Unit: 4 DEBT MARKET

Evolution of debt market in India

Existence of well-developed government (govt.) debt market is critical for investors, market participants and policy makers. Administered interest rates, artificially low coupon rates were some of the dominant features of the market until 1990. Starting 1992, Reserve Bank of India (RBI) has taken several reform initiatives to build a vibrant liquid, competitive and integrated govt. debt market with the purpose of: 1) providing a benchmark yield curve whose information content could guide policymakers and investors; 2) making transmission mechanism of monetary policy impulses effective; 3) making a constant source of government borrowing to finance the fiscal deficit. Over the past two decades, the govt. debt market has demonstrated a steady improvement in terms of liquidity and infrastructure enhancements which should convince the investors that it does not function under the manipulation of RBI. The study by Kanjilal (2011) shows that movements in govt. debt market are still a reflection of RBI's policy change. Separation of 'debt management' from 'monetary management', widening both domestic andforeign investment .

Debt market Debt market is where investors buy and sell debt securities, mostly in the form of bonds. Debt market is where investors buy and sell debt securities, mostly in the form of bonds. Debt market in India is one of the largest in Asia. Like all other countries, Indian debt market is also considered a useful substitute to banking channels for finance.

The debt market in India consists of mainly two categories — the government securities or the G-Sec markets comprising central government and state government securities, and the corporate bond market. market in India is one of the largest in Asia. Like all other countries, Indian debt market is also considered a useful substitute to banking channels for finance.

The debt market in India consists of mainly two categories — the government securities or the G-Sec markets comprising central government and state government securities, and the corporate bond market.

Money market: Money market in India in India is a correlation for short-term funds with maturity ranging from overnight to one year in India including financial instruments that are deemed to be close substitutes of money.[1] Similar to developed economies the Indian money market is diversified and has evolved through many stages, from the conventional platform of treasury bills and call money to commercial paper, certificates of deposit, repos, forward rate agreements and most recently interest rate swaps[2]

The Indian money market consists of diverse sub-markets, each dealing in a particular type of short-term credit. The money market fulfills the borrowing and investment requirements of providers and users of short-term funds, and balances the demand for and supply of short-term funds by providing an equilibrium mechanism. It also serves as a focal point for the central bank's intervention in the market.

Instruments in debt market : Bonds

Bonds on the other hands are issued generally by the government, central bank or large companies are backed by a security. Bonds also ensure payment of fixed interest rates to the lenders of the money. On maturity of the bond, the principal amount is paid back

Goverment securities : government security is a bond or other type of debt obligation that is issued by a government with a promise of repayment upon the security's maturity date. Government securities are usually considered low-risk investments because they are backed by the taxing power of a government. In fact, investment in U.S. treasury securities is probably the safest investment that can be made.

Government securities are usually issued for two different reasons. The primary reason that most government securities are issued is to raise funds for government expenditures. The federal government issues treasury securities to cover shortfalls (deficits) in its annual budget.

Psus bonds: PSU bond funds are mutual fund schemes that invest in bonds issued by commercial banks and public sector undertakings (PSU). ... PSU bonds are seen as sovereign risk and mutual funds typically restrict themselves to buying securities issued by financially sound banks with high credit ratings

Corporate bonds: corporate bond is a type of debt instrument that is issued by a firm and sold to an investor. The company gets the cash it needs for capital and in return the investor is paid a pre-established number of interest payments at either a fixed or variable interest rate. When the bond expires, or "reaches maturity," the payments cease and the original investment is returned.

The backing for the bond is generally the ability of the company to repay, which depends on its future revenues and profitability. In some cases, the company's physical assets may be used as collateral.

Primary dealers in goverment securities: primary dealer is a firm that buys government securities directly from a government, with the intention of reselling them to others, thus acting as a market maker of government securities. The government may regulate the behaviour and number of its primary dealers and impose conditions of entry. Some governments sell their securities only to primary dealers; some sell them to others as well. Governments that use primary dealers

Feature of bonds: Face value

Corporate bonds normally have a par value of $1,000, but this amount can be much greater for government bonds.

