullish phase as before. Hence, the returns on equity will be lower. This will make most investors shift to a debt - equity mix portfolio.

4. One of the major impediments to active secondary debt market is stamp duty. Following were the points highlighted in this regard:
   (a) Stamp duty is charged on issue as well as transfer.
   (b) The issuer complains that there is no difference between stamp duty on a short term paper and a long term one. Hence, he has no incentive to issue a short term. paper on which the annual stamp duty (Stamp duty/no. of years for which funds are available) is more compared to a long term paper.
   (c) Trader complains that stamp duty is too high, especially because the price fluctuation in debt instruments is too low. The problem assumes significance for a market maker who cannot offer a high buy/sell spread and hence invariably end up making loss due to payment of stamp duty.
   (d) Stamp duty on transfer is not uniform across issues. While PSU bonds are exempted from stamp duty on transfer, private companies' debentures are not.

   It was suggested that stamp duty should be charged only one time on issue and all transfers should be duty free.

5. Another major impediment to debt market is the cash credit facility to corporates. At present, any corporate is granted Maximum Permissible Bank Finance (MPBF), 60% of which is working capital loans and 40% is cash credit. The difference between the two is that, while interest is charged only on the amount borrowed and only for the time that it is borrowed in the case of cash credit, for working capital loans, the interest is charged on the whole amount irrespective of whether it is borrowed/used or not. From the nature of the two, it can be clearly seen that working capital loans compete directly with the debt market but have an edge above the latter due to the cash credit facility available along with them. If cash credit facility is removed, corporates will have an incentive to tap the debt markets if they are offering lower interest rates than the bank working capital loans.

6. Large investors in the debt markets, mainly banks and PFs are bound by regulatory framework. PFs have to invest 40% of their portfolio in Central Govt. securities, 30% in state govt. or central govt. bonds/ special deposit schemes and 30% in PSU and All India Financial Institutions (AIFI) bonds. They cannot invest in shares or private sector debentures.

   Banks can invest only 5% of their incremental deposits in debt instruments and equity (corporate and PSUs).

7. Interest earned on bonds/debentures attract the same tax as that on dividends. It is also subject to the same exemption limit (upto Rs. 13000 under section 80L of the act). Hence, there is no incentive to invest in debt as far as taxation is concerned. Also, capital (long term) gains tax is lower and since equity earnings are mostly by capital appreciation, debt tends to have a disincentive.

8. According to him, if debt instruments are positioned against Fixed Deposits (FD), the investors perceive FD as more liquid (minimum duration is 46 days) and safer. If positioned against equity, the investor see it as a hedging tool in debt - equity portfolio. In such a scenario, convertible instruments would be more successful.

9. A copy of the report on Debt Market Study done by DSP Financial Consultants was given by him.

Meeting with Mr.C.N.V. Krishnan, Asst. VP, ICICI Ltd.

1. ICICI has offered two major issues so far. Both offered 16% interest payable half yearly and were not targeted at the retail segment since it was very comfortable off loading it on the institutional investors. The issue in 1993 was of 460 crores, out of which 100 crores was picked up by the retail segment. The issue in 1995 was of 700 crores and the retail market picked up 200 crores.

2. The 1996 issue is targeted at the retail segment because of a study done by Mr. Vinod Aachi of ICICI Securities (I-Sec). The salient findings of the study are as follows:
   * Bank Deposits are growing at the rate of Rs. 65,000 crores per year (the figure needs to be verified).
   * There is no product in the market to compete with Bank Deposits. UTI units have also lost their charm in the wake of major off loading by corporates.

   Besides this, the institutional segment is also squeezed since everyone knows the potential customers and the competition is very hot. Institutional investors also emphasize a lot on interest rates while a retail investor is driven more by safety and the emotional appeal, i.e., issues like daughter's marriage, son's study, etc.

3. The salient features of the 1000 crores 1996 issue are as follows:
   * Three products are targeted purely at the retail segment, namely:
   (i) Deep Discount Bond
   (ii) Monthly Income Bond
   (iii) Money Back Plus Bond

The fourth product, Regular Return Bond, is the old product which is expected to be picked up mainly by the institutional investors as before.

* In order to educate the investor, investor conferences have been organised in 125 cities spread throughout the country. The issue also has a heavy advertising budget.
* The target is to tap the Bank Deposits market.
* Book Building for a part of the issue is being tried for the first time.

4. He feels that the equity market slump is not a major reason for people showing interest in debt instruments. This might be true for big cities like Bombay, Delhi and Calcutta, but people in rural and semi urban areas are not big equity players. Their motive is to have safety and regular income.

5. According to him, they expect majority of the issue to be subscribed in Deep Discount Bond. In terms of geographical location, at least 40% of the issue is expected to be subscribed in Western Region, i.e., Maharashtra and Gujarat.

6. As positioned against Bank Fixed Deposits, the bonds gain in terms of yield but loose out on issues of liquidity and safety. Positioned against equity, they score on safety and regular income.

7. According to him, the biggest obstacle to development of secondary debt market in retail is the mindset of the investor. It is a chicken and egg problem where the investor does not perceive debt as a trading instrument because there is not enough liquidity in the market and the latter also follows from the former. In this regard, market making can break the chain and assist in development of secondary debt market in retail.

   Another cause of lack of buyers in secondary market is the presence of lucrative instruments in the primary market.

8. Of the previous two issues, the only secondary market trading has been between institutions. In the present issue also, he does not expect much of secondary retail trading.

9. Like IDBI, ICICI will also try market making in the future through its lead managers. It will fund the lead managers for the purpose. These bonds, like IDBI bonds, are transferable by endorsement and do not have any stamp duty on transfer. This makes the instruments convenient for secondary market trading.

Meeting with Mr. G.V. Nageswara Rao, DGM, Merchant Banking Division, IDBI

1. In the IDBI Flexibonds Public Issue, 19 lakh applications have been received. The total collection is 1511 crores. In the coming year, IDBI has to raise 7000 crores out of which it expects to raise at least 3000 crores from the retail market. They are concentrating on the retail segment mainly because the avenues in wholesale market are quite limited.

2. Design of instruments : The Deep Discount Bond was a major success in 1992 with 11 lakh investors subscribing to it. Hence it was again included in this issue. The other products were designed mainly by judgement. No study was undertaken to identify the market potential or retail investors' taste.

3. According to him the major factors for the success of Flexibonds issue were:
   (a) The name and reputation of the issuer.
   (b) Instruments were designed to suit the retail investors' needs.
   (c) Marketing was done very effectively. Advertising and Press write ups coupled with extensive network of brokers and sub brokers for distribution made the issue a success.

   He felt that equity market slump was not an important reason for the success.

4. He was of the view that development of secondary debt market in retail was a very complex task. He did not offer any suggestions for the same. He said that major response for the Flexibonds issue has come from the interiors of the country and by investors of middle and lower middle class, even uneducated people. They are looking at it mainly as a fixed income instrument. Bringing these investors to trade on the stock exchange involves many issues.

5. According to him, Market making in these instruments will be mainly for the wholesale segment. IDBI will do it to develop liquidity in the absence of active secondary market and also to minimise the risk of these big investors exercising their put options since market makers will offload the same securities in the market. At the retail level, the facility would be used by only some investors who need money in between two put options.

Meeting with Mr. Sundar Sankaran, Associate VP, Kotak Mahindra Capital Co.

1. He discussed the growth of Indian Debt Markets over time.
   * Prior to liberalisation, loans from Financial Institutions (FIs) was the favourite form of debt for corporates. This was mainly because permission of CCI was required for any debt issue which was a very cumbersome procedure.
   * In 1992, CCI was abolished but the interest rates were too high. Hence there were not too

many debt issues in the market.

* 1993 onwards, debt issues by corporates started but only in the form of private placements. This was because this was very simple and, also, nobody had realised the potential of retail market.
* By Dec. '94, interest rates again shot up due to liquidity crunch being faced by the FIs. This made the corporates look for other avenues of finance. They found their financers in Provident Funds (PFs). But, by Aug. '95, PFs, guided by strict norms, had saturated their limit of these kinds of investment.
* In Dec. '95, ICICI came out with a public issue. But the instrument, 16% payable half yearly, was not really targeted at the retail segment. As a result, only 200 out of 700 crores was picked up by the retail segment. Rest was picked up by PFs, who had some funds for investment now, and trusts.
* In Feb. '96, IDBI came in the market with its public issue offering four instruments, three of which were specifically targeted at the retail segment. Hence, it can be called the first debt issue targeted at the retail segment. The unexpected success of the issue (according to him, the merchant bankers were estimating the collection to be only 750 - 800 crores but it was 1500 crores finally) displayed the retail market potential.

2. Just before the IDBI issue, Kotak Mahindra had come out with its own 100 crores bond issue for the retail investor. This was mainly because, being a NBFC, it did not have much avenues of finance from banks and FIs. Besides this, the other reasons were:
   (a) It had gained a certain level of trust and comfort with the retail investor through its regular feature, the Kotak Fixed Deposits (FD).
   (b) Handling the ICICI issue gave them a feel of the market in terms of geographical concentration of funds.
   (c) Its wide network of 8000 - 9000 sub brokers spread throughout the country made a good distribution channel for the instruments. This highlights the importance of sub brokers in the distribution channel.
   (d) One of the feedbacks they had got from the investors in ICICI issue was that they preferred liquidity. Since this was not possible in the absence of active secondary market, they offered an exit option to the investors in their issue thus making it more attractive to the individual investor.

3. According to him, the main reasons for the success of IDBI issue were as follows:
   (a) Although the FIs were facing liquidity crunch, the retail investor was having his regular inflow of funds.
   (b) Inflation was low.
   (c) Equity markets were down.
   (d) The only investment option for the investor was Bank Deposits which were giving low returns.
   (e) Absence of instrument like Deep Discount Bond (DDB) in the market had created a large

pent-up demand. This, coupled with heavy advertising through hoardings, created a pull in the market (He pointed out that in ICICI issue they have to push the product since a large part of this demand has been satisfied by the IDBI issue).
(f) Use of a wide and in depth distribution network of sub brokers.

4. He sees a bright future for debt markets because:
   (a) Even if equity markets pick up, days of supernormal returns will not return. Also, the investors have imbibed a fear of loss in equity.
   (b) From the issuers' point of view:
      *They have begun to realise that cost of debt is less than cost of equity.
      * Family managed companies do not want to dilute their stake by offering more equity to the public.
      * Many variations are possible in debt instruments which will target at different needs of the individual. This is not possible in equity.

5. However, he felt that as long as there is surplus of issues in the primary market, the investor will not look towards secondary debt market. This is because:
   (a) Since the scam, investor has always perceived primary market to be safer than the secondary market.
   (b) Infrastructural problems in the secondary market increase the hassles for the investor.

6. He also stressed the need for market making since, with the exception of people investing in DDB, everyone wants liquidity in the market. Since banks cannot invest in corporate paper in the secondary market, this has to be done by brokers. For this he recommended funding lines for the brokers.
   Kotak Mahindra is also planning to do market making for which they have submitted a proposal to IDBI. They intend to widely publicize the facility and ultimately change the buy-hold psychology of the individual.

7. Kotak FDs, a very popular instrument, was also discussed:
   * Compared to bond/debenture issue, FD issue is much more convenient because the former requires permission from SEBI while the latter requires just one advertisement in the newspaper making some mandatory disclosures.
   * Investor psychology is such that he perceives FDs to be safer even if both are offered by the same corporate.
   * However, FDs are subject to limits on mobilisation of funds, interest rates that can be offered and the brokerage charges.
   * "Shelf Registration" is a facility within which the issuer has to get clearance from the authority only once in a year for any number of issues in that particular year. This facility exists outside India. Once this is introduced in India, issuers will move towards issue of debt instruments instead of FDs.

CHAPTER 6: DESIGN OF QUESTIONNAIRES

BROKER QUESTIONNAIRE

The Price Waterhouse Financial Institutions Reform and Expansion (PW-FIRE) Project is conducting a study to understand the retail market potential for debt instruments. Kindly respond to the questions below and oblige. Complete confidentiality is assured.

1. What exchanges do you trade on?
   - ☐ NSE
   - ☐ BSE
   - ☐ OTCEI
   - ☐ Any other (please specify)____________________

2. What percentage of your activity (*in terms of volume*) is in debt instruments?
   - ☐ Less than 2%
   - ☐ 2 - 5%
   - ☐ 5 -10%
   - ☐ 10 - 20%
   - ☐ More than 20% (Please specify)___________

3. If you were to categorise your clients (*retail investors only*) in terms of the *size of their portfolio*, what would be the *percentage of debt instruments in the portfolio* held by each category? (*Please tick one in each column*):

Portfolio -> / *% Debt*	Less than 1 lakh	1 - 2 lakhs	2 - 5 lakhs	5 - 10 lakhs	More than 10 lakhs
Less than 10%					
10 - 20%					
20 - 30%					
30 - 50%					
More than 50%					

4. Of the clients who trade in debt *(buy and sell through the exchange)*, what percentage are *retail investors(individuals)*?

