Primer on State Development Loans (SDL)

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Edelweiss MUTUAL FUND

1. What is an SDL?

State Development Loans (SDL) are market borrowing by various States of India in form of bonds. These bonds are auctioned by the Reserve Bank of India (RBI) on regular basis in the same manner as G-Sec and share similar characteristics such as:

- The coupon rate for each state is decided by the auction process
- The RBI conducts the auction process on behalf of States
- The interest is paid on semi-annual basis with bullet payment on maturity
- SDLs do not carry any credit risk. As a result, they carry zero risk weight – similar to G-Sec & T-Bills
- SDL are eligible for SLR investments – similar to G-Sec & T-Bills
- SDL are eligible for LAF and Repo operations – similar to G-Sec & T-Bills

2. Why do States issue SDLs?

States issue SDLs to finance the gap between their revenues and expenditures. In the Indian system, the GOI cash transfers form bulk of States' annual revenues. However, states' total expenditure far exceeds their total revenue collection. A large portion of this gap is funded by issuing SDLs in the open market in a transparent manner. In recent times, around 80% of States' fiscal deficit is being funded through issuance of SDLs.

3. How do States services SDLs?

All SDLs are serviced by the RBI through the Consolidated Sinking Fund (CSF) and Guarantee Redemption Fund (GRF) that States maintained with the RBI. As a result, there is a high degree of certainty on interest payments and principal payment on SDL.

4. Is there any instance of default in SDL?

There is no instance of any default by an SDL in India.

5. In that case, why do SDL pay higher interest rate the G-Sec?

This is on account of relative illiquidity in our opinion. Although, SDLs and G-Sec carry similar risk and credit characteristics, one major difference is the sheer number of primary supply of SDLs by various states. While the GOI tends to reissue same bonds multiple number of times until the amount outstanding reach a particular threshold, States, on the other hand, generally prefer to issue new securities on each auction date. This causes fragmentation of SDLs in the bond market and prevents consolidation of single SDLs. This contributes to relative illiquidity in the secondary market as compared to G-Sec. The following table captures the major difference in terms of outstanding number of SDLs and G-Sec in the market as on Jan 31, 2021:

	G-Sec	**SDL**
Total Amount Outstanding:	Rs. 66.59 trillion	Rs. 37.66 trillion
# of bonds outstanding:	88	3,871

Weighted-Average Maturity:	~9.5 years	7.12 years

Source: CCIL

6. How are SDLs traded & settled?

SDLs are traded in two ways – Either in Over the Counter (OTC) or on NDS – OM. Regardless of their mode of transaction, all SDL trades are settled by the Clearing Corporation of India (CCIL) – similar to a settlement process for G-Sec & T-Bills. All SDL transactions are settled on T+1 basis. The following table captures the break-up of secondary market trading in SDL in FY20:

	OTC trades	**NDS-OM**	**Total Traded Amount**
Total FV Amount:	Rs. 4,84,576 crore	Rs. 2,01,800 crore	Rs. 6,86,376
% of trade:	70.6%	29.4%	100%

Source: CCIL

Fixed income brokers also play important role in creating additional liquidity in SDL. Brokered deals contributed to around 11% of all OTC trades in FY20 according to CCIL.

That said, SDL contributes to around 7% of total trading volume as compared to around 77% for G-Sec and around 16% of T-Bills in Jan 2021.

7. What are different maturity tenors of SDLs?

States generally prefer to issue long-tenor SDLs. Most states prefer to issue 10-year SDL in order to seek favorable yield spread over 10Y G-Sec. However, lately, some States have also been issuing SDLs for as low as 2 years and as high as 25 years.

