Retail Debt And Retail Investors

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Debt plays a role into our everyday lives - now, even more than ever before. Think of our household balance sheets and the role that debt and debt markets play in it – directly and indirectly. Close to 60 to 65 percent of an average Indian's savings are parked into financial products that involve an active role of debt - the rest being shared by real estate, gold and equities. Of this financial universe invested in debt products, some of the most common investments are that into public provident fund, pension funds, employee provident fund, post office savings schemes, RBI Relief bonds, etc. – which mainly qualify under small savings schemes. All the investments that we make in these small savings schemes are invested with the Government of India as a special fixed interest rate bond, besides directly being invested into government securities. Besides, a large part of an average Indian's balance sheet is exposed to life insurance premia and its various insurances schemes. LIC invests close to 80 percent of its investments into government securities and other Public Sector Bonds' loans and debentures – again a retail investor's indirect exposure into the debt markets. Employee Provident Funds' investments are guided by their investment pattern, of which all is supposed to be invested in either government securities or a government backed corporation debt, with marginal allowance to private sector debt. RBI Relief Bonds are borrowings of the central government, as a part of their federal budget, which are conducted by the Reserve Bank of India. More direct exposure to the debt markets, lately, is in the form of debt schemes floated by various mutual funds, like liquid schemes, gilt schemes, income schemes, fixed maturity plans, etc. These funds are invested directly into various debt market products like government securities, corporate debentures and bank deposits. As retailers, we have even been acquainted with the concept of company fixed deposit schemes. However, our most direct exposure to debt markets come in the form of investments in fixed deposits with banks. The banks, in any economical set up, act as a channel for matching the savings to the investments, i.e. making the demand and supply of funds meet. In India, one of the largest demand for funds comes from the central government, and the supply of funds comes from savers like you and me. Our savings are channelised into investment in government securities and other form of loans to corporates by any or all of the above mentioned investments. Hence, indirectly or directly, we are already exposed to debt markets. Debt market, in the Indian scenario, construes of non equity securities issued by the central

and state government, the public sector and the private sector. That means debt markets act as a channel where borrowers of money (demand for money) is met by the suppliers of money like banks, statutory investment institutions like provident and pension funds, banks and insurance companies, and dedicated debt investment institutions like mutual funds.

This January, the Reserve Bank of India and SEBI allowed, government securities to be traded in retail lots on stock exchanges. The allowance of trading of government securities was more to provide the retail investors with risk free debt investments and in a easier and a much transparent mode, and it gathered much steam after the Finance Minister announced the same in the 2002 Federal Budget. Through the above paragraph, I have already made it clear that the retail investors are already indirectly investing in government securities, through various channels. However, trading government securities in the stock exchanges provided the transparency for retail investors. After the first day volumes of around Rs. 1.5 – 2 crores, with around 200 deals, the daily trading volumes have tapered off. Analyzing the total retail trades traded in the two premier stock exchanges of India – Bombay Stock Exchange and the National Stock Exchange, the total trading volumes – measured, as the number of trades and total traded value are very low. If one discounts the first three trading days, the average numbers of trades daily are barely 6 to 10 trades. Also, the total average daily traded volume is barely Rs. 5 – 10 lakhs – peanuts as compared to the daily average volume of Rs. 3543 crores in the wholesale debt market segment. Looking at the figures alone, retail debt trading on exchanges has been a non starter. There are various reasons, in my opinion, which contributed to the same :

- Government securities and debt market trading, as a concept, is less understood by the retail investors. Retail investors would like to have fixed interest rate products like deposits, for investments rather than for trading purposes. Trading of interest rate products are well understood in terms of risk management and market understanding by institutions like banks and mutual funds.
- A retail investor coming to the stock exchange is more used to equities rather than debt. That is the reason that the "F" category trading segment of the BSE and the Capital Market Segment of the NSE, for debt trades like debentures and bonds, barely show volumes relevant to equities.
- The daily movement in the government securities is about 10-25 paise on a normal trading day and about Rs. 2-3, on very volatile days. A retail investor who wants to buy government securities through exchange would compare such a daily movement in prices with their equity counterparts, where the movements would be in much larger denominations.
- The prices of the government securities quoted on the stock exchanges are in dirty price terms, i.e. it includes the accrued interest component added onto the clean price (which is derived from the yields traded). In contrast to that, the prices quoted and traded in the wholesale debt markets are in clean prices, while trading (they are settled in dirty price terms). Difference in the quoting conventions in the retail and wholesale debt markets, would itself confuse the retail trader.
- Retailing of government securities is not a new concept. In fact, the Reserve Bank of India, promoted the scheme of satellite dealers, whose main objective was to retail government debt. However, the same was discontinued by the RBI, 2 years back, as the response was not good enough. This besides, many banks like Punjab National Bank, actively displayed two - way buy – sell quotes on their deposit counters, especially for depositors, who wanted to access these markets. But, in my view, such quotes display would be conflicting the banks' interest itself as, as the bank would not like to offer products, which are competing with their own deposits.