In terms of no.	In terms of volume
□ Less than 10%	□ Less than 2%
□ 10-20%	□ 2 - 5%
□ 20-30%	□ 5 - 10%
□ 30-50%	□ 10 - 20%
□ More than 50% (Pls. specify)_____	□ More than 20% (Pls. specify)_____

5.Of your retail clients, how many *trade actively* in debt instruments?
□Less than 10%
□10 - 25%
□25 - 50%
□More than 50%

6. Have you ever advised your clients to trade in debt instruments?
□Yes
□No
□Sometimes

7. If less than 50% retail clients trade actively in debt, then what do you perceive to be the important reasons for investors *not trading actively* in debt? (Please tick *all* that you feel to be relevant):
□ Not enough variety of debt instruments available
□ Spreads in debt are too high (The same quantum of spread as in shares becomes high in debt because volumes are high)
□ Not enough liquidity in the market
□ Returns on trading debt are not too high
□ The investor is not at all interested in trading debt. He just wants to buy and hold it.
□ Inadequate trading facilities, i.e., the stock exchange has not concentrated on developing the required infrastructure.
□ People who want liquidity prefer investing in bank Fixed Deposits which can be encashed easily, though with a penalty.
□ Issuer's settlement facilities are not reliable.
□ No market makers in debt instruments.
□ Stamp duties and taxes make trading in debt instruments unattractive.
□You, as his broker cum adviser, never advised him to buy and sell debt instruments.

8. If you were to draw a profile of a retail investor trading in debt instruments, what would it be? (e.g., in terms of his income, investment portfolio, etc.).

THANK YOU FOR YOUR COOPERATION

Logic of the Broker Questionnaire:

The reason for surveying the brokers and the sub brokers was that these people interact with the investors on a daily basis and have a fair amount of idea of the investors' preferences for various types of investment opportunities. Besides this, during administration of the questionnaire, the brokers were also interviewed to get their views on the primary and the secondary market and suggestions for development of secondary debt market in retail. Following is the logic of different questions asked:

1. Question 1 and 2 draw the profile of the broker/ sub broker in terms of the exchanges that he trades on and the extent of his activity in debt instruments. Question 2 also gives an idea of secondary market trading in debt instruments.

2. Question 3 tries to find out the segment in terms of portfolio size (and hence, net worth) which holds the maximum percentage of debt. The hypothesis for this question was that as the size of portfolio increases, the percentage of debt should increase. The logic behind this hypothesis is that in smaller portfolio, there is no room for debt since an Indian investor views debt as secondary to equity. However, in larger portfolio, the investor carries a proper mix of risk capital (equity) and regular/ assured income capital, i.e., risk free capital (debt).

3. Question 4 tries to find the percentage of retail trade in secondary debt market. The question asks for separate percentages in terms of numbers and volumes because very few wholesale investors (banks, FIs, etc.) would trade volumes equivalent to many retail investors put together.

4. Question 5 tries to determine the percentage of retail clients who display as much interest in debt instruments trading as many in equity. The hypothesis for this question was that this percentage would be negligible since, at present, retail investor has not viewed debt trading lucrative and his only activity in the secondary debt market is selling off the "khokha", the non convertible part of Partly Convertible debenture (PCD) which he has bought for the part which will be converted to equity.

5. The assumption behind Question 6 is that most of the investors in the country invest on the advice of the broker. Hence this question tries to find out whether the brokers themselves view debt trading as an attractive offer or not.

6. Question 7 tries to find out the views of brokers on the importance of various impediments to secondary debt market in retail. All the possible reasons that were thought were put down as choices for the convenience of the respondent. Besides these, the respondents were also asked if any other reason is there which they feel to be important.

7. The objective of Question 8 was to try to find out the investor segment that should be targeted for development of this market. Since it was felt that leaving the respondents choice wide open would be more beneficial than constraining it by a few choices, no choices were offered for this question.

INVESTOR QUESTIONNAIRE

The Price Waterhouse Financial Institutions Reform and Expansion (PW-FIRE) Project is a USAID project for initiating structural reforms in the Indian Capital Markets. As a part of this project, we are conducting a study to understand the retail market potential for debt instruments. We assure you of complete confidentiality and request you to respond to the questions below.

1. What is your profession?
   ☐Service
   ☐Business
   ☐Self Employed professional
   ☐Any other (please specify) _______________

2. What is your age?
   ☐20 - 35 years
   ☐35 - 50 years
   ☐More than 50 years

3. What is your educational qualification?
   ☐Less than Graduate
   ☐Graduate
   ☐Post Graduate
   ☐Doctorate

4. What is the annual income on which *you* take investment decisions (your income + income of your spouse, children, etc.)?
   □Less than 2 lakhs
   □2-5 lakhs
   □5 - 10 lakhs
   □More than 10 lakhs

5. What percentage of *this income* do you generally save?
   □Less than 15%
   □15 - 20%
   □20 - 25%
   □25 - 40%
   □More than 40%

6. What percentage of your *assets* (total wealth) do you hold in the following (*please tick one in each column*):

	Physical Assets (Real estate, gold, car, etc.)	Bank Deposits (Savings A/C, Fixed Deposits, etc.)	Non Tax Concession debt (Debentures, taxable bonds, Company FDs, etc.)	Tax Concession Debt (PF, Insurance, tax free bonds, etc.)	Equity Shares	Mutual funds
Nil						
Less than 10%						
10 - 25%						
25 - 50%						
More than 50%						

7. What percentage of your *savings in the following year* do you plan to invest in the following (*please tick one in each column*) :

	Physical Assets	Bank Deposits	Non Tax Concession debt	Tax Concession Debt	Equity Shares	Mutual funds
Nil						
Less than 10%						
10 - 25%						
25 - 50%						
More than 50%						

8."You can make money by trading debt instruments due to interest rate movements". What is your feeling about the statement?

□True

□False

□Have not thought about it

9. Have you traded regularly in debt instruments?

□Yes

□No

10. *According to you,* what are the important reasons for people generally not trading actively in debt instruments? *Please rate the following on a scale of 1 to 5, 5 for very important reasons and 1 for least important* ones. More than one reason can have the same rating.

□ Not enough variety of debt instruments available.

□You cannot sell/buy the instrument anytime you want to because there are not enough buyers/sellers in the market.

□ Returns on trading debt are not too high because price fluctuation is not as high as equity.

□ Investors are not at all interested in trading debt. They just want to buy and hold it.

□ Settlement facilities are too cumbersome and time consuming.

□ Stamp duties and taxes make trading in debt instruments unattractive.

□Lack of information and investment advice.

11. Has your broker ever told you of the possibility of secondary market purchase and sale of debt instruments?

□Yes □No

12. If returns on Securitized debt (bonds/ debentures) are reasonable (say, 5% more than Bank FDs) and, also, you can encash them if you need money, would you tend to *save more*? If yes, by how much will you increase your savings (and *sacrifice current consumption*)?
 - □No increase
 - □Less than 2% of current savings (*not income*)
 - □2-5%of current savings (*not income*)
 - □5-10% of current savings (*not income*)
 - □More than 10% of current savings (*not income*)

13. In the scenario mentioned above, would you shift your investment from other options to debt instruments?
 - □No
 - □Yes, I will cut down on bank deposits/ equity shares/ mutual funds (*please tick the relevant ones*) and increase investment in debt instruments by:
 - □Less than 10% of current investment
 - □10 - 25% of current investment
 - □25 - 40% of current investment
 - □More than 40% of current investment

14. What kind of returns do you *expect* from the following? (*please tick one in each column*):

	Physical Assets	Bank Deposits	Non Tax concession debt	Tax concession debt	Equity Shares	Mutual funds
10 - 15%						
15 - 25%						
25 - 40%						
More than 40%						

15. Please *rate* the following options on a scale of 1 to 5 on the basis of the risk *you perceive* in them, *5 for most risky options and 1 for the least risky ones*:
 - □Physical Assets
 - □Bank Deposits
 - □Non Tax concession debt
 - □Tax concession debt
 - □Equity shares
 - □Mutual funds

16.Please *rank* each of the following options in decreasing order of your preference. (please indicate the rank besides each choice)
□Govt. of India Securities (e.g., T-bills, Dated Securities)
□PSU/Financial Institutions bonds (e.g., bonds issued by IDBI, ICICI, etc.)
□Corporate debentures (e.g., debentures issued by Reliance, TISCO, etc.)
□Company Fixed Deposits (e.g., Kotak Mahindra FD, etc.)
□Bank Fixed Deposits

17.Please *rank* each of the following bond/debenture options in decreasing order of your preference. (please indicate the rank besides each choice)
□Long Term (More than 10 yrs. but higher interest rate)
□Medium Term (5 - 10 yrs. with lesser interest rate)
□Short Term (Less than 5 yrs. with least interest rate)

18. In order to reduce the risk of depreciation of portfolio, what measures would you prefer? Please *rank* in decreasing order of preference:
□Put option, i.e., buying the right to sell the security at a certain price within a certain specified time.
□Active secondary market which gives you ample opportunity to sell the security.
□Compulsory market making by brokers which gives you an opportunity to sell even if the market is not active.

19. While buying an equity share/debenture, which one do you give more importance to (*please rank in decreasing order of preference*)?
□Name (reputation) of the company
□Credit rating of the company/ issue (by CRISIL, ICRA, CARE etc.)
□Industry sector (e.g., power, telecom, etc.)

Please give your name and address below:

THANK YOU FOR YOUR COOPERATION

Logic of the Investor Questionnaire:

The purpose of the investor questionnaire was to identify the retail investors' appetite for debt instruments, his perception of this investment vis a vis other investment opportunities, his preference for various instruments within the debt segment, his change of preferences once certain reforms are introduced and his willingness to come to the secondary market in debt instruments.

Following is the logic of different questions asked:

1. Questions 1 to 4 profile the investor in terms of his profession, age, educational qualification and family income.

2. Question 5 finds out the marginal propensity to save (s) of the investors. This is important because it gives an idea of funds available for investment purpose. The hypothesis for this question is that as the income increases, the marginal propensity to save increases. The logic for this hypothesis is that people with lower income have fewer funds left after meeting their essential expenditures.

3. Question 6 finds out the present preferences of investor for various investment opportunities, viz., Physical assets, bank deposits, securitized debt instruments (with and without tax concession), equity shares and mutual funds.

4. Question 7 tries to determine the incremental investment in these assets. For example, an investor may hold a significant portion of his savings in real estate but once he has bought his house, he may not invest in it every year.

5. Question 8 determines the level of investor awareness about appreciation/ depreciation of portfolio due to interest rate movements. The hypothesis is that most of the investors would not have thought about it since they have looked at debt instruments as a regular income investment and not as a capital appreciation instrument.

6. Question 9 finds out whether the assumption that the secondary debt market in retail is dull or not.

7. Question 10 tries to find out from the investors the importance of various reasons for retail investor shying away from the secondary debt market. Various choices are provided for the convenience of the respondent. The responses will add to the information received from the broker questionnaire about this market being dull.

8. Question 11 tries to determine whether the investors are advised by their brokers to trade in

secondary debt market. This question is also based on the assumption that most of the investors invest on the basis of advice from the broker.

9. Questions 12 and 13 paint the picture after reforms, i.e., high returns coupled with the elimination of liquidity risk. The questions find out whether, in such a situation:
   * Marginal propensity to save would increase, thus channelizing more funds for investment.
   * Whether investors would shift their portfolio in favour of debt and, if yes, where would the majority of funds come from.

10. Question 14 and 15 find out where do investors place the different investment opportunities on the risk-return curve.

11. Having found out the investors' preference for debt vis a vis other investment opportunities, questions 16 and 17 try to determine the preferences for various options within the debt segment in terms of nature of the instrument and period of maturity. This would help in designing a product most suited for investors' needs.

12. Question 18 determines the investor preference for put options vs market making vs active secondary market. This would help in prioritising the different reform options.

13. Question 19 finds out the investors' preference for reputation vs credit rating vs Industry sector. Past experience shows that investors do not have much faith in credit rating and decide mainly on the basis of the name and reputation of the issuer. The IDBI issue was a major success while the IRFC issue a failure when both were rated AAA. This kind of attitude is bad for a healthy market.

