inducing greater efficiency and competitiveness in all spheres of activity. Within this overall context, reforms in the Government securities market were undertaken essentially to finance the budgetary requirements of the government in a non-inflationary and more ‘efficient’ manner; develop a benchmark for the pricing and valuation of other securities; and facilitate monetary policy operations through indirect instruments in the context of a liberalised financial environment.

Under India’s federal system of government, the Constitution allocates the revenue powers and expenditure functions between the Central and State Governments. The Central Government can borrow both within and outside the country. It is worth noting in this context, that even though combined fiscal deficit of the Central and State Governments in India has been among the

20 per cent of the total outstanding liabilities of the State Governments whereas net market borrowings account for around 20 per cent of their GFD.

Against this backdrop, the structure of my presentation is as follows. In Section, I shall briefly trace the evolution of deficits and debt of the Central Government over the period of reforms. In Section II, I shall discuss the various initiatives for the development of the Central Government debt market. Section III would highlight the impact of the reforms on various parameters of the Central Government debt market. The next tw63p42 The n

Table 2: Financing Pattern of the Centre's Gross Fiscal Deficit (in per cent)

	1990-91	1991-92	1995-96	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07

Fifth Pay Commission award; and (c) the increase in interest payments following the sharp rise in yields on Government securities in the first phase following the introduction of auctions.

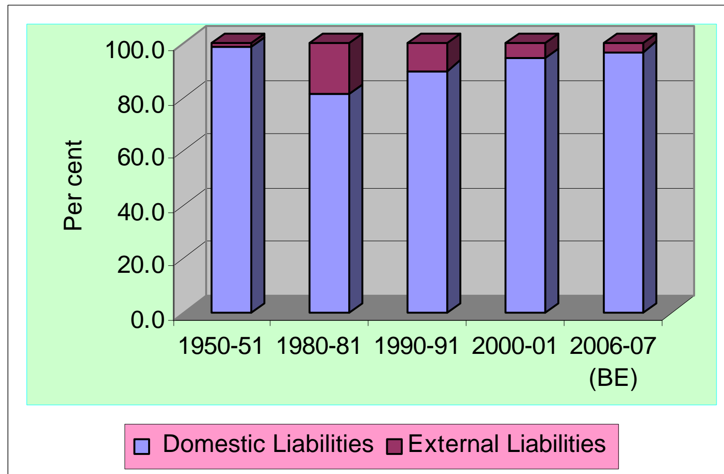
In the **third phase**, which began in 2002-03, signs of improvement in the fiscal situation are again evident, with the fiscal deficit and revenue deficit progressively reduced to around 4 per cent and 2 per cent of GDP, respectively. (In fact, as per the recently released Union Budget for 2007-08, the fiscal deficit and the revenue deficit have been placed at 3.3 per cent and 1.5 per cent of GDP in 2007-08). The debt-GDP ratio has begun inching downwards, even though its level remains on the higher side at around 62 per cent. The on-going improvement in the fiscal situation in the third phase can be attributed to a rebound in economic growth to a higher trajectory which, in turn, has positively impacted on tax buoyancy as well as enhanced fiscal discipline following the enactment of fiscal responsibility legislation, to which we now turn.

The Central Government's **Fiscal Responsibility and Budget Management Act, 2003 (FRBMA)** came into force in August 2003 and associated Fiscal Rules were notified in July 2004. In terms of the Act, the Centre was required to eliminate its revenue deficit by end-March 2008, and thereafter build up adequate revenue surplus. The rules under the Act further require the Centre to reduce the revenue deficit by an equivalent of at least 0.5 per cent of GDP at the end of each fiscal year beginning 2004-05. The Gross Fiscal Deficit (GFD) is to be reduced by at least 0.3 per cent of GDP at the end of each fiscal year beginning 2004-05, so that it is brought down to 3 per cent of GDP in 2008. The Finance Act, 2004 shifted the targets fixed for end-March 2008 in respect of the revenue deficit and GFD to end-March 2009 (consistent with the fiscal restructuring plan envisaged by the Twelfth Finance Commission). The enactment of FRBMA provides a clear direction to the fiscal consolidation process and enhances the credibility of fiscal policies. Furthermore, in terms of the provisions of the FRBMA, the RBI is prohibited from subscribing to the primary issuances of Central Government securities

with effect from April 2006. This will complete the transition to a fully market-based issuance of Central Government securities.