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- Again, retailing of government securities was something, which was already done even before this January, especially by some high net worth individuals and provident funds. The infrastructure was already available in the form of SGL II accounts held with any banks for the purpose of settling these deals. Government securities are already settled in an electronic form, and hence an investor could either open a SGL II account with the bank or even use his demat account for the purpose of settling their government security deals.
- Globally, the participation of retail investors in the their respective government securities through exchanges is almost absent. Most of them invest through mutual funds.

However, there are various reasons for the savings community to deal directly in government securities:

- Given the secular downtrend in interest rates, the returns generated from some high coupon government securities have been in double digits. The benchmark ten years

government security yields have fallen by more than half since the last four years. This has generated annualized returns of almost 30 – 38 percent, consistently every year, since the last three years. This is as compared to Sensex giving negative returns. Currently, such returns are primarily enjoyed by investors in gilt schemes of debt mutual funds.

- There is zero default risk on the interest rates and the principal redemption, as these are liabilities of the central government.
- There is no Tax Deducted at Source at the time of interest payment, making it relatively better than company and bank fixed deposits.
- There are additional income tax benefits of Rs. 3000 per annum to the investor under section 80L of the Income Tax Act.
- The markets are very liquid, unlike the fixed deposits, and hence, an investor can easily sell the government securities or even readily pledge them with banks, to generate liquidity. It is relatively difficult to break a fixed deposit, and the margins on loans against shares and even against RBI Relief Bonds are around 30-40 percent. The similar margin for loans against government securities is around 10-15 percent.
- There is a wide distribution of brokers and sub-brokers around the country for the servicing the retail investors.
- The prices at which the government security prices are dealt are very transparent, with newspapers and the RBI declaring the prices at which they are dealt every day, along with the security wise volumes.
- The minimum face value, for the purpose of retail trades is Rs. 1000, making it quite accessible for retail debt investors.
- Comparing government as an option for investors with its other peers, Relief Bonds pay around 6.5 percent tax free, but liquidity is very limited. Bank fixed deposits offer between 5 percent to 7 percent, depending upon the maturity of the deposit, but the same enjoys limited tax concessions in terms of 80L, and there is little liquidity. Company fixed deposits offer better returns in terms of interest rates, but there is credit risk that the investor carries apart from no tax benefit and no liquidity. Small savings schemes like post office savings deposits and PPFs, offer moderate relative return, but no liquidity. Government securities offer the middle path to all these avenues, in terms of better tax advantage and liquidity than bank fixed deposits, and no credit risk attached at all.

Lately, with the falling interest rates, debt markets govern not only the asset side of our household balance sheets but also the liability side of it - in the form of housing loans, personal loans, EMIs on cars, loans against share facility, etc. This is because, with the falling returns on government securities, the banks are also cutting rates on other retail loan products. However, the same is yet a small proportion of our overall exposure to the debt markets.

We have been used to a very stable interest rate structure, where a fixed deposit rate of a bank did not differ from that of the other, the services of one bank did not differentiate much and there were little means of accessing the personal loans directly from the banks. Earlier, the government used to borrow directly from the Reserve Bank of India at rates, which were not market determined. However, since 1993-94, as the RBI deregulated the interest rates, the interest rates went up for the initial four years and have seen a continuous fall from 1997 to date. Measuring the magnitude of such a fall, the benchmark ten year government security yields have fallen by more than a half from 14 percent in 1997 to 6 percent currently. In the initial years of the fall, the volatility of the general interest rates in India, did not bother the retail investors much, however, lately, the general interest rates follow the market demand and supply trend broadly. We have never seen such a fast revision of LIC policy rates and cutting of the bank deposit rates, as we have in the recent past, and the main reason for such cuts were the avenues that these institutions invested monies in, that is the government securities, were yielding less. This meant that even though the government's borrowings have increased at a very fast pace in the past 4 years, such a pressure on borrowings is little felt as the supply of money is relatively more, especially as the private sector demands lesser due to general economic slowdown, which led to the returns on such government borrowings, viz yields on their securities, was also kept falling. Given that we are in a complete paradigm shift for interest rates, retail investors would need to keep in active touch with debt markets and the movement of interest rates. And government securities are the genesis of all the other interest rates in India.

SENSEX

BSE adopts yet another international best practice by moving its india's benchmark equity index into a

Free Float Index

FROM SEPTEMBER 1, 2003, SENSEX, INDIA'S BENCHMARK EQUITY INDEX IS FREE FLOAT BASED.