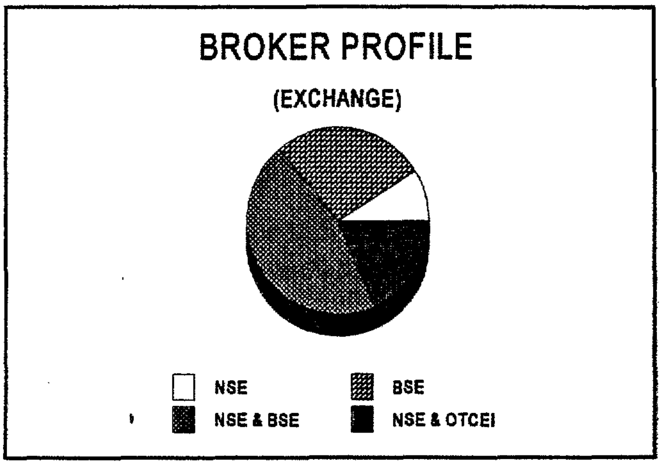
CHAPTER 7: ANALYSIS OF QUESTIONNAIRE RESPONSES

BROKER QUESTIONNAIRE RESPONSES

A total of **11** brokers and sub brokers in Bombay were surveyed and interviewed. The responses did not display much variation and hence the sample size was not increased. Following were the responses recorded.

1. Following was the profile of the brokers surveyed on the basis of exchange:

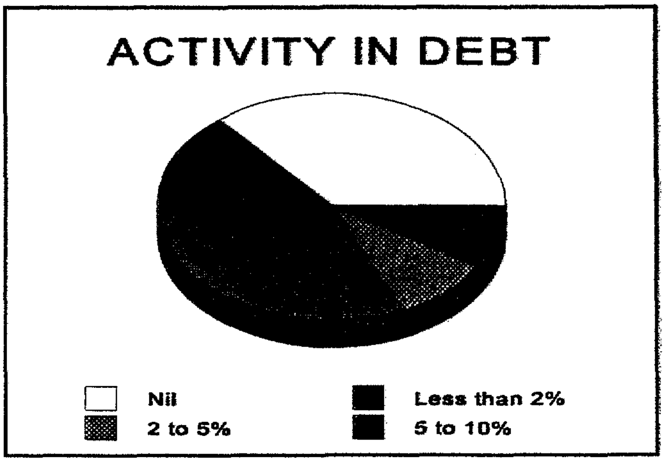
Exchange	Number	Percentage (%)
NSE	1	9.09
BSE	3	27.27
NSE & BSE	5	45.45
NSE & OTCEI	2	18.18



*67% of the brokers on NSE did not have debt market card.

2. Following was the percentage of activity in terms of volume in debt instruments:

Category	Number	Percentage (%)
Nil	4	36.36
Less than 2%	5	45.45
2 to 5%	1	9.09
5 to 10%	1	9.09

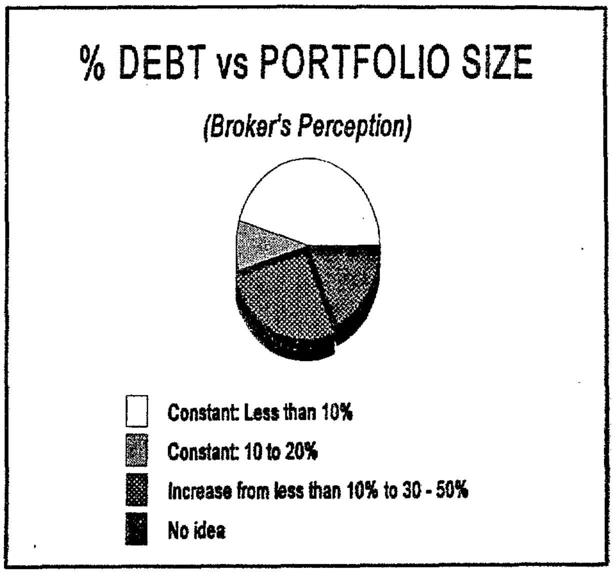


*The activity in debt instruments is so less because most of the brokers surveyed were in retail trade and there is very little debt activity in this segment.

3. Following were the responses to question about percentage of debt vs portfolio size:

Response	Number	Percentage (%)
Constant: Less than 10%	5	45.45
Constant: 10 to 20%	1	9.09
Increase from less than 10% to 30 - 50%	3	27.27
No idea	2	18.18

*The response goes against the hypothesis that percentage of debt increases with increase in portfolio size.



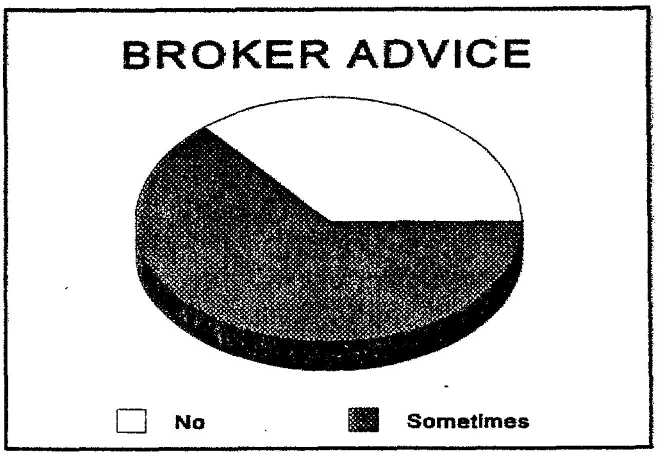
4. Since most of the brokers surveyed were dealing with retail clients only, the response to question 4 was "All" (in terms of no. as well as volume). However, for the few who were also into wholesale trade, the response was "Less than 10%" in terms of no. and "Less than 2%" in terms of volume.

5. For all the brokers surveyed, no retail client is trading actively in debt instruments. According to the brokers, the only trading activity of retail clients is selling the "khokha".

6. Following were the responses to question about brokers advising their clients to trade in debt instruments:

Response	Number	Percentage (%)
No	4	36.36
Sometimes	7	63.63

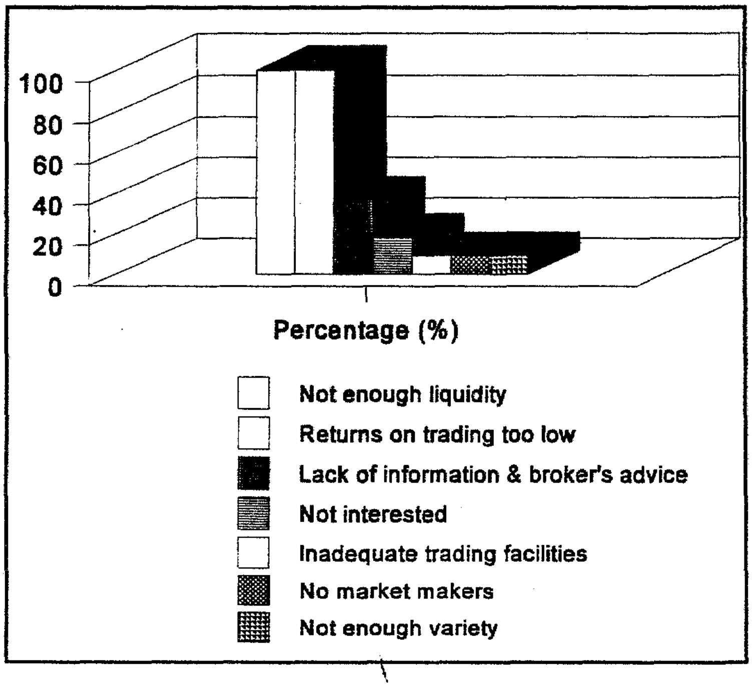
*Respondents answering "Sometimes" said that they advice clients to invest in debt instruments, not for trading with



them. They give this advice to old people, or to regular clients when the equity markets are dull.

7. Following were the responses received for brokers' perception of relevant reasons for retail investors not trading actively in debt instruments:

Reason	Number	Percentage (%)
Not enough liquidity	11	100
Returns on trading too low	11	100
Lack of information & broker's advice	4	36.36
Not interested	2	18.18
Inadequate trading facilities	1	9.09
No market makers	1	9.09
Not enough variety	1	9.09



8. Only 4 respondents were able to draw the profile of a retail investor trading in debt instruments. The profile is:

   * High Net Worth
   * Educated
   * Business Class

Salient Points made by brokers and sub brokers surveyed:

During the administration of questionnaire, the brokers and the sub brokers were also interviewed. Following are the salient points put forth by them:

1. IDBI bonds were not issued on pro rata basis. Everybody got the amount he had applied for. Hence demand in the secondary market is unlikely (This point was made before the news that IDBI has not been allowed to retain the oversubscription).

2. Investors are not much interested in long durations of 20 - 25 years because cannot predict the actual value of money at that time. (This is against the fact that 60% of IDBI issue went into 25 year paper).

3. Investors buy bonds mainly for tax shelter and not income.

4. Due to incidences of companies failing to fulfil their interest obligations and renewing the debentures when due for redemption, people have lost faith in issuers. However, companies like Reliance, TISCO still command faith among the investors.

5. People investing in debt instruments typically have the following profile:
   * Retired people
   * Govt. officials
   * Women looking for secured life in the absence of males.
   * People investing for Tax savings.

6. As compared to equity, returns on debt are too low.

7. IDBI issue was successful mainly because of dull equity markets. Any other issue now will not be as successful.

8. Investors are not interested in trading debt mainly because price fluctuation is not much. Equity shares are viewed as small investments with more return. Investors in secondary market are interested more in capital appreciation and not regular income.

9. High minimum limit on amount of GoI securities also prove to be a disincentive for retail investor.

10. The only debt instruments that investors are interested in are Fully convertible debentures (FCD) and Partly Convertible debentures (PCD). The only trading that these investors do is selling the "Khokha", the non convertible part of PCD.

11. Money invested in Badla financing yields 24 - 30% with commitment of only 1 week. Investment in debt instruments yields only 16 - 18% with no liquidity option.

12. An educated investor would shift his funds from Fixed deposits to debt instruments and later on to Mutual Funds.

13. Active secondary market trading in equity shares is mainly in the form of squaring off. Investors do not want to face the hassles of transfer procedures. Squaring off is possible only because of high liquidity in the market.

14. The first step to development of active secondary market in debt is market making. Only the big FIs have the financial strength to do it. But in private placements, they can bargain for higher returns. While a retail investor is satisfied with a return of 18 - 20%, these institutions demand 24-26%. In addition, the top management of these institutions ask for anything upto 1% as their commission. It is because of this selfish motive that they are not interested in developing secondary market liquidity since this will make the retail investor come to debt market in a big way and no issuer will go for private placements.

    The FIs should be forced to buy a part of their portfolio through secondary market and do market making.

15. At present, 80 - 90% of debt issues are private placements for which listing is not compulsory. Hence, even if the retail investor wants, he cannot participate in these scrips. Compulsory listing should be there for all issues.

16. IDBI issues of 1992 and 1996 were major success only because of one product, the DDB. No private sector corporate is allowed to offer this product and, hence, cannot tap the retail market in a big way. Therefore they have no other option but to go for private placements.

17. The retail debt market actually took off in 1992 with the IDBI issue of DDB.

18. Debt market is cyclical and has a strong correlation with the equity market. If one gets bad, the other picks up. After '91-'92, the debt market has picked up recently. Both the times, equity markets have been down.

19.The most important concern for any investor is the exit route. The put option and buy back schemes do provide the facility but there is no liquidity in between two put options. Hence the need for market making.

20.In future, a typical profile of person trading in debt instruments would be:
* High net worth (enough money left after investing in shares)
* Business Class
* Educated enough to predict the interest rate movements
(This profile is the polar opposite of an investor in these instruments today)

21.The investor considers debt secondary to equity. Hence for an investor with smaller portfolio, there is no room for debt while one with a bigger portfolio is likely to have some investment in debt.

22.Investor is not conversant with the trading modalities. For example, PSU bonds are transferable by endorsement and delivery. But before the interest payment is due, the issuer has to be informed about the transfer. People tend to forget interest dates and redemption dates of various scrips, especially ifthe
portfolio is big.

23.As regards the FDs, they have the following advantages over debenture/bonds issue:

* They are open throughout the year. This means that the investor can invest anytime he has surplus funds, unlike debt issues where he has to invest only when the issue is open. This also helps the issuer in cash management since he has continuous cash inflow and outflow whereas, in case of debt issue, funds flow in and out in bulk.
* They offer better liquidity options to the investor in terms of loans against deposits and premature withdrawals. These facilities have simple documentation and less time consuming. Also, no intermediaries are present. In case of bonds/debentures some issuers have now started offering put options but no liquidity is available in between two options.
* Investor psychology is such that he perceives FDs to be safer than other debt instruments.
* From the issuer's point of view, he has to take SEBI's permission everytime he comes out with an issue. For FDs, no permission is required.