Interest

Most bonds pay interest every 6 months, but it's possible for them to pay monthly, quarterly or annually.

Coupon or interest rate

Fixed-rate bonds generate a constant interest rate. You receive the same amount each year or month, depending on the interest payment schedule.

There are also 2 types of floating-rate bonds. The interest rate is either set in advance each year or tied to market rates.

Step-up bonds have yields that increase over a set period (e.g., 4% the first year, 4.5% the second year, etc,). They can also be bought back at the issuer's choosing.

Other bonds have an adjustable floating rate, tied to market rates such as Treasury bills. If Treasury bill yields to up, the investor wins out. The reverse also is true: if yields go down, the bond issuer wins out.

Fixed-rate bonds are therefore considered safer than floating-rate bonds, but their yield may be lower.

Maturity

Maturities can range from as little as one day to as long as 30 years (though terms of 100 years have been issued!

A bond that matures in one year is much more predictable and thus less risky than a bond that matures in 20 years. Therefore, the longer the time to maturity, the higher the interest rate. Also, a longer term bond will fluctuate more than a shorter term bond.

Issuers

The issuer's stability is your main assurance of getting paid back when the bond matures.

For example, the Canadian and U.S. governments are far more secure than any corporation. Their default risk–the chance of the debt not being paid back–is extremely small, so small that they are considered risk free assets. The reason behind this is that a government will always be able to bring in future revenue through taxation.

A company on the other hand must continue to make profits, which is far from guaranteed. This means the corporations must offer a higher yield in order to entice investors–this is the risk/return trade-off in action.

Rating agencies

The bond rating system helps investors distinguish a company's or government's credit risk.

Blue-chip firms, which are safer investments, have a high rating while risky companies have a low rating.

The chart below illustrates the different bond rating scales from the major rating agencies:

Methods of bonds :

Fixed rate bonds have a coupon that remains constant throughout the life of the bond. A variation are stepped-coupon bonds, whose coupon increases during the life of the bond.

Floating rate notes (FRNs, floaters) have a variable coupon that is linked to a reference rate of interest, such as Libor or Euribor. For example, the coupon may be defined as three-month USD LIBOR + 0.20%. The coupon rate is recalculated periodically, typically every one or three months.

Zero-coupon bonds (zeros) pay no regular interest. They are issued at a substantial discount to par value, so that the interest is effectively rolled up to maturity (and usually taxed as such). The bondholder receives the full principal amount on the redemption dateHigh-yield bonds (junk bonds) are bonds that are rated below investment grade by the credit rating agencies. As these bonds are riskier than investment grade bonds, investors expect to earn a higher yield.

Convertible bonds let a bondholder exchange a bond to a number of shares of the issuer's common stock. These are known as hybrid securities, because they combine equity and debt features.

Exchangeable bonds allows for exchange to shares of a corporation other than the issuer.

Bonds rating:

Bond Rating:

A bond rating is a way to measure the creditworthiness of a bond, which corresponds to the cost of borrowing for an issuer. These ratings typically assign a letter grade to bonds that indicates their credit quality. Private independent rating services such as Standard & Poor's, Moody’s Investors Service, and Fitch Ratings Inc. evaluate a bond issuer's financial strength, or its ability to pay a bond's principal and interest, in a timely fashion.A bond rating is a letter-based credit scoring scheme used to judge the quality and creditworthiness of a bond.

Investment grade bonds assigned “AAA” to “BBB-“ ratings from Standard & Poor's, and Aaa to Baa3 ratings from Moody’s. H gbJunk bonds have lower ratings.

The higher a bond's rating, the lower the interest rate it will carry, all else Rating

A rating is an assessment tool assigned by an analyst or rating agency to a stock or bond indicating its potential for opportunity or safety. more

Credit Quality Definition

Credit quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. more

Ba3/BB-

Ba3/BB- is the bond rate given to debt instruments that are generally considered to be non-investment grade and speculative in nature, providing a measure of the riskiness of the security and the likelihood of the issuer defaulting on the debt.