The Bond Starts Here...

BSE DEBT SEGMENT
FAQs on Debt Markets

To know more about investing in the fixed income markets, Please contact:

- Mr. R. Vaidyanath, General Manager — (022) 2721414/2721233 (8069)
- Mr. P.K. Ramesh, Dy. General Manager — (022) 2723429/2721233 (8012)
- Mr. Rajesh M. Varma, Dy. Manager — (022) 2721233/34 (8701)

BSE Debt Segment, 23rd Floor, The Stock Exchange, P.J. Towers, Dalal Street, Fort, Mumbai — 400 001
Fax: (022) 2721824
Email: debtsegment@bseindia.com, rvaidyanath@bseindia.com, pkramesh@bseindia.com, rvarma@bseindia.com
1. What is the Debt Market?

The Debt Market is the market where fixed income securities of various types and features are issued and traded. Debt Markets are therefore, markets for fixed income securities issued by Central and State Governments, Municipal Corporations, Govt. bodies and commercial entities like Financial Institutions, Banks, Public Sector Units, Public Ltd. companies and also structured finance instruments.

2. Why should one invest in fixed income securities?

Fixed Income securities offer a predictable stream of payments by way of interest and repayment of principal at the maturity of the instrument. The debt securities are issued by the eligible entities against the moneys borrowed by them from the investors in these instruments. Therefore, most debt securities carry a fixed charge on the assets of the entity and generally enjoy a reasonable degree of safety by way of the security of the fixed and/or movable assets of the company.

The investors benefit by investing in fixed income securities as they preserve and increase their invested capital or also ensure the receipt of dependable interest income.

The investors can even neutralize the default risk on their investments by investing in Govt. securities, which are normally referred to as risk-free investments due to the sovereign guarantee on these instruments.

Debt Markets in India and all around the world are dominated by Government securities, which account for between 50 – 75% of the trading volumes and the market capitalization in all markets.

Government securities (G-Secs) account for 70 – 75% of the outstanding value of issued securities and 90-95% of the trading volumes in the Indian Debt Markets.

3. What are the advantages of investing in Government Securities (G-Secs)?

The Zero Default Risk is the greatest attraction for investments in G-secs so that it enjoys the greatest amount of security possible. The other advantages of investing in G-Secs are:

- Greater safety and lower volatility as compared to other financial instruments.
- Variations possible in the structure of instruments like Index linked Bonds, STRIPS
- Higher leverage available in case of borrowings against G-Secs.
- No TDS on interest payments
- Tax exemption for interest earned on G-Secs. up to Rs.3000/- over and above the limit of Rs.9000/- under Section 80L
- Greater diversification opportunities
- Adequate trading opportunities with continuing volatility expected in interest rates the world over

The returns earned on the government securities are normally taken as the benchmark rates of returns and are referred to as the risk free return in financial theory. The Risk Free rate obtained from the G-sec rates are often used to price the other non-govt. securities in the financial markets.

3. **Who can issue fixed income securities?**

Fixed income securities can be issued by almost any legal entity like Central and State Govts., Public Bodies, Banks and Institutions, statutory corporations and other corporate bodies. There may be legal and regulatory restrictions on each of these bodies on the type of securities that can be issued by each of them.

4. **Who regulates the fixed income markets?**

The issue and trading of fixed income securities by each of these entities are regulated by different bodies in India. For eg: Government securities and issues by Banks, Institutions, Public Corporations are regulated by the RBI. The issue of non-government securities comprising basically issues of Corporate Debt is regulated by SEBI.

5. **What are the different types of instruments, which are normally traded in this market?**

The instruments traded can be classified into the following segments based on the characteristics of the identity of the issuer of these securities:

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<th>Market Segment</th>
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<td></td>
<td>Banks</td>
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<td></td>
<td>Financial Institutions</td>
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The G-secs are referred to as SLR securities in the Indian markets as they are eligible securities for the maintenance of the SLR ratio by the Banks. The other non-Govt securities are called Non-SLR securities.