The only disadvantage that FDs have is that they cannot offer more than 15% p.a. payable monthly (16.08% yield) and 1% brokerage cost. The issuers have circumvented this rule by offering incentives ranging from 2-6%. But, in an imperfect market, leakages do occur and investor does not get the full incentive always. In contrast, Bond market is transparent and all advantages are properly communicated to the investor.

24.The profile of an investor in FDs is:

* Age : 40 and above
* Service Class
* Risk averse
* Looks for assured/ fixed return. It is because of this reason that investor has not shown much interest in mutual funds.

25.Investors in different regions of the country have displayed different preferences.

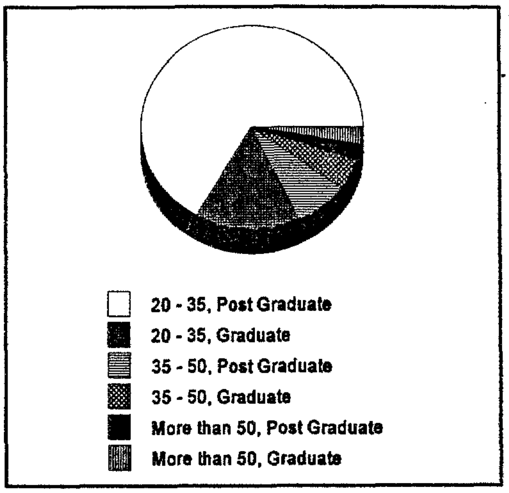
* In Madras region, investors are totally incentive oriented.
* Investors in North and South prefer 1 year deposits.
* Investors in West (Bombay) prefer 3 year deposits.

ANALYSIS OF INVESTOR RESPONSES IN BOMBAY:

A total of **39** investors were surveyed in Bombay. Following was the profile of the respondents:

1. All the respondents were in service.
2. In terms of age and qualification, following was the profile:

Age, Qualification	Number	Percentage (%)
20 - 35, Post Graduate	26	66.66
20 - 35, Graduate	6	15.38
35 - 50, Post Graduate	3	7.69
35 - 50, Graduate	2	5.12
More than 50, Post Graduate	1	2.56
More than 50, Graduate	1	2.56



Out of all the respondents, those in the age group 20 - 35 and post graduates were put in a separate category because of the following reasons:

1. These people are young and hence most preferable target for any long term strategy for development of secondary debt market.
2. They are highly educated and, according to feedback received from brokers and industry experts, the investors coming to secondary debt market would be educated.

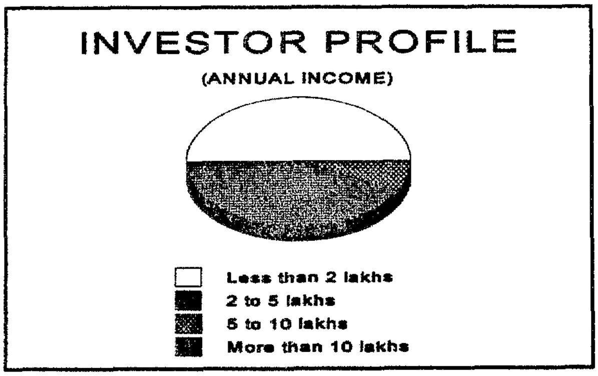
The rest of the respondents were analysed under "others" category.

Following were the responses received in the two categories:

Age Group 20 - 35 and Post Graduates:

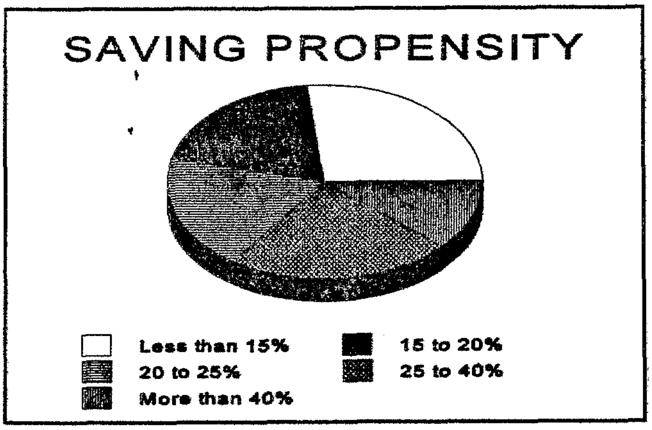
1. Profile of the respondents in terms of annual income:

Income	Number	Percentage (%)
Less than 2 lakhs	13	50.0
2 to 5 lakhs	11	42.31
5 to 10 lakhs	2	7.69
More than 10 lakhs	0	0.0



2. Following was the marginal propensity to save of the respondents:

Savings	Number	Percentage (%)
Less than 15%	7	26.92
15 to 20%	5	19.23
20 to 25%	5	19.23
25 to 40%	6	23.07
More than 40%	3	11.53



Average marginal propensity of the respondents is 23.84%.

3. Following was the investment profile observed of the investors in this category:

Investment Type		Category				
		Nil	Less than 10%	10 to 25%	25 to 50%	More than 50%
Physical Assets	No. of respondents	7	6	3	3	4
	Percentage (%)	30.42	26.08	13.0	13.04	17.39
	Cumulative Percentage(%)	30.42	56.5 *	69.5	82.54	99.93
Bank Deposits	No. of respondents	2	7	8	5	2
	Percentage (%)	8.33	29.16	33.30	20.83	8.33
	Cumulative Percentage(%)	8.33	37.49	70.79*	91.62	99.95
Non Tax Concession Debt	No. of respondents	9	9	7	0	0
	Percentage (%)	36	36	28	0	0
	Cumulative Percentage(%)	36 *	72	100	100	100
Tax Concession Debt	No. of respondents	4	5	10	5	0
	Percentage (%)	16.66	20.83	41.66	20.83	0
	Cumulative Percentage(%)	16.66	37.49 *	79.15	99.98	99.98
Mutual Funds	No. of respondents	9	10	5	2	0
	Percentage (%)	34.63	38.46	19.24	7.69	0
	Cumulative Percentage(%)	34.63	73.09 *	92.33	100.02	100.02
Equity Shares	No. of respondents	7	7	8	1	2
	Percentage (%)	28	28	32	4	8
	Cumulative Percentage(%)	28	56 *	88	92	100

* indicates Median Category.

In general, following trends can be observed in this category:

1. 56% of the respondents invest less than 10% in physical assets. This can possibly be because

of their young age.
2. 72% invest less than 10% of their assets in Non Tax Concession Debt. This shows that debt instruments are not a favourite investment opportunity even in this segment.
3. 62% of the investors in this category hold 10 to 50% of their assets in Tax concession debt. This shows that the investors are educated enough to do their tax planning.
4. 73% of the respondents invest less than 10% of their assets in Mutual Funds.
5. 56% of the respondents invest less than 10% in Equity Shares. This again emphasises the fact that they are educated enough to realise that they cannot make abnormal gains on equity.

4. The investors in this category display the following investment behaviour with regards to their incremental deposits in the following year:

Investment Type		Category				
		Nil	Less than 10%	10 to 25%	25 to 50%	More than 50%
Physical Assets	No. of respondents	4	9	4	4	3
	Percentage (%)	16.66	37.50	16.70	16.66	12.50
	Cumulative Percentage(%)	16.66	54.16 *	70.86	87.52	100.02
Bank Deposits	No. of respondents	2	9	7	3	2
	Percentage (%)	8.69	39.13	30.40	13.04	8.69
	Cumulative Percentage(%)	8.69	47.82 *	78.22	91.26	99.95
Non Tax Concession Debt	No. of respondents	6	7	10	2	0
	Percentage (%)	24	28	40	8	0
	Cumulative Percentage(%)	24	52 *	92	100	0
Tax Concession Debt	No. of respondents	3	5	14	3	0
	Percentage (%)	12	20	56	12	0
	Cumulative Percentage(%)	12	32 *	88	100	100
Mutual Funds	No. of respondents	9	5	7	2	0
	Percentage (%)	39.14	21.73	30.40	8.69	0.0
	Cumulative Percentage(%)	39.14	60.87 *	91.27	99.96	99.96

Investment Type		Category				
		Nil	Less than 10%	10 to 25%	25 to 50%	More than 50%
Equity Shares	No. of respondents	4	4	12	4	1
	Percentage (%)	16	16	48	16	4
	Cumulative Percentage(%)	16	32 *	80	96	100

* indicates Median Category.

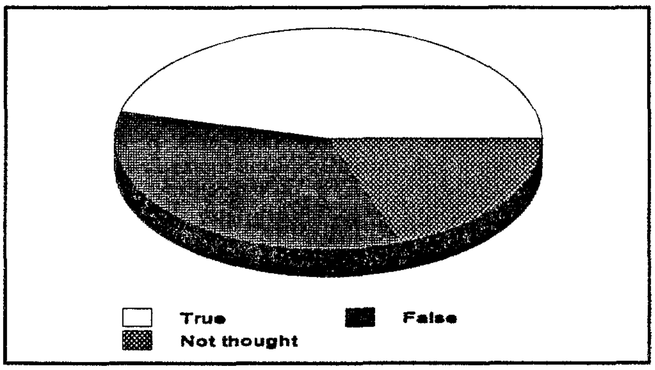
In general, following trends can be observed in this category:

1. 54% of the respondents plan to invest less than 10% in Physical Assets.
2. 40% and 56% of the respondents plan to invest 10 to 25% Non Tax Concession Debt and Tax Concession Debt respectively. This makes them potential customers for debt instruments.
3. 60% of the respondents will invest less than 10% of their savings in Mutual Funds.
4. 80% of the respondents will invest less than 25% in equity.

On the whole, based on their present and future investment patterns, one can conclude that this segment is going to come heavily in debt market.

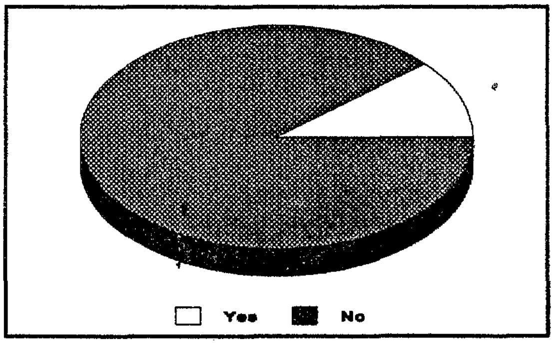
5. On the question about awareness of capital appreciation on debt instruments trading, following were the responses:

Response	Number	Percentage (%)
True	12	46.15
False	9	34.61
Not thought	5	19.23



6. Following were the responses to question about people trading regularly in debt instruments:

Response	Number	Percentage (%)
Yes	3	11.5
No	23	88.4



7. Following was the rating given to various reasons for dull secondary retail debt market:

Reason	No. of respondents for each rating					Mean Rating
	1	2	3	4	5	
Not Enough Variety	3	5	5	6	4	3.13
Not Enough Liquidity	4	2	8	1	9	3.37
Returns too low	4	5	8	5	2	2.83
Not interested	4	7	6	5	2	2.75
Cumbersome settlement	6	1	5	6	5	3.13
Stamp Duties and Taxes	4	5	9	2	3	2.78
Lack of information & advice	3	1	3	8	10	3.84

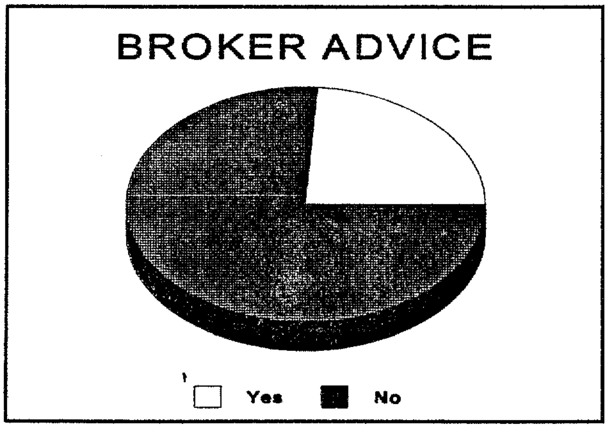
As is clearly evident from the analysis, the two most important reasons are:

1. Lack of information and investment advice.
2. Not enough liquidity in the market.

The other important reasons are absence of enough variety of instruments and cumbersome settlement facilities.