I would like to conclude this Section by highlighting that the share of external debt in the total debt of the Central Government has been low even before the initiation of the reforms. All the external loans were obtained from multilateral/bilateral sources. Subsequent to the reforms, the share of external loans declined substantially. The Government of India has not borrowed on 'commercial' basis externally.

Chart 2: Composition of Centre's Debt



II. Initiatives for the Development of the Central Government Securities Market

As indicated earlier, the pre-reform period was characterized by a substantial and sustained increase in the fiscal deficit of the Government. While such budgetary imbalances had adverse macroeconomic consequences, these

which made real rates of return negative for several years till the mid-1980s. During the 1980s, the volume of Government debt expanded considerably, particularly short-term debt, due to automatic accommodation to Central Government by the Reserve Bank, through the mechanism of *ad hoc* Treasury Bills. However, with a captive investor base and low interest rates, the secondary market for Government bonds remained dormant. Artificial yields on Government securities affected the yield structure of financial assets in the system, and led to an overall high interest rate environment in the rest of the market. Driven by these compulsions, the Reserve Bank's monetary management was characterised by a regime of administered interest rates, and rising Cash Reserve Ratio (CRR) and SLR prescriptions. High CRR and SLR left little room for monetary manoeuvering. Furthermore, the period was marked by greater pre-emption of financial savings. Given such high pre-emptions and administered interest rates which were artificially kept lower than the market rates, there was no possibility of price discovery. Reforms in the Government securities market undertaken as part of the overall structural reforms process initiated in 1991-92, aimed to redress these infirmities.

The **early initiatives** (1992-95) in the reform of the G-sec market which aimed at creating an enabling environment included (i) the elimination of the

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and Primary Dealers Association of India (PDAI) to improve practices; and (iv) permission to Foreign Institutional Investors to invest in Government securities in both the primary and secondary markets, with a view to broaden the markets;

Instrument diversification was also undertaken during this phase of

electronic trading platform

small and medium sized investors to participate in the primary auction of government securities, a "Scheme of Non Competitive Bidding" was introduced in January 2002, which is open to any person including firms, companies, corporate bodies, institutions, provident funds, trusts, and any other entity prescribed by RBI. The scheme provides for allocation of up to 5 per cent of the notified amount at the weighted average rate of accepted bids. Investors can bid through banks or PDs a minimum amount of Rs.10,000 to a maximum amount of Rs. 20 million. A few PDs have already introduced schemes for retail marketing of Government securities using the network of bank branches and post offices.

Foreign portfolio investors [called Foreign Institutional Investors (FIIs)] are also permitted to invest in G-Secs subject to a limit that is currently placed at US$2.6 billion, to increase to US$3.2 billion by the end of the year.

With effect from the fiscal year 2006-07, as per the provisions under the **Fiscal Responsibility and Budget Management (FRBM) Act 2003**, the Reserve Bank's participation in the primary market for Central Government securities stands withdrawn. This has necessitated significant changes in the setting and operating framework of monetary, debt management and regulatory policies of the Reserve Bank.

In order to address these emerging needs and equip RBI as well as the market participants appropriately, a Technical Group on Central Government Securities Market was constituted which proposed a medium-term framework for the evolution of the Central Government securities market.

On the basis of the recommendations of the above Group, the Reserve Bank's Annual Policy Statement of April 2005 indicated that in the post-FRBM period, the Reserve Bank would reorient government debt management operations while simultaneously strengthening monetary operations. Accordingly, the Reserve Bank constituted a new department named as Financial Markets Department (FMD) in July 2005 with a view to moving towards functional separation between debt management and monetary operations.

Sixth, guidelines for introduction of 'when issued' market in Central government securities market were issued on May 3, 2006. This would facilitate an efficient distribution process for Government securities by stretching the actual distribution period for each issue and allowing the market more time to absorb large issues without disruption, in addition to providing better price discovery.

Seventh, PDs have been permitted to diversify their activities, as considered appropriate, in addition to their core business of Government securities, subject to limits. This would enable better risk management through generation of alternative sources of income.

Eighth, guidelines on the extension of PD business to banks which fulfil certain minimum eligibility criteria were issued on February 27, 2006.

Ninth, a revised scheme for underwriting commitment and liquidity support to PDs has been introduced with effect from April 1, 2006 whereby PDs are required to meet 100 per cent underwriting commitment in each auction, replacing the earlier requirement of bidding commitment and voluntary underwriting (which did not guarantee that the notified amount will be sold in each auction).