6. What is the importance of the Debt Market to the economy?

The key role of the debt markets in the Indian Economy stems from the following reasons:
- Efficient mobilization and allocation of resources in the economy
- Financing the development activities of the Government
- Transmitting signals for implementation of the monetary policy
- Facilitating liquidity management in tune with overall short term and long term objectives.

Since the Government Securities are issued to meet the short term and long term financial needs of the government, they are not only used as instruments for raising debt, but have emerged as key instruments for internal debt management, monetary management and short term liquidity management.

7. What are the benefits of an efficient Debt Market to the financial system and the economy?

- Reduction in the borrowing cost of the Government and enable mobilization of resources at a reasonable cost.
- Provide greater funding avenues to public-sector and private sector projects and reduce the pressure on institutional financing.
- Enhanced mobilization of resources by unlocking illiquid retail investments like gold.
- Development of heterogeneity of market participants
- Assist in the development of a reliable yield curve.

8. What are the different types of risks with regard to debt securities?

The following are the risks associated with debt securities:

Default Risk: This can be defined as the risk that an issuer of a bond may be unable to make timely payment of interest or principal on a debt security or to otherwise comply with the provisions of a bond indenture and is also referred to as credit risk.

Interest Rate Risk: can be defined as the risk emerging from an adverse change in the interest rate prevalent in the market so as to affect the yield on the existing instruments. A good case would be an upswing in the prevailing interest rate scenario leading to a situation where the investors’ money is locked at lower rates whereas if he had waited and invested in the changed interest rate scenario, he would have earned more.
Reinvestment Rate Risk: can be defined as the probability of a fall in the interest rate resulting in a lack of options to invest the interest received at regular intervals at higher rates at comparable rates in the market.

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

Counter Party Risk: is the normal risk associated with any transaction and refers to the failure or inability of the opposite party to the contract to deliver either the promised security or the sale-value at the time of settlement.

Price Risk: refers to the possibility of not being able to receive the expected price on any order due to a adverse movement in the prices.

9. Who are the main investors of Govt. Securities in India?

Traditionally, the Banks have been the largest category of investors in G-secs accounting for more than 60% of the transactions in the Wholesale Debt Market.

The Banks are a prime and captive investor base for G-secs as they are normally required to maintain 25% of their net time and demand liabilities as SLR but it has been observed that the banks normally invest 10% to 15% more than the normal requirement in Government Securities because of the following requirements:

- Risk Free nature of the Government Securities
- Greater returns in G-Seqs as compared to other investments of comparable nature

10. What is Yield?

Yield refers to the percentage rate of return paid on a stock in the form of dividends, or the effective rate of interest paid on a bond or note. There are many different kinds of yields depending on the investment scenario and the characteristics of the investment.

Yield To Maturity (YTM) is the most popular measure of yield in the Debt Markets and is the percentage rate of return paid on a bond, note or other fixed income security if you buy and hold the security till its maturity date. The calculation for YTM is based on the coupon rate, length of time to maturity and market price. It is the Internal Rate of Return on the bond and can be determined by equating the sum of the cash-flows throughout the life of the bond to zero. A critical assumption underlying the YTM is that the coupon interest paid over the life of the bond is assumed to be reinvested at the same rate.

Current Yield is the coupon divided by the Market Price and gives a fair approximation of the present yield.
The yield on the government securities is influenced by various factors such as level of money supply in the economy, inflation, borrowing program of the government & the monetary policy followed by the government.

11. How is the price determined in the debt markets?

The price of a bond in the markets is determined by the forces of demand and supply, as is the case in any market. The price of a bond in the marketplace also depends on a number of other factors and will fluctuate according to changes in

- Economic conditions
- General money market conditions including the state of money supply in the economy
- Interest rates prevalent in the market and the rates of new issues
- Credit quality of the issuer

There is however, a theoretical underpinning to the determination of the price of the bond in the market based on the measure of the yield of the security.