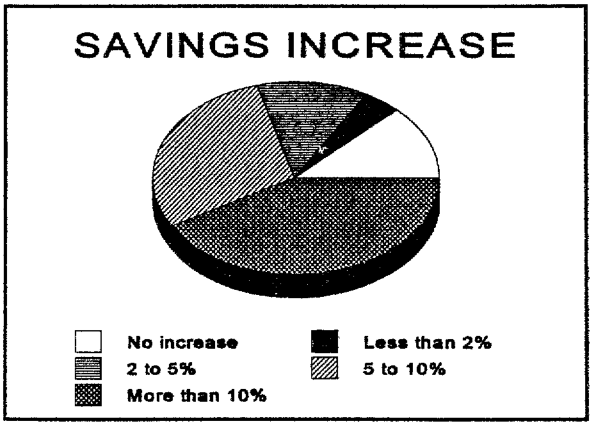
8. Following were the answers received for broker advice on buying and selling debt instruments in the secondary market:

Response	Number	Percentage (%)
Yes	6	24
No	19	76



9. In case the reforms are implemented, following would be the increase in the marginal propensity to save in this category of investors:

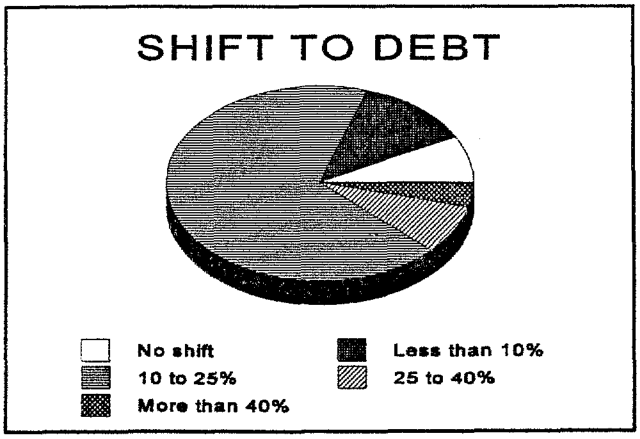
Increase	Number	Percentage (%)
No increase	3	12.50
Less than 2%	1	4.167
2 to 5%	3	12.50
5 to 10%	7	29.16
More than 10%	10	41.66



Average increase in savings is 7.1% of current savings which means the rising of marginal propensity to save to approximately 26% which would yield substantial funds for investment.

10.In the reformed scenario, following would be the extent of shift towards debt instruments:

Shift	Number	Percentage (%)
No shift	2	8
Less than 10%	3	12
10 to 25%	17	68
25 to 40%	2	8
More than 40%	1	4



As can be seen, 68% of the investors will shift 10 to 25% of their investment to debt which is a very healthy sign.

In such a scenario, the majority of funds will come from the following:

Shift From	Number	Percentage (%)
Bank Deposits	7	46.6
Equity Shares	3	20
Mutual funds	5	33.33

Hence, it can be said that funds will flow out from all other investment opportunities but mostly from Bank Deposits.

11.Following are the kinds of returns that investors expect from various investment opportunities:

Investment Type		Returns Expected			
		10 to 15%	15 to 25%	25 to 40%	More than 40%
Physical Assets	No. of respondents	7	9	4	3
	Percentage (%)	30.43	39.13	17.39	13.04
	Cumulative Percentage(%)	30.43	69.56*	86.95	99.99
Bank Deposits	No. of respondents	22	2	0	0
	Percentage (%)	91.66	8.33	0	0
	Cumulative Percentage(%)	91.66 *	99.99	99.99	99.99
Non Tax Concession Debt	No. of respondents	9	13	2	0
	Percentage (%)	37.50	54.16	8.33	0.0
	Cumulative Percentage(%)	37.5 *	91.66	99.99	99.99
Tax Concession Debt	No. of respondents	15	10	0	0
	Percentage (%)	60	40	0	0
	Cumulative Percentage(%)	60*	100	100	100
Mutual Funds	No. of respondents	8	13	2	0
	Percentage (%)	34.78	56.52	8.69	0.0
	Cumulative Percentage(%)	34.78 *	91.3	99.99	99.99
Equity Shares	No. of respondents	3	9	7	5
	Percentage (%)	12.50	37.50	29.16	20.83
	Cumulative Percentage(%)	12.5	50 *	79.16	99.99

* indicates Median Category.

At the same time, following are the risk perceptions of various investment opportunities in the minds of investors:

Investment type	No. of respondents for each rating					Mean Rating
	1	2	3	4	5	
Physical Assets	14	5	3	2	1	1.76
Bank Deposits	19	5	1	0	0	1.28
Non Tax Concession Debt	5	11	8	1	0	2.2
Tax Concession Debt	9	10	5	0	0	1.83
Mutual Funds	0	1	3	10	11	4.24
Equity shares	0	4	9	6	6	3.56

Thus following rankings can be given to the various investment opportunities:

On the basis of return:
1. Equity Shares and Physical Assets.
2. Bank Deposits, Non Tax Concession Debt, Tax concession Debt and Mutual Funds.

On the basis of risk:
1. Mutual funds
2. Equity Shares
3. Non Tax Concession Debt
4. Tax Concession Debt
5. Physical Assets
6. Bank Deposits

Thus, physical assets seem to be the favourite in this category of investors. Debt instruments are perceived as low risk low return instruments.

12.Following was the ranking given to various kinds of debt instruments according to investor preferences:

Debt instrument		Rank					Median Rank
		1	2	3	4	5	
GoI Securities	No. of respondents	3	1	3	7	11	4
	Percentage (%)	12	4	12	28	44	
	Cumulative %	12	16	28	56 *	100	
PSU/ FI Bonds	No. of respondents	8	10	4	2	1	1
	Percentage (%)	32	40	16	8	4	
	Cumulative %	32 *	72	88	96	100	
Corporate Debentures	No. of respondents	8	5	6	6	0	2
	Percentage (%)	32	20	24	24	0	
	Cumulative %	32	52*	76	100	100	
Company FDs	No. of respondents	1	5	7	5	6	3
	Percentage (%)	4.16	20.84	29.16	20.83	25.0	
	Cumulative %	4.16	25	54.16*	74.99	99.99	
Bank FDs	No. of respondents	3	2	6	4	6	3
	Percentage (%)	14.30	9.52	28.57	19.04	28.56	
	Cumulative %	14.3	23.82	52.39 *	71.43	99.99	

* indicates Median Rank

Following points need to be noted:

1. PSU/FI Bonds have been rated first mainly because of the high acceptability of Deep Discount Bond in the retail segment.
2. GoI securities have been rated least which shows that the Govt. needs to take steps to build investor trust before it can think of tapping the retail market.

13.Following was the ranking given to the various maturity options according to investor preferences:

Maturity Option		Rank			Median Rank
		1	2	3	
Long Term	No. of respondents	2	5	18	N.A.
	Percentage (%)	8	20	72	
	Cumulative Percentage (%)	8	28	100	
Medium Term	No. of respondents	10	14	1	N.A.
	Percentage (%)	40	56	4	
	Cumulative Percentage (%)	40	96	16	
Short Term	No. of respondents	14	6	6	N.A.
	Percentage (%)	53.84	23.07	23.07	
	Cumulative Percentage (%)	53.84	76.91	99.98	

The median ranks have not been calculated in this case because of highly skewed distribution. As can be observed from the data:

1. 53% of the respondents prefer short term instruments.
2. 56% of the respondents have ranked medium term instruments as second.
3. 72% of the respondents have ranked long term. instruments as third. This goes against the fact that the Deep Discount Bond has been a major success in the retail debt market.

With an active secondary market, the investors would not be averse to investing in long term instruments which is what most of the issuers need since most of them are long term lenders for the industry.

14. The investors showed the following preferences for measures to reduce the risk of depreciation of portfolio:

Measure		Rank			Median Rank
		1	2	3	
Put Option	No. of respondents	2	5	18	N.A.
	Percentage (%)	8	20	72	
	Cumulative Percentage (%)	8	28	100	
Active Secondary Market	No. of respondents	10	14	1	N.A.
	Percentage (%)	40	56	4	
	Cumulative Percentage (%)	40	96	100	
Compulsory Market Making	No. of respondents	14	6	6	N.A.
	Percentage (%)	53.84	23.07	23.07	
	Cumulative Percentage (%)	53.84	76.91	99.98	

Once again, the median has not been calculated due to highly skewed distribution. The following can be observed from the data:

1. 54% of the respondents have preferred market making over any other option.
2. 56% of the respondents have ranked active secondary market as second.
3. 72% of the respondents have preferred the put option the least.

This makes a case for active market making in the secondary market.

15.Following was the importance of various factors which went into an individual's investment decision making:

Factor		Rank			Median Rank
		1	2	3	
Name of the company	No. of respondents	3	10	7	2
	Percentage (%)	15.0	50.0	35.0	
	Cumulative Percentage (%)	15	65	100	
Credit Rating	No. of respondents	14	6	2	1
	Percentage (%)	63.63	27.27	9.09	
	Cumulative Percentage (%)	63.63	90.9	99.99	
Industry Sector	No. of respondents	5	5	10	2
	Percentage (%)	25	25	50	
	Cumulative Percentage (%)	25	50	100	

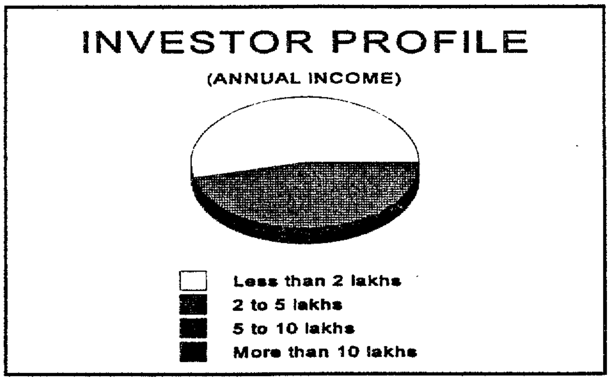
Investors in this category give more weightage to credit rating which is an indication them being mature and educated.

Others:

Following were the responses of the other investors:

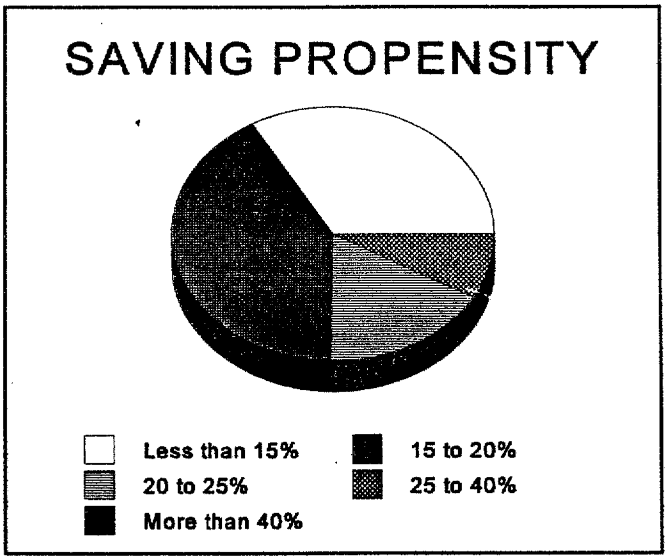
1. Profile of the respondents in terms of annual income:

Income	Number	Percentage (%)
Less than 2 lakhs	7	53.84
2 to 5 lakhs	6	46.15
5 to 10 lakhs	0	0
More than 10 lakhs	0	0



2. Following was the marginal propensity to save of the respondents:

Savings	Number	Percentage (%)
Less than 15%	4	33.33
15 to 20%	5	41.66
20 to 25%	2	16.67
25 to 40%	1	8.33
More than 40%	0	0



Average marginal propensity to save in this category is 19.75 which is low and signifies less funds available for investment.

3. Following was the investment profile observed of the investors in this category:

Investment Type		Category				
		Nil	Less than 10%	10 to 25%	25 to 50%	More than 50%
Physical Assets	No. of respondents	1	2	3	1	4
	Percentage (%)	9.09	18.18	27.27	9.09	36.36
	Cumulative Percentage(%)	9.09	27.27	54.54*	63.63	99.99
Bank Deposits	No. of respondents	2	3	7	0	0
	Percentage (%)	16.67	25	58.33	0	0
	Cumulative Percentage(%)	16.67	41.67 *	100	100	100
Non Tax Concession Debt	No. of respondents	4	2	3	1	0
	Percentage (%)	40	20	30	10	0
	Cumulative Percentage(%)	40	60 *	90	100	100
Tax Concession Debt	No. of respondents	5	1	4	1	1
	Percentage (%)	41.67	8.33	33.33	8.33	8.33
	Cumulative Percentage(%)	41.67	50 *	83.33	91.66	99.99
Mutual Funds	No. of respondents	2	1	2	3	0
	Percentage (%)	25	12.5	25	37.5	0
	Cumulative Percentage(%)	25	37.5 *	62.5	100	100
Equity Shares	No. of respondents	5	3	2	0	0
	Percentage (%)	50	30	20	0	0
	Cumulative Percentage(%)	50 *	80	100	100	100

* indicates Median Category.