III. Impact of Reforms on the Central Government Securities Market

As a result of gradual reform measures taken over the years, the Indian G-Sec market has become increasingly broad-based, characterised by an efficient auction process, an active secondary market and a liquid yield curve up to 30 years. The market is now supported by an active Primary Dealer (PD) system and electronic trading and settlement technology that ensure safe settlement with Straight Through Processing (STP) and central counterparty guarantee.

The outstanding stock of G-secs as on end-March 2006 is nearly thirteen times the level in 1992. Outstanding stock of G-secs as a ratio to GDP has nearly doubled to around 28 per cent over this period. Turnover of G-secs has

been placed at well over 200 per cent in recent years as against 34 per cent in 1996.

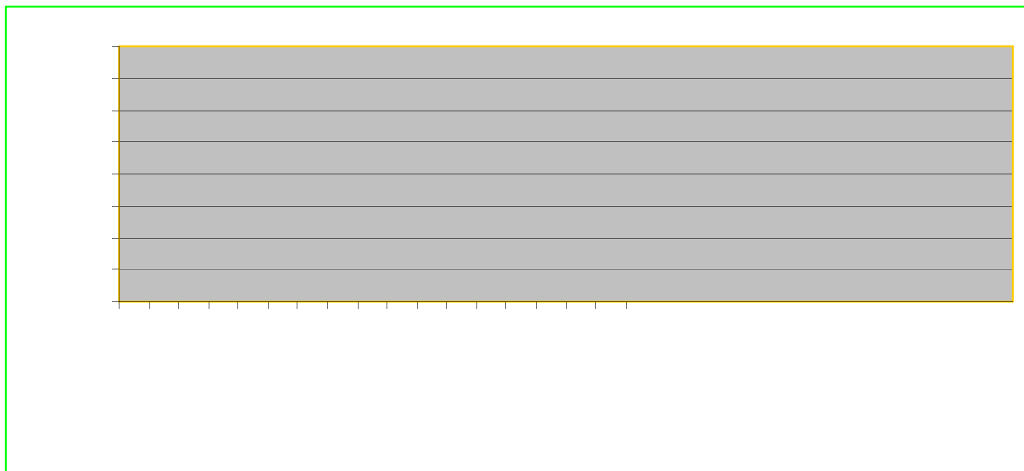
Table 3

It is pertinent to add here that recently the Government of India converted (non-tradable) special securities amounting to nearly Rs.900 billion issued to banks towards capital infusion, into tradable, SLR Government of India dated securities. The substitution of non-tradable securities to tradable securities is expected to facilitate increased access of the banking sector to additional resources for lending to productive sectors, in the light of the increasing credit needs of the economy.

It may be also important to note that the Reserve Bank has been encouraging the growth of the collateralized money market with the objective minimizing default risk in the money market. As a consequence, there has been a major shift in transactions from the uncollateralized to the collateralized segment, underscoring the development of the G-sec market.

During the greater part of the 1990s, the maturity of Central Government securities ranged upto 10 years. This resulted in potential

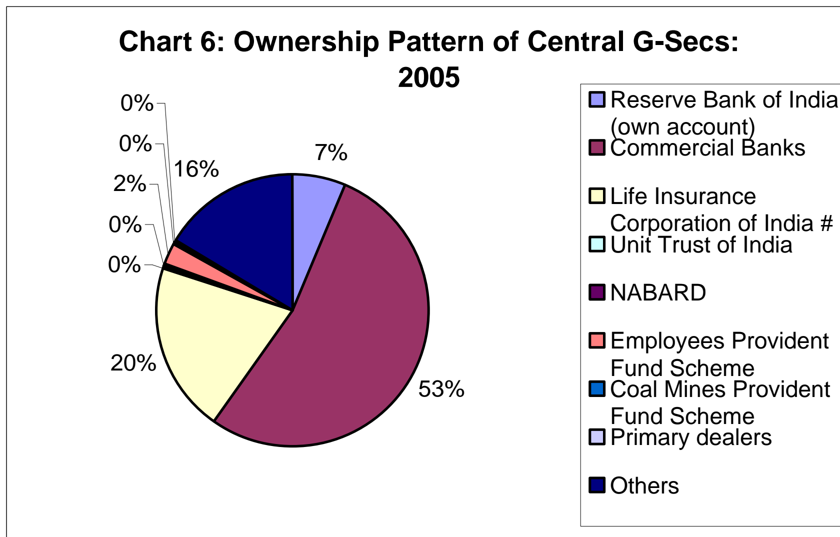
securities also declined from 13.8 per cent in 1995-



The process of passive consolidation (through reopening of existing stock instead of issuing new securities every time) has helped in containing the number of bonds around the level that was prevailing at the end of 1998-99. This was a significant factor that promoted secondary market liquidity for Government Securities.