12. How is yield related to the price?

Yields and Bond Prices are inversely related. So a rise in price will decrease the yield and a fall in the bond price will increase the yield.

There will be an immediate and mostly predictable effect on the prices of bonds with every change in the level of interest rates. (The predictability here however refers to the direction of the price change rather than the quantum of the change)

When the prevailing interest rates in the market rise, the prices of outstanding bonds will fall to equate the yield of older bonds into line with higher-interest new issues. This will happen as there will be very few takers for the lower coupon bonds resulting in a fall in their prices. The prices would fall to an extent where the same yield is obtained on the older bonds as is available for the newer bonds.

When the prevailing interest rates in the market fall, there is an opposite effect. The prices of outstanding bonds will rise, until the yield of older bonds is low enough to match the lower interest rate on the new bond issues.

These fluctuations ensure that the value of a bond will never be the same throughout the life of the bond and is likely to be higher or lower than its original face value depending on the market interest rate, the time to maturity (or call as the case may be) and the coupon rate on the bond.
13. **What are the main features of G-Secs and T-Bills in India?**

All G-Secs in India currently have a face value of Rs.100/- and are issued by the RBI on behalf of the Government of India. All G-Secs are normally coupon (Interest rate) bearing and have semi-annual coupon or interest payments with a tenor of between 5 to 25 years. This may change according to the structure of the Instrument.

Eg: a 11.50% GOI 2005 security will carry a coupon rate (Interest Rate) of 11.50% on a face value per unit of Rs.100/- payable semi-annually and maturing in the year 2005.

Treasury Bills are for short-term instruments issued by the RBI for the Govt. for financing the temporary funding requirements and are issued for maturities of 91 Days and 364 Days. T-Bills have a face value of Rs.100 but have no coupon (no interest payment). T-Bills are instead issued at a discount to the face value (say @ Rs.95) and redeemed at par (Rs.100). The difference of Rs. 5 (100 – 95) represents the return to the investor obtained at the end of the maturity period.

State Government securities are also issued by RBI on behalf of each of the state governments and are coupon-bearing bonds with a face value of Rs.100 and a fixed tenor. They account for 3-4 % of the daily trading volumes.

14. **What are the segments in the secondary debt market?**

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

- Wholesale Debt Market – where the investors are mostly Banks, Financial Institutions, the RBI, Primary Dealers, Insurance companies, Provident Funds, MFS, Corporates and FIIs.

- Retail Debt Market involving participation by individual investors, Small trusts and other legal entities in addition to the wholesale investor classes.

15. **What is the structure of the Wholesale Debt Market?**

The Debt Market is today in the nature of a negotiated deal market where most of the deals take place through telephones and are reported to the Exchange for confirmation. It is therefore in the nature of a wholesale market.

16. **Who are the most prominent investors in the Wholesale Debt Market in India?**

The Commercial Banks and the Financial Institutions are the most prominent participants in the Wholesale Debt Market in India.
During the past few years, the investor base has been widened to include Cooperative Banks, Investment Institutions, cash rich corporates, Non-Banking Finance companies, Mutual Funds and high net-worth individuals. FIIs have also been permitted to invest 100% of their funds in the debt market, which is a significant increase from the earlier limit of 30%. The government also allowed in 1998-99 the FIIs to invest in T-bills with a view towards broadening the investor base of the same.

17. What are the types of trades in the Wholesale Debt Market?

There are normally two types of transactions, which are executed in the Wholesale Debt Market –

♦ An outright sale or purchase and
♦ A Repo trade.

18. What is a Repo trade and how is it different from a normal buy or sell transaction?

An outright Buy or sell transaction is a one where there is no intended reversal of the trade at the point of execution of the trade. The Buy or sell transaction is an independent trade and is in no way connected with any other trade at the same or a later point of time.

A Ready Forward Trade (which is normally refereed to as a Repo trade) is a transaction where the said trade is intended to be reversed at a later point of time at a rate which will include the interest component for the period between the two opposite legs of the transactions.