In general, following trends can be observed in this category:

1. As is evident from the saving propensity analysis also, the investment is this category is very

less.

2. 40% of the respondents do not hold any Non Tax Concession debt and 41% do not hold any Tax Concession debt.
3. 50% of the respondents do not invest in equity shares.
4. However, 59% of the respondents hold 10 to 25% of their assets in Bank Deposits. This means that if liquidity in debt instruments improves and the issuers gain the same investor trust that Banks have, these funds can flow into the debt segment.

4. Of their incremental savings, the investors plan to invest the following in each investment category:

Investment Type		Category				
		Nil	Less than 10%	10 to 25%	25 to 50%	More than 50%
Physical Assets	No. of respondents	1	4	1	1	1
	Percentage (%)	12.5	50	12.5	12.5	12.5
	Cumulative Percentage(%)	12.5	62.5 *	75	87.5	100
Bank Deposits	No. of respondents	2	2	3	1	0
	Percentage (%)	25	25	37.5	12.5	0
	Cumulative Percentage(%)	25	50 *	87.5	100	100
Non Tax Concession Debt	No. of respondents	2	3	1	2	0
	Percentage (%)	25	37.5	12.5	25	0
	Cumulative Percentage(%)	25	62.5*	75	100	100
Tax Concession Debt	No. of respondents	2	0	4	2	2
	Percentage (%)	20	0	40	20	20
	Cumulative Percentage(%)	20	20	60 *	80	100
Mutual Funds	No. of respondents	2	2	1	2	0
	Percentage (%)	28.5	28.5	14.2	28.5	0
	Cumulative Percentage(%)	28.5	57 *	71.2	99.7	99.7

Investment Type		Category				
		Nil	Less than 10%	10 to 25%	25 to 50%	More than 50%
Equity Shares	No. of respondents	4	2	2	0	0
	Percentage (%)	50	25	25	0	0
	Cumulative Percentage(%)	50*	75	100	100	100

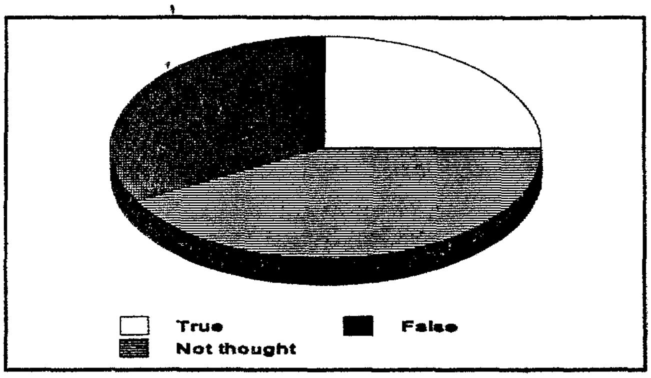
* indicates Median Category.

In general, following trends can be observed in this category:

1. Once again, it is evident that very few funds are being mobilised from this segment.
2. However, 80% of the respondents plan to invest more than 10% in Tax Concession Debt which is a healthy sign.

5. On the question about awareness of capital appreciation on debt instruments trading, following were the responses:

Response	Number	Percentage (%)
True	3	25
False	4	33.33
Not thought	5	41.67



As the analysis clearly shows that 75% of the respondents feel that the statement is false or have not thought about it. Hence the need for investor education.

6. Following were the responses to question about people trading regularly in debt instruments:

Response	Number	Percentage (%)
Yes	0	0
No	11	100

Hence, none of the respondents trade actively in debt which also draws from the fact that majority of them do not hold any form of debt instrument.

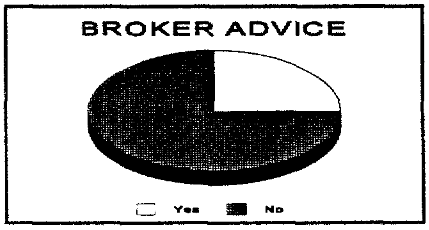
7. Following was the rating given to various reasons for dull secondary retail debt market:

Reason	No. of respondents for each rating					Mean Rating
	1	2	3	4	5	
Not Enough Variety	3	2	3	0	4	3
Not Enough Liquidity	0	1	1	5	4	4.09
Returns too low	0	4	2	2	3	3.36
Not interested	2	2	4	2	1	2.8
Cumbersome settlement	1	2	2	3	2	3.3
Stamp Duties and Taxes	3	4	1	3	0	2.36
Lack of information & advice	1	1	3	3	4	3.67

Once again, Lack of information and absence of liquidity come forth as the two most important reasons.

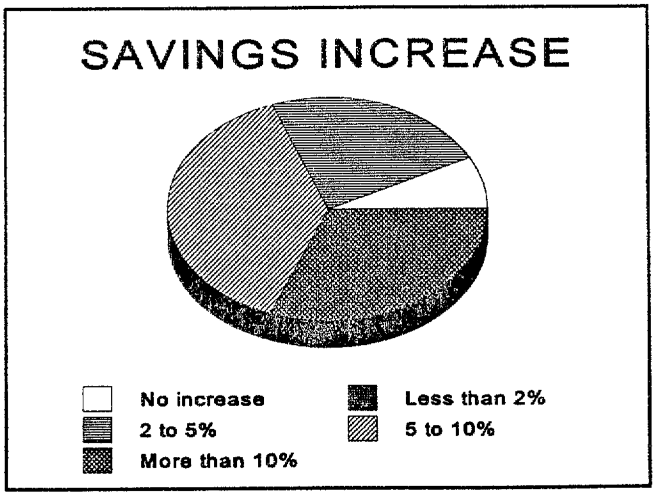
8. Following were the answers received for broker advice on buying and selling debt instruments in the secondary market:

Response	Number	Percentage (%)
Yes	3	25
No	9	75



9. In case the reforms are implemented, following would be the increase in the marginal propensity to save in this category of investors:

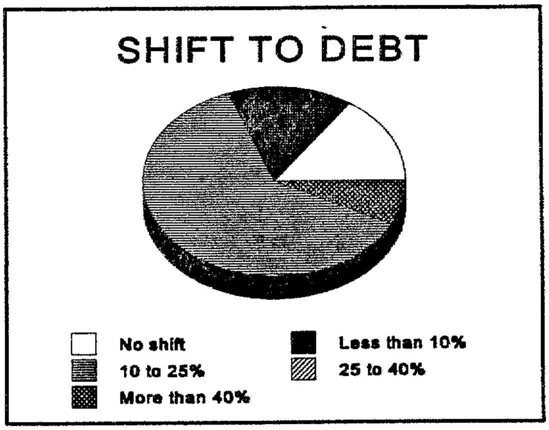
Increase	Number	Percentage (%)
No increase	1	7.69
Less than 2%	0	0
2 to 5%	3	23.07
5 to 10%	5	38.47
More than 10%	4	30.77



Average increase in savings will be 6.53% of current savings which is urgently required in this segment.

10. In the reformed scenario, following would be the shift towards investment in debt instruments:

Shift	Number	Percentage (%)
No shift	2	15.38
Less than 10%	2	15.38
10 to 25%	8	61.53
25 to 40%	0	0
More than 40%	1	7.69



In such a scenario, the majority of funds will come from the following:

Shift From	Number	Percentage (%)
Bank Deposits	2	40
Equity Shares	3	60
Mutual funds	0	0

11.Following are the kinds of returns that investors expect from various investment opportunities:

Investment Type		Returns Expected			
		10 to 15%	15 to 25%	25 to 40%	More than 40%
Physical Assets	No. of respondents	4	3	2	2
	Percentage (%)	36.37	27.27	18.18	18.18
	Cumulative Percentage(%)	36.37	63.64 *	81.82	100
Bank Deposits	No. of respondents	5	1	0	0
	Percentage (%)	83.33	16.16	0	0
	Cumulative Percentage(%)	83.33 *	99.99	99.99	99.99
Non Tax Concession Debt	No. of respondents	4	6	0	0
	Percentage (%)	40	60	0	0
	Cumulative Percentage(%)	40 *	100	100	100
Tax Concession Debt	No. of respondents	7	5	0	0
	Percentage (%)	58.33	41.67	0	0
	Cumulative Percentage(%)	58.33 *	100	100	100
Mutual Funds	No. of respondents	1	5	1	0
	Percentage (%)	14.28	71.42	14.28	0
	Cumulative Percentage(%)	14.28	85.7 *	99.98	99.98

Investment Type		Returns Expected			
		10 to 15%	15 to 25%	25 to 40%	More than 40%
Equity Shares	No. of respondents	2	1	5	1
	Percentage (%)	22.22	11.11	55.56	11.11
	Cumulative Percentage(%)	22.22	33.33 *	88.89	100

* indicates Median Category.

At the same time, following are the risk perceptions of various investment opportunities in the minds of investors:

Investment type	No. of respondents for each rating					Mean Rating
	1	2	3	4	5	
Physical Assets	8	4	0	0	0	1.33
Bank Deposits	9	2	1	0	0	1.33
Non Tax Concession Debt	0	7	4	1	1	2.69
Tax Concession Debt	5	4	1	2	0	2
Mutual Funds	0	0	4	4	4	4
Equity shares	0	0	0	5	8	4.61

Following is the ranking on the basis of returns expected:

1. Physical Assets, Mutual Funds and Equity Shares.
2. Bank Deposits, Non Tax Concession debt and Tax Concession Debt.

Following is the ranking based in risk perceived:
1. Equity Shares
2. Mutual Funds
3. Non Tax Concession Debt
4. Tax Concession Debt
5. Physical Assets and Bank Deposits

Again, Physical assets seem to be the favourite with highest perceived returns and lowest perceived risk.

12. Following was the ranking given to various kinds of debt instruments according to investor preferences:

Debt instrument		Rank					Median Rank
		1	2	3	4	5	
GoI Securities	No. of respondents	2	2	2	0	5	3
	Percentage (%)	18.18	18.18	18.18	0	45.45	
	Cumulative %	18.18	36.36	54.54	54.54	99.99	
PSU/ FI Bonds	No. of respondents	3	6	3	1	0	2
	Percentage (%)	23.07	46.15	23.07	7.69	0	
	Cumulative %	23.07	69.22	92.29	99.98	99.98	
Corporate Debentures	No. of respondents	1	4	4	3	1	2
	Percentage (%)	7.69	30.76	30.76	23.07	7.69	
	Cumulative %	7.69	38.45	69.21	92.28	99.97	
Company FDs	No. of respondents	4	0	2	4	3	3
	Percentage (%)	30.76	0	15.38	30.76	23.07	
	Cumulative %	30.76	30.76	46.14	76.9	99.97	
Bank FDs	No. of respondents	4	0	3	5	1	3
	Percentage (%)	30.76	0	23.07	38.46	7.69	
	Cumulative %	30.76	30.76	53.83	92.29	99.98	

Thus investors in this category have not displayed any marked preference for any investment opportunity.

13.Following was the ranking given to the various maturity options according to investor preferences:

Maturity Option		Rank			Median Rank
		1	2	3	
Long Term	No. of respondents	3	3	6	2
	Percentage (%)	25	25	50	
	Cumulative Percentage (%)	25	50	100	
Medium Term	No. of respondents	6	5	2	1
	Percentage (%)	46.15	38.46	15.38	
	Cumulative Percentage (%)	46.15	84.61	99.99	
Short Term	No. of respondents	4	4	4	2
	Percentage (%)	33.33	33.33	33.33	
	Cumulative Percentage (%)	33.33	66.67	99.99	

The investors in this category have preferred 5 to 10 year investment over any other type.

14.The investors showed the following preferences for measures to reduce the risk of depreciation of portfolio:

Measure		Rank			Median Rank
		1	2	3	
Put Option	No. of respondents	6	2	2	1
	Percentage (%)	60	20	20	
	Cumulative Percentage (%)	60	80	100	
Active Secondary Market	No. of respondents	4	3	4	2
	Percentage (%)	36.36	27.27	36.36	
	Cumulative Percentage (%)	36.36	63.63	99.99	

Measure		Rank			Median Rank
		1	2	3	
Compulsory Market Making	No. of respondents	1	5	4	2
	Percentage (%)	10	50	40	
	Cumulative Percentage (%)	10	60	100	

Respondents in this category have preferred put options to others.