Market liquidity today compares well not only with the emerging economies, but also with the developed world, with bid-offer spreads in benchmark securities at 1-2 bps. The illiquidity premium levels are also in line with those in the international markets.

The holding of G-secs among financial institutions has been more diversified, particularly, with the emergence of insurance and pension funds as a 'durable' investor class for the long-term securities. This became possible due



It may be observed from the above charts that over the period 1991 to 2005, the share of the Reserve Bank inthe end TD 0.0209 Tc -0.02sPril S re s9.44 c li0.0oie06i

the States in the face of a slowdown in the growth rate. At the same time, State finances have been long afflicted with stagnant non-tax revenues as a consequence of inappropriate user charges on various services. Indeed, the GFD and the revenue deficit had increased to over 4 per cent and over 2.5 per cent of GDP, in the early years of the present decade, while the debt was placed at over 33 per cent of GDP.

Table 4: Trends in the Budget Deficits of the State Governments (as a per cent of GDP)

	1990-91	1991-92	1995-96	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
									(RE)	(BE)
GFD	3.3	2.89	2.65	4.25	4.21	4.17	4.46	3.5	3.23	2.68
Revenue Deficit	0.93	0.87	0.69	2.54	2.59	2.25	2.22	1.17	0.49	0.05
Gross Primary Deficit	1.78	1.22	0.8	0.09	-0.15	-0.61	-0.75	-1.65	-2.03	-2.47

Table 5: Financing Pattern of the Gross Fiscal Deficit of the State Governments (in per cent)

	1990-91	1991-92	1995-96	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
									(RE)	(BE)
Loan From Central Gov.	53.1	49.6	47.1	9.4	11.4	-0.9	11.5	-15.1	2.3	4.8
Market Borrowing	12.0	17.5	18.7	14.0	18.0	27.9	38.4	30.1	15.7	21.0
NSSF	-	-	-	36.4	37.1	51.2	16.9	66.5	65.0	53.5
Others	33.3	32.9	34.2	40.2	33.5	21.9	33.2	18.5	17.0	20.7

The recommendations of the Twelfth Finance Commission (TFC) are an important milestone in the fiscal path of the States (and Central) Governments over the five-year period beginning 2005-06. The TFC recommended for th-

the State Governments will be increasing market determined, paving the way for the emergence of a vibrant sub-national debt market. The TFC also recommended a fiscal restructuring plan under which revenue deficit would be eliminated and the fiscal deficit would be reduced to 3 per cent of GDP, separately for the Centre and the States. In order to incentivise adherence to the fiscal restructuring plan, the TFC recommended a debt relief scheme linked to the enactment of fiscal responsibility legislation by the States with provisions consistent with the restructuring plan.

The TFC recommendation accelerated the enactment of fiscal responsibility legislation at the State level. As many as 24 States have enacted Fiscal Responsibility Legislation (FRL) as compared with only 5 States in 2003-04. As in the case of the Centre, the State FRLs provide for the elimination of the revenue deficit as well as the reduction of the GFD-

48.5 per cent in the previous year and 2.3 per cent in 2004-05. Moreover, in all but one auction of State Government securities during 2006-07 so far, the spreads of the cut-off yields over the secondary market yields of a Central Government security of corresponding maturity have remained lower than that of 50 basis points (which is the spread fixed in the case of tap issuances). This is indicative of a number of factors including improved market perception of

Securities market, the corporate debt market has a long way to go. Though the corporate debt market in India has been in existence since independence in 1947, it was only after 1985-86, following some debt market reforms that State owned public enterprises (PSUs) began issuing PSU bonds. Such debt instruments, however, generally remained highly illiquid and unpopular among the investors since a well-functioning secondary market was absent. However, corporates continued to prefer private placements to public issues. The predilection towards private placement has been attributed to several factors, *viz.,* ease of procedures and operation of private placement, involved procedure and considerably higher costs of public issues, and higher subscriptions for private placements. Mainly as a consequence of this, the financial institutions have tended to dominate public issues in the primary corporate debt market. The secondary market for corporate debt has also certain shortcomings in terms of lack of market-making resulting in poor liquidity, tendency on the part of institutional investors to hold these securities to maturity and the consequent reduction in market supply of these securities.