So in such a transaction, one participant sells securities to other with an agreement to purchase them back at a later date. The trade is called a Repo transaction from the point of view of the seller and it is called a Reverse Repo transaction from point of view of the buyer.

Repos therefore facilitate creation of liquidity by permitting the seller to avail of a specific sum of money (the value of the repo trade) for a certain period in lieu of payment of interest by way of the difference between the two prices of the two trades.

Repos and reverse repos are commonly used in the money markets as instruments of short-term liquidity management and are also called as a Collateralised Lending and Borrowing Mechanism. Banks and Financial Institutions usually enter into reverse repo transactions to manage their reserve requirements or to manage liquidity.
19. What is the concept of the broken period interest as regards the Debt Market?

The concept of the Broken period interest or the accrued interest arises as interest on bonds are received after certain fixed intervals of time to the holder who enjoys the ownership of the security at that point of time. Therefore an investor who has sold a bond which makes half-yearly interest payments three months after the previous interest payment date would not receive the interest due to him for these three months from the issuer. The interest on these previous three months would be received by the buyer who has held it for only the next three months but receive interest for the entire six month periods as he happens to be holding the security at the interest payment date.

Therefore, in case of a transaction in bonds occurring between two interest payment dates, the buyer would pay interest to the seller for the period from the last interest payment date up to the date of the transaction. The interest thus calculated would include the previous date of interest payment but would not include the trade date.

20. What are the conventions followed for the calculation of Accrued Interest?

The Day Count Convention to be followed for the calculation of Accrued Interest in case of transactions in G-Secs is 30/360. I.e. each month is to be taken as having 30 days and each year is to be taken as having 360 days, irrespective of the actual number of days in the month. So, months like February, March, January, May, July, August, October and December are to be taken as having 30 days.

21. What is the Clean Price and the Dirty Price in reference to trading in G-Secs?

G-Secs are traded on a clean price (Trade price) but settled on the dirty price (Trade price + Accrued Interest). This happens, as the coupon payments are not discounted in the price, as is the case in the other non-govt. debt instruments.

22. How are the Face Value, Trade Value and the settlement value different from each other?

The Cumulative face Value of the securities in a transaction is the face Value of the Transaction and is normally the identifiable feature of each transaction.

Say, a transaction of Rs.5,00,000 worth of G-Secs will comprise a trade of 5000 G-Secs of Rs.100 each.
The Trade value is the cumulative price of the traded G-Secs (i.e. no. of securities multiplied by the price).

Say, the G-Secs referred to above may be traded at Rs.102 each so that the Trade Value is Rs.5,10,000 (102 x 5000).

The Settlement value will be the trade value plus the Accrued Interest.

23. **What is the issuance process of G-secs?**

G-secs are issued by RBI in either a yield-based (participants bid for the coupon payable) or price-based (participants bid a price for a bond with a fixed coupon) auction basis. The Auction can be either a Multiple price (participants get allotments at their quoted prices/yields) Auction or a Uniform price (all participants get allotments at the same price).

RBI has recently announced a non-competitive bidding facility for retail investors in G-Secs through which non-competitive bids will be allowed up to 5 percent of the notified amount in the specified auctions of dated securities.

24. **How can investors in India hold G-Secs?**

G-Secs can be held in either of the following forms:
- Physical Security (which is mostly outdated & not used much)
- SGL (Subsidiary General Ledger) A/c with the Public Debt Office of the RBI. The SGL A/cs are however restricted only to few entities like the Banks & Institutions.
- Constituent SGL A/c with Banks or PDs who hold the G-secs on behalf of the investors in their SGL-II A/cs of RBI, meant only for client holdings.
- Same Demat A/c as is used for equities at the Depositories. NSDL & CDSL will hold them in their SGL-II A/cs of RBI, meant only for client holdings.

25. **What are the type of transactions which take place in the market?**

The following two types of transactions take place in the Indian markets:

- Direct transactions between banks and other wholesale market participants which account for around 25% of the Wholesale Market volumes: Here the Banks and the Institutions trade directly between themselves either through the telephone or the NDS system of the RBI.