15.Following was the importance of various factors which went into an individual's investment decision making:

Factor		Rank			Median Rank
		1	2	3	
Name of the company	No. of respondents	6	2	3	1
	Percentage (%)	54.54	18.18	27.27	
	Cumulative Percentage (%)	54.54	72.72	99.99	
Credit Rating	No. of respondents	6	3	3	1
	Percentage (%)	50	25	25	
	Cumulative Percentage (%)	50	100	100	
Industry Sector	No. of respondents	0	6	5	2
	Percentage (%)	0	54.54	45.45	
	Cumulative Percentage (%)	0	54.54	99.99	

Investors giving high weightage to credit rating is a good sign. At the same time giving equal weightage to name of the company also is not a sign of maturity.

ANALYSIS OF INVESTOR RESPONSES IN CALCUTTA:

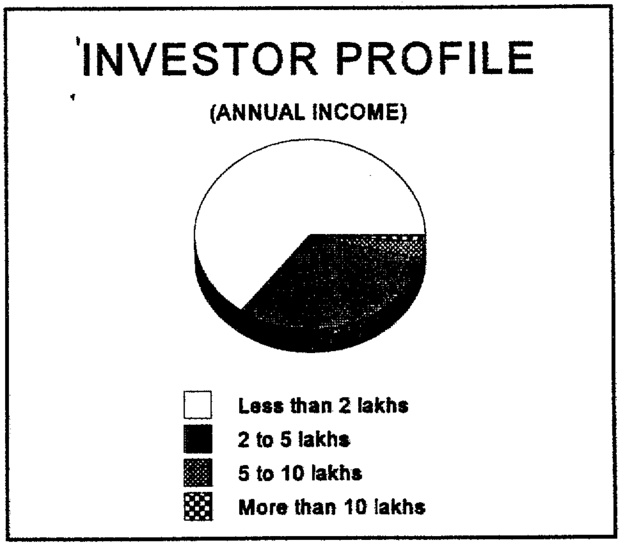
The Investor Questionnaire was administered in Calcutta at the Direct Contact Investor Education Programme organised by Invest India on May 24 - 26, 1996. Due to investors being busy in the programme and not being able to spare substantial time, the whole questionnaire was not administered. Only the following questions were asked to the respondents:

1. Question 4 to determine the investor profile in terms of annual income at his disposal.
2. Question 5 to determine the marginal propensity to save.
3. Question 6 to find out his investment profile in terms of percentage of assets he holds in each type of investment opportunities.
4. Question 10 to know the investors' perception about the various reasons of secondary retail debt market being dull.
5. Question 16 to understand the investors' preferences for various kinds of debt instruments available in the market.

A total of **100** investors were surveyed in Calcutta. Following responses were recorded:

1. Profile of the respondents in terms of annual income:

Income	Number	Percentage (%)
Less than 2 lakhs	65	65
2 to 5 lakhs	31	31
5 to 10 lakhs	3	3
More than 10 lakhs	1	1

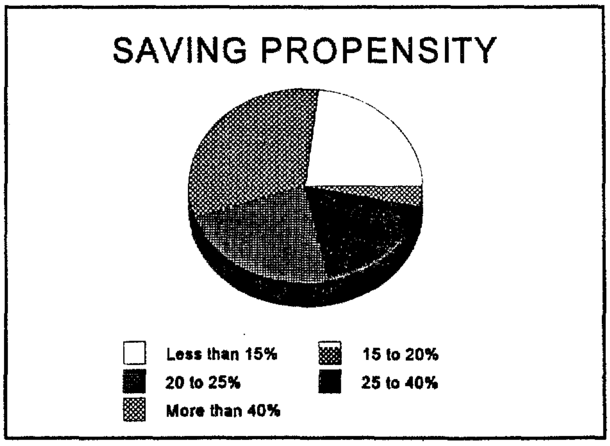


Based on annual income, the respondents were divided into two categories : Those with income less than 2 lakhs and those with income greater than 2 lakhs. Following are the responses received in the two categories:

Annual Income Less than 2 lakhs:

1. Following was the marginal propensity to save of the respondents:

Savings	Number	Percentage (%)
Less than 15%	15	23.07
15 to 20%	21	32.30
20 to 25%	15	23.07
25 to 40%	12	18.46
More than 40%	2	3.07



The average marginal propensity to save works out to 24.61%.

2. Following was the investment profile observed of the investors in this category:

Investment Type		Category				
		Nil	Less than 10%	10 to 25%	25 to 50%	More than 50%
Physical Assets	No. of respondents	9	10	17	14	7
	Percentage (%)	15.7	17.5	29.8	24.5	12.2
	Cumulative Percentage(%)	15.7	33.2	63 *	87.5	99.7
Bank Deposits	No. of respondents	3	25	23	7	1
	Percentage (%)	5.1	42.3	38.9	11.9	1.7
	Cumulative Percentage(%)	5.1	47.4 *	86.3	98.2	99.9
Non Tax Concession Debt	No. of respondents	16	22	14	4	0
	Percentage (%)	28.6	39.2	25.0	7.2	0
	Cumulative Percentage(%)	28.6	67.8 *	92.8	100	100

Investment Type		Category				
		Nil	Less than 10%	10 to 25%	25 to 50%	More than 50%
Tax Concession Debt	No. of respondents	9	21	18	3	1
	Percentage (%)	17.3	40.3	34.6	5.7	1.9
	Cumulative Percentage(%)	17.3	57.6 *	92.2	97.9	99.8
Mutual Funds	No. of respondents	8	32	10	4	3
	Percentage (%)	14.1	56.14	17.5	7.1	5.2
	Cumulative Percentage(%)	14.1	70.2 *	87.7	94.8	100
Equity Shares	No. of respondents	7	19	14	10	8
	Percentage (%)	12.1	32.7	24.1	17.2	13.7
	Cumulative Percentage(%)	12.1	44.8 *	68.9	86.1	99.8

* indicates Median Category.

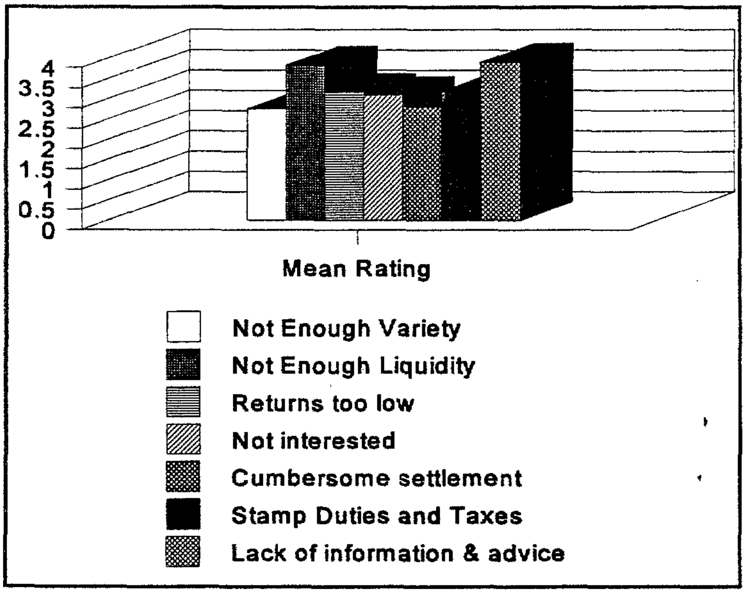
In general, following trends can be observed in this category:

1. 55% of the respondents hold 10 to 50% of their assets as physical assets.
2. 81% of the respondents hold upto 25% of their assets in Bank Deposits.
3. 68% of the respondents hold less than 10% of their assets in Non Tax Concession Debt.
4. 58% of the respondents hold less than 10% of their assets in Tax Concession Debt.
5. 70% of the respondents invest less than 10% of their assets in Mutual Funds.
6. 75% of the respondents invest upto 25% of their assets in Equity Shares.

3. Following was the rating given to various reasons for dull secondary retail debt market:

Reason	No. of respondents for each rating					Mean Rating
	1	2	3	4	5	
Not Enough Variety	7	11	5	3	7	2.75
Not Enough Liquidity	6	2	6	8	21	3.83
Returns too low	9	7	8	8	12	3.16

Reason	No. of respondents for each rating					Mean Rating
	1	2	3	4	5	
Cumbersome settlement	10	7	12	5	7	2.80
Stamp Duties and Taxes	5	9	7	6	10	3.18
Lack of information & advice	6	8	1	5	30	3.90



4. Following were the rankings given to various debt instruments by investors in this category:

Debt instrument		Rank					Median Rank
		1	2	3	4	5	
GoI Securities	No. of respondents	9	5	5	6	21	4
	Percentage (%)	19.5	10.8	10.8	13.1	45.6	
	Cumulative %	19.5	30.3	41.1	54.2	99.8	
PSU/ FI Bonds	No. of respondents	11	16	10	11	3	2
	Percentage (%)	21.6	31.3	19.6	21.5	5.9	
	Cumulative %	21.6	52.9	72.5	94.0	99.9	

Debt instrument		Rank					Median Rank
		1	2	3	4	5	
Corporate Debentures	No. of respondents	13	12	10	12	4	2
	Percentage (%)	25.4	23.5	19.6	23.5	7.8	
	Cumulative %	25.4	48.9	68.5	92.0	99.8	
Company FDs	No. of respondents	10	3	16	7	14	3
	Percentage (%)	20	6	32	14	28	
	Cumulative %	20	26	58	72	100	
Bank FDs	No. of respondents	15	14	8	10	4	2
	Percentage (%)	29.4	27.4	15.6	19.6	7.8	
	Cumulative %	29.4	56.8	72.4	92.0	99.8	

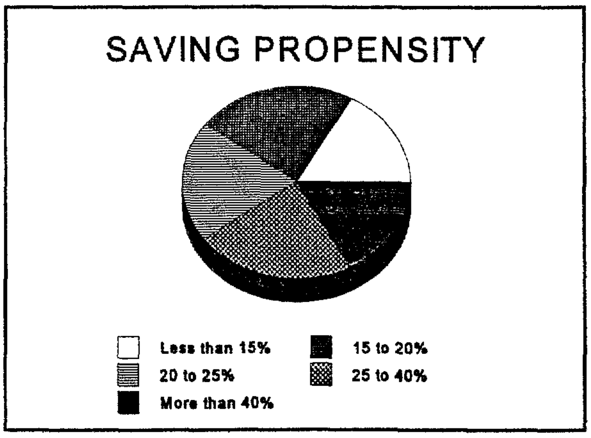
Following points can be concluded from the above analysis:

1. Govt. of India debt, though sovereign debt, is the least popular instrument among all.
2. PSU/ FI bonds have become the favourites of retail investor. This is mainly because of the design of these instruments, especially the Deep Discount bond.
3. Bank FDs still hold a higher rating in the minds of investor inspite of giving lower yields compared to Company FDs. This can be because of the higher perceived safety associated with the former.

Annual Income More than 2 lakhs

1. Following was the marginal propensity to save observed in this category:

Savings	Number	Percentage (%)
Less than 15%	6	17.14
15 to 20%	8	22.85
20 to 25%	7	20.0
25 to 40%	8	22.85
More than 40%	6	17.14



The average marginal propensity to save in this category is 25.36%.

2. Following was the investment profile observed of the investors in this category:

Investment Type		Category				
		Nil	Less than 10%	10 to 25%	25 to 50%	More than 50%
Physical Assets	No. of respondents	0	3	7	13	7
	Percentage (%)	0.0	10.0	23.30	43.33	23.33
	Cumulative Percentage(%)	0.0	10.0	33.3	76.33 *	99.96
Bank Deposits	No. of respondents	2	16	9	3	0
	Percentage (%)	6.66	53.33	30.0	10.0	0.0
	Cumulative Percentage(%)	6.66	59.99 *	89.99	99.99	99.99
Non Tax Concession Debt	No. of respondents	2	16	10	0	0
	Percentage (%)	7.14	57.14	35.70	0.0	0.0
	Cumulative Percentage(%)	7.14	64.28 *	99.98	99.98	99.98

Investment Type		Category				
		Nil	Less than 10%	10 to 25%	25 to 50%	More than 50%
Tax Concession Debt	No. of respondents	0	17	8	3	1
	Percentage (%)	0	58.62	27.6	10.34	3.44
	Cumulative Percentage(%)	0	58.62 *	86.22	96.56	100
Mutual Funds	No. of respondents	2	15	10	3	2
	Percentage (%)	6.25	46.87	31.3	9.37	6.25
	Cumulative Percentage(%)	6.25	53.12 *	84.42	93.79	100.04
Equity Shares	No. of respondents	1	15	12	8	7
	Percentage (%)	2.32	34.88	27.9	18.60	16.27
	Cumulative Percentage(%)	2.32	37.2 *	65.1	83.7	99.97

* indicates Median Category.