Several measures have been taken in the recent past to transform the corporate debt market in India. Some of these measures include de-materialisation and electronic transfer of securities, rolling settlement, introduction of sophisticated risk management, trading and settlement systems. Towards the end of 2003, SEBI also initiated reforms in the private placement market. In conjunction with these measures, Reserve Bank of India, issued guidelines to banks on investment of their non-SLR securities. All these measures are expected to improve the functioning of corporate debt market in India.

The High Level Expert Committee on Corporate Bonds and Securitisation (Chairman: Dr. R. H. Patil) (2005) observed that the primary corporate debt market is dominated by private placements by essentially financial institutions (including banks and non-banking companies) with fairly low levels of transparency until recently. Secondary market trading and settlement procedures are rather archaic with settlement not even DvP based.

There is a growing primary market for securitized instruments but hardly any trading activity is seen. In this background the Expert Committee had recommended measures to enhance activity level as well as efficiency of corporate debt markets. Some of the important recommendations relate to the following:

(i) To encourage a well-developed primary issuance process, the Committee suggested steps to enhance the issuer base and investor base including measures to bring in retail investors. Listing of primary issues and creation of a centralized database of primary issues was proposed to improve transparency and disclosure standards.

(ii) For an all-round development of the secondary market, the Committee recommended an electronic trading system, a comprehensive automated trade reporting system and safe and efficient clearing and settlement standards. It was also suggested that repo in corporate bonds may be allowed (currently only Government securities are eligible collateral for repos).

The Committee also recommended a host of measures, including legal and tax aspects to give a boost to the securitized debt market, including suggestions to promote credit enhance047 incla. 209 rency ante258c 3.66 Tw (and tax asp

creation of any form of security was rare and the portfolios simply moved from balance sheet of one originator over to that of another. These transactions often included provisions which provided recourse to the originator as well. Now, loan sales is common through the direct assignment route, which is structured using the true sale concept. Securitisation of auto loans was the mainstay of the Indian securitization market through most the 1990s. Since 2000, residential mortgage backed securities has fuelled the growth in the market.

In the early stage of securitization in India, creation of transferable securities in the form of pass-through certificates (PTCs) was the most common form of securitization. PTC has almost become synonymous with securitisation in India and most market practitioners do not envisage issuance of notes or bonds as a securitised product. There are PTCs which have a specific coupon rate, there are structured PTCs and PTCs have different payback periods. Many PTCs are essentially derived debt instruments but they are not called as such.

Over time, the market has spread into several asset classes – while auto loans and residential housing loans are still the mainstay, there are corporate loans, commercial mortgage receivables, future flow, project receivables, toll revenues, etc that have been securitised.

Trend in Structured Finance Issuance Volumes (in Rs. billion)

Type	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
ABS					

which could sell off their NPAs to ARCs registered with RBI. More recently, RBI has issued guidelines for secutisation of standard assets by Banks, FIs and NBFC which are in accordance with international best practices in February 2006 which provides regulatory framework for several critical aspects of securitization. Recently, an amendment has been proposed to SCRA which recognizes pass-through certificates (PTC) as eligible securities to be listed and traded on exchanges.

VII. Concluding Observations

Centre and the State Governments so as to enhance the credibility of fiscal policies, impart greater stability to financial markets and further strengthen macroeconomic fundamentals.

It would also be necessary to continue the efforts to develop a deep and liquid G-Sec market. Notwithstanding passive consolidation through reissuances, the number of actively traded securities remains low relative to the number of securities outstanding. This results in a kinked yield curve which impedes pricing of securities. The finer modalities for implementing the scheme are being worked out.

The possibility of reintroducing instruments like Inflation-Indexed Bonds and Floating Rate Bonds is also being explored by addressing the observed infirmities in the earlier 'avatars' of these instruments, as highlighted in Section II.

STRIPS could also be introduced with the enactment of the Government Securities Act that would facilitate lien marking and pledge of securities for raising loans against G-Secs.

The need for appropriate risk management in the context of the G-Sec also needs to be emphasized. An important issue of concern is the lack of uniform accounting standards for derivatives and the lack of transparent appropriateness standards. In the interest of systemic safety, further developments in the derivatives markets in terms of more instruments and wider participation base also need to be synchronized with effective accounting and disclosure norms in line with international best practices.