- Broker intermediated transactions, which account for around 70-75% of the trades in the market. These brokers need to be members of a Recognized Stock Exchange for RBI to allow the Banks, Primary Dealers and Institutions to undertake dealings through them.
26. *What is the role of the Exchanges in the WDM?*

BSE and other Exchanges offer order-driven screen based trading facilities for Govt. securities. The trading activity on the systems is however restricted with most trades today being put through in the broker offices and reported to the Exchange through their electronic systems which provide for reporting of "Negotiated Deals" and "Cross Deals".

27. *When was the BSE accorded regulatory permission for the WDM?*

The Reserve Bank of India, vide its circular DBOD.FSC.BC.No. 39/24.76.002/2000 dated October 25, 2000 permitted the Banks and the Financial Institutions in India to undertake transactions in debt instruments among themselves or with non-bank clients through the members of The Stock Exchange, Mumbai (BSE). This notification paved the way for the Exchange to commence trading in Government Securities and other fixed income instruments.

28. *How is the settlement carried out in the Wholesale Debt Market?*

The settlement for the various trades is finally carried out through the SGL of the RBI except for transfers between the holders of Constituent SGL A/cs in a particular Bank or Institution like Intra-a/c transfers of securities held at the Banks and CCIL.

As far as the Broker Intermediated transactions are concerned, the settlement responsibility for the trades in the Wholesale market is primarily on the clients i.e. the market participants and the broker has no role to play in the same. The member only has to report the settlement details to the Exchange for monitoring purposes. The Exchange reports the trades to RBI regularly and monitors the settlement of these trades.

29. *What are the trading and reporting facilities offered by the BSE Wholesale Debt Segment?*

The BSE Wholesale Debt Segment offers trading and reporting facilities through the GILT System, an automatic on-line trading system, which will over a period of time provide an efficient and reliable trading system for all the debt instruments of different types and maturities including Central and State Govt. securities, T-Bills, Institutional bonds, PSU bonds, Commercial Paper, Certificates of Deposit, Corporate debt instruments and the new innovative instruments like municipal securities, securitized debt, mortgage loans and STRIPs.
30. **What are the three modules in the GILT system?**

GILT permits trading in the Wholesale Debt Market through the three following avenues:

- Order Grabbing System – which provides for active interaction between the market participants in keeping with the negotiated deal structure of the market.

- Negotiated Deal Module – which permits the reporting of trades undertaken by the market participants through the members of the Exchange.

- Cross Deal Module – permitting reporting of trades undertaken by two different market participants through a single member of the Exchange.

31. **What is the membership criteria and charges for the membership of the BSE Wholesale Debt Segment?**

The membership of the debt market segment is being granted only to the Existing Members of the Exchange. The members need to have a minimum net worth of Rs.1.5 crores for admission to undertaking dealings on the debt segment. No security deposit is applicable for the membership of the Debt Segment as in other Exchanges. The annual approval/renewal charges at present is Rs.25,000/-.

32. **What is the settlement mode allowed in GILT?**

The settlements for all the trades executed on the GILT system are on a rolling basis. Each order has a unique settlement date specified upfront at the time of order entry and used as a matching parameter. The Exchange will allow settlement periods ranging from T+0 to T+5.

27. **What are the aspects for settlement of trades in G-secs in GILT?**

The Settlement for the securities traded in the Debt Segment would be on a Trade by Trade DVP basis. The primary responsibility of settling trades concluded in the wholesale segment rests directly with the participants who would settle the trades executed in the GILT system on their behalf through the Subsidiary Ledger Account of the RBI. Each transaction is settled individually and netting of transaction is not allowed. The Exchange would monitor the Clearing and Settlement process for all the trades executed or reported through the ‘GILT’ system. The Members need to report the settlement details to the Exchange for all the trades undertaken by them on the GILT system.