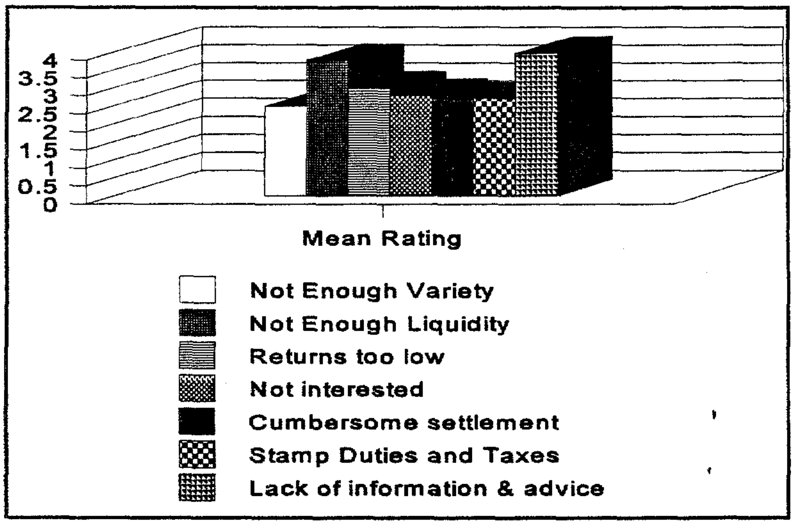
In general, following trends can be observed in this category:

1. 44% of the respondents hold 25 - 50% of their assets as physical assets.
2. 60% of the respondents have less than 10% of their assets in Bank Deposits which seems too be abnormal since the respondents have not displayed very high investments in any other category.
3. 65% of the respondents invest less than 10% of their assets in Non Tax Concession Debt.
4. 59% of the respondents invest less than 10% of their assets in tax Concession Debt.
5. 54% of the investors surveyed invest less than 10% of their investment in Mutual Funds.

3. Following was the rating given to various reasons for dull secondary retail debt market:

Reason	No. of respondents for each rating					Mean Rating
	1	2	3	4	5	
Not Enough Variety	10	3	5	4	3	2.48
Not Enough Liquidity	3	2	5	9	11	3.76

Reason	No. of respondents for each rating					Mean Rating
	1	2	3	4	5	
Not interested	7	5	3	4	5	2.79
Cumbersome settlement	5	3	6	5	1	2.7
Stamp Duties and Taxes	6	4	4	2	4	2.7
Lack of information & advice	2	3	3	5	14	3.96



As can be seen, investors in both the categories felt that the following two reasons were the most important for them not coming in the secondary market:

1. Lack of information and investment advice.
2. Not enough liquidity in the market.

4. Following were the rankings given to various debt instruments by investors in this category:

Debt instrument		Rank					Median Rank
		1	2	3	4	5	
GoI Securities	No. of respondents	6	2	3	3	14	4
	Percentage (%)	21.4	7.14	10.7	10.7	50	
	Cumulative %	21.4	28.54	39.24	49.94	99.94	
PSU/ FI Bonds	No. of respondents	7	4	7	7	3	3
	Percentage (%)	25	14.3	25	25	10.7	
	Cumulative %	25	39.3	64.3	89.3	100	
Corporate Debentures	No. of respondents	5	9	4	6	4	2
	Percentage (%)	17.9	32.1	14.3	21.4	14.3	
	Cumulative %	17.9	50	64.3	85.7	100	
Company FDs	No. of respondents	6	5	9	7	1	3
	Percentage (%)	21.4	17.9	32.1	25	3.57	
	Cumulative %	21.4	39.3	71.4	96.4	99.97	
Bank FDs	No. of respondents	6	7	6	5	5	2
	Percentage (%)	20.7	24.1	20.7	17.2	17.2	
	Cumulative %	20.7	44.8	65.5	82.7	99.9	

Following points can be concluded from the above analysis:

1. Just like the "less than 2 lakhs annual income" category, investors in this category also have the least preference for Govt. of India debt and prefer bank FDs to Company FDs.

CHAPTER 8: CONCLUSIONS

The study draws the following conclusions:

1. There is an urgent need for development of retail debt market since the wholesale market cannot satisfy all of the investment needs. Also it would deepen the shallow market since the number of investors will increase.

2. A secondary market for retail investor is essential to minimise his liquidity risk and broaden the investor base.

3. As viewed by industry experts and brokers, market making can significantly improve the secondary debt market. Also, since only the big Financial Institutions have the financial strength for the purpose, it should be done by them or lines of credit should be provided by them to the market makers.

4. In terms of geographical location, retail funds are concentrated most in the Western region (Maharashtra and Gujarat) followed by northern region (Delhi).

5. The major impediments to development of secondary debt market, as perceived by experts are:
   (a) Stamp duty
   (b) Cash Credit facility to corporates
   (c) Regulations regarding investment imposed on Banks and PFs.
   (d) Glut of issues in the primary market.
   (e) Cumbersome settlement facilities.

   According to brokers, the important factors are:
   (a) Absence of liquidity in the market.
   (b) Returns on trading debt instruments are too low.

   According to investors, the major reasons are:
   (a) Absence of liquidity.
   (b) Lack of information and investment advice.

   Most of the people interviewed and surveyed said that it is more of a chicken and egg problem since the investor does not come to the secondary market because of absence of liquidity and the latter, in turn, follows from the former. At present, a retail investor come to the secondary market only to sell his "khokha".

6. Experts see a bright future for the debt markets because of the following reasons:

(a) Maturing Equity markets is removing the potential for making abnormal gains.
(b) Government has removed the artificial ceilings on interest rates and is itself borrowing at market determined rates.
(c) Mutual Funds and FIIs have started showing interest in debt instruments.
(d) Corporates are more inclined to fund their investment needs through debt since equity dilution is becoming a concern for them.
(e) Bank deposits are growing at the rate of Rs. 65,000 crores every year and there is no product in the market to compete with these Deposits.

7. At present the profile of investors in debt is that of someone who is risk averse and wants a regular/ assured income. In future, the investor coming to secondary market would be highly educated and have high net worth.

8. The majority of subscribers to FI Bonds today are from the interiors of the country. Bringing these people to trade on the stock exchange is a complex task.

Broker Questionnaire Responses:

1. The brokers had negligible activity in debt instruments. The little activity they had was mainly because of wholesale market and retail investor selling his "khokha".

2. The percentage of debt remains negligible with increase in portfolio size. The only debt that investors hold if Fully Convertible Debentures and Partly Convertible Debentures.

3. Brokers do not advice their clients to do secondary market trading in debt. They, however, advice to invest in primary issues if the client wants a regular income.

Investor Questionnaire Responses:

1. The marginal propensity to save was around 24% in general which needs to be improved. Majority of the investors said that they would be willing to increase their savings by 7 to 8% if the returns on debt instruments are reasonable and liquidity risk is eliminated.

2. Investors, at present, hold very less percentage of debt in their portfolio. An exception is the young and educated category of Bombay investors who hold 10 to 50% of their investment in Tax Concession Debt. However, in future, the investors plan to invest more in Tax Concession Debt.

3. Majority of the investors surveyed are not aware of the possibility of capital appreciation due to interest rate movements. They also do not trade actively in the secondary market.

4. Most of the investors do not get any advice from their brokers about debt trading, a fact corroborated by the brokers too.

5. In a reformed scenario (with reasonable yields and minimal liquidity risk), the investors are willing to shift 10 to 25% of their portfolio to debt instruments. These funds will come mainly from Bank Deposits.

6. In terms of risk and return, physical assets are the favourite of investors. They are perceived to be low risk high return investment. Debt instruments are perceived as low risk low return investment.

7. Among debt instruments, GoI securities are the least preferred across all sections of the investors. PSU/ FI Bonds and Corporate debentures are the most preferred instruments.

8. The respondents do not prefer long term securities. This goes against the fact that 60% of the IDBI issue was subscribed by Deep Discount Bond.

9. Investors in the young and educated category prefer market making while those in the others prefer put option. In both the cases, it is the responsibility of big institutions to provide these facilities.

10. Investors give more weightage to credit rating in their investment decisions. This is a sign of investors being mature.

CHAPTER 9: RECOMMENDATIONS

The following strategy should be adopted to develop the secondary retail debt market:

1. **Market Making:** Market Making is the most essential step to develop liquidity in the secondary debt market. Following points need to be noted regarding the same:

   (a) The effort should be initiated by the banks and Financial Institutions since they have the required financial strength for the purpose. If it is being done by lead manager or some other broker, suitable lines of credit should be made available to him by the FI.
   (b) Market making should be targeted at the retail segment specifically. The present market makers are being used only by the wholesale segment. Even the market makers in IDBI issue will cater mainly to the wholesale segment.
   (c) It should be advertised intensely so that even the individual investor in the interiors of the country comes to know about the facility.

2. **Education programme for the investors and the sub brokers:** As has been revealed by the study, the level of investor awareness regarding debt trading is very low. It has also been sighted as one of the most important reasons for dull secondary market. Also, since most of the Indian investors invest on the basis of advice received from their sub brokers, the sub brokers also need to be educated about merits of secondary market operations in debt instruments. The education programmes should include:

   (a) Lectures by the industry experts on the mechanics of interest rate movements and its effect on the capital in terms of appreciation or depreciation.
   (b) Explaining the investors how the downside risk is very low in case of debt instruments as compared to equity and how it can be used as a hedging tool in a debt - equity mix.
   (c) Exhibition by various issuers of debt explaining their products and the returns and risks associated with them.

3. **Encouraging Money Market Mutual Funds (MMMFs):** Even in the US, a retail investor does not participate directly in debt market activity but through MMMFs. The RBI has made an attempt to encourage these funds. But some of the guidelines which are inhibiting the growth of these funds are:

   (a) Corporates have not been allowed to invest in the MMMFs.
   (b) There is a minimum lock-in period of 46 days.
   (c) They are not allowed to buy short term (less than 1 year) corporate paper.

4. **Setting up of Depository:** There are lot of physical delivery problems associated with retailing of debt securities. As far as the Delivery vs Payment (DVP) system is concerned, the

individuals are not allowed to open SGL account with RBI and some foreign banks are reported to be charging Rs. 20,000 as account opening fees.

5. **Removal of stamp duties on transfer:** At present, stamp duty is charged on issue as well as transfer. Transfer stamp duty eats into the small capital gains that the investor can make due to little price fluctuation. It is proposed that stamp duty be charged only once on issue.

6. **Reintroduction of Repurchase agreements (Repos):** The activity in repos has been severely curtailed after the scam. However, it is important to realise that 96% of the debt transactions throughout the world are repos and, before the scam, 90% of deals in the Indian Debt Markets were made through repos. Curtailing of this activity has sucked the liquidity out of the system.

7. **Development of Primary Dealers (PDs) for retail segment:** As found in the study, the Government Securities do not hold much preference in the eyes of the investor. An effort to improve their image can be taken up by the Primary Dealers. At present, PDs are already doing market making for the wholesale segment. Tapping the retail market would require good distribution network and advertising.

APPENDIX

LIST OF BROKERS SURVEYED

1. D. Hirawat
   Global Finance Corpn. Ltd.
   Saheb Building, 4th Floor, 195, D.N. Road, Fort

2. Ashok Thakker
   Babubhai Purshottamdas & Co.
   24/26, Cama Building, Dalal Street, Fort

3. Yogesh R. Gupta
   3rd Floor, Cama Building, 24/26, Dalal Street

4. Pankaj V. Shah
   Jagruti Securities Ltd.
   16, Gundecha Chambers, Gr. Floor, Nagindas Master Road

5. Col. L.M. Buxi
   R.R. Nabar &Co.
   Examiner Press Building, 31, Dalal Street

6. M/S Malini Ajit Singhvi
   22, Bombay Samachar Marg, 2nd Floor, Above George Restaurant

7. Kaushal H. Registrar
   Sigma Credit & Capital Services (P) Ltd.
   Ground Floor, Joshi Chambers, B-66, Ahmedabad Street, Carnac Bunder

8. Monica Mansukhani
   Skindia Finance Pvt. Ltd.
   83, Maker Chambers III, Nariman Point

9. Sanjeev Goel
   Synergy Credit Corpn. Ltd.
   No. 1, Gita Building, Gr. Floor, Dr. Pandita Ramabai Road, Gamdevi

10. M/S V.B. Desai Financial Services Ltd.
    1st Floor, Cama Building, 24/26, Dalal Street

11. Umesh B. Dharnadharka
    121, Stock Exchange Towers, Dalal Street

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