As far as the corporate bond market is concerned, the Government of India's Economic Survey 2006-07, observed that "*Outlook in infrastructure will depend on how investment in infrastructure is facilitated. Such investment requires long-term funds with long pay back periods, for example, from insurance and pension funds. Thus, success on the infrastructure front will be facilitated by the development of a vibrant bond market, and pension and insurance reforms.*" (para 9.10

would, in turn necessitate institutional measures for credit enhancement. This is already facilitated by the prevalence of credit rating institutions in India (all the three major rating agencies are represented in India). Credit risk could also be addressed by developing bond insurance institutions. Institutional investors with superior risk assessment capacity along with investment capacity could also take on the role of credit enhancers. In addition, the issuer and instrument base needs to be widened through encouragement of segments like municipal bonds, mortgage backed securities and general securitized paper, in order to meet the diverse requirements of investors and issuers in respect of the corporate bond market.

ANNEX

IMF/World Bank Guidelines for Public Debt Management: The Indian Position

Sr. No.	Guideline	Status
1.	**Debt Management Objectives and Coordination**	
1.1	Objectives	The Reserve Bank of India, as the Government's debt manager, is guided by the twin objectives of minimisation of interest cost over time and rollover risk.
1.2	Scope	The RBI manages the **internal marketable debt** of the Central Government by statute. Internal marketable debt accounts for 40 per cent of the total outstanding debt of the Central Government, whereas net market borrowings account for around 77 per cent of the GFD. The RBI manages the internal marketable debt of the State Governments under voluntary agreements. Internal marketable debt accounts for around 20 per cent of the total outstanding liabilities of the State Governments whereas net market borrowings account for around 20 per cent of their GFD.
1.3	Coordination with monetary and fiscal policies	With a view to moving towards functional separation between debt management and monetary operations, the RBI constituted a new department viz., the Financial Markets Department in July 2005. Coordination between debt management, monetary and fiscal policies is achieved via (i) the Financial Markets Committee of the RBI that meets daily to review the developments, on a daily basis, in various market segments and bring about co-ordination in monetary, exchange and debt management; (ii) the Standing Committee on Cash and Debt Management that consists of representatives of the Central Government and the RBI that meets periodically to examine issues relating to debt management and ensure co-ordination of various policy instruments; (iii) a Standing Technical Committee has been constituted recently with representatives from all State Governments, the Central Government and the RBI to advise on the wide-ranging issues relating to the borrowing programmes of Central and State Governments through a consensual and co-operative approach.
2.	**Transparency and Accountability**	
2.1	Clarity of Roles, Responsibilities and objectives	The allocation of responsibilities between the Central Government and the RBI (which is both the debt manager and the monetary authority) for the formulation and execution of debt management policy is clearly defined by law (Constitutional provisions,

		RBI Act, Government Securities Act) and is publicly disclosed. The Clearing Corporation of India (CCIL) acts as a clearing house and a central counterparty through novation in the transactions of Government securities. The objectives of debt management (as given in 1.1) are set out in the Annual Report of the RBI, as a part of the review of debt management policy and operations.
2.2	Open process for formulating and reporting of debt management policies	Regulations and procedures for primary auctions, primary dealer activities and secondary market operations in G-Secs are publicly disclosed.
2.3	Public availability of information on debt management policies	The budgets of the Central and State Governments provide information on the past, present and future budgetary activities and the financing of the fiscal deficit. Government budgets are also analysed in various publications of the RBI including its Annual Report. The consolidated financial position of the Central and State Governments is reported in the RBI's Annual Report. The consolidated financial position of the Central and State Governments as also of their public sector enterprises is reported in the Central Government's annual Economic Survey. The budget of the Central Government provides information on the stock and composition of its debt and financial assets. Various aspects of the internal marketable debt of the Central and State Governments are analysed in the RBI's Annual Report. Indicative auction calendars for dated securities and Treasury Bills of the Central Government are issued on a half-yearly basis and annual basis, respectively. The RBI announces auct

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	and assurances of integrity by agencies responsible for debt management	Reserve Bank operations which covers the debt management activities. The debt management activities are also covered by concurrent audit. In addition, there is an internal Management Audit and Systems Inspection which focuses on the macro management of debt activities. The annual accounts of the RBI are audited by external auditors and published in its Annual Report.

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in their efforts to develop codes of conduct for market participants and to ensure best practices.

Promotion of an active repo market.

Removal of TDS from G-secs. G-secs are also not subject to Securities Transaction Tax (STT) applicable to equities.
An ordinance has recently been passed to remove the floor (25 per cent) on SLR.

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