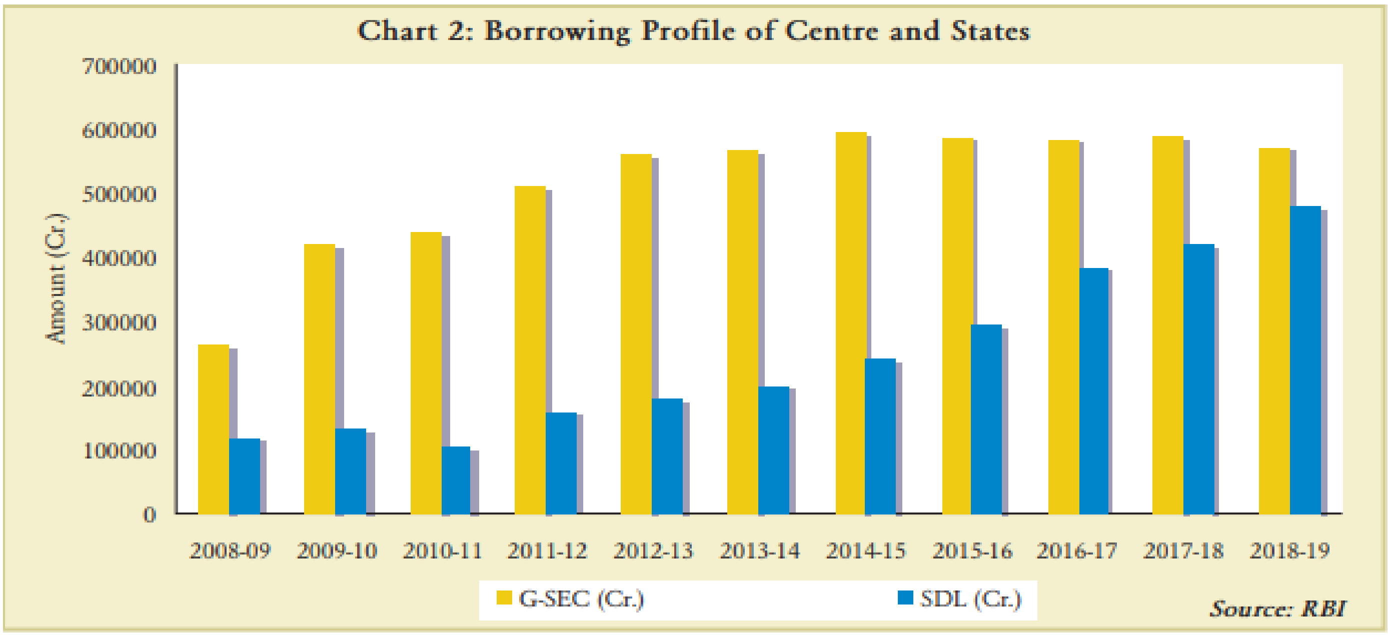
8. What has been the average yield spread for SDL over G-Sec?

Between FY12 and FY19, the volume-weighted average yield spread for SDL has been around 45 basis points over comparable maturity G-Sec according to a research paper. However, recently, the spread has widened to around 100 basis points over 10-year G-Sec on account of massive increase in the primary supply of SDLs coinciding with the massive increase in the primary supply of G-Sec on account of the pandemic.

9. What has been the recent trend in SDL issuances?

Due to decentralization of the economic activities, States play a pivotal role in India's growth story and nation building. It has been observed that total annual expenditure by all States put together is similar to the annual total expenditure by the Central Government. As a result, primary supply of SDL has been growing at a faster pace than growth in G-Sec. For example, total issuance of SDL in FY21 is Rs. 7.14 trillion as on March 3, 2021 according to a report by CARE Ratings. This is around 31% higher than corresponding borrowing of Rs. 5.14 trillion in the same period in FY2020.

The following chart illustrates the growth in SDL issuance:



10. Is there a difference between an SDL and a bond issued by a State-owned entity?

Yes. While an SDL is considered a sovereign risk and therefore credit risk free, the same cannot be true for a bond issued by a State-owned entity. This major difference is on account of these two bonds are serviced with regard to interest payments and principal payments.

While SDLs are serviced by the RBI through States accounts maintained with the RBI, market participants have never experienced any delay or default in any of the SDL from any States.

At the same time, bonds issued by State-owned entities are normally serviced by either the bond issuing entity or the treasury of the respective states. Since, most States are running a high level of deficit, there is always an element of uncertainty with regards to timely payment of interest and principal. As a result, bond investors tend to price bonds issued by a State-owned entity several notch lower than an SDL issued by same State.

11. Is there any difference between an SDL issued by State A and an SDL issued by State B?

Theoretically speaking – Should be. Practically speaking – Hardly. Since bond market participants are quite comfortable with the present mechanism for SDL involving the RBI. As a result, the difference in coupon rate of an identical maturity SDL issued by State A and State B is generally not commensurate with the fiscal strength of State A or State B. In General, the difference in coupon rate is around 2-5 basis points during the primary auction cut-offs. That said, the RBI has been trying to introduce various measures through which bond market will start differentiating SDLs based on fundamental factors of States and price them differently.

12. Is there any linkage between State's financial conditions and their borrowings through SDL?

It is hard to tell as market participants generally don't have access to States' finances on timely basis. However, based on the primary supply of SDL in FY21, CARE Ratings has highlighted the following facts as on March 2, 2021:

Top 6 Borrowing States:	TN, MH, UP, KA, RJ, AP (~53% of total supply in FY21)
Top 5 States with highest YoY increase in SDL supply:	MP (112%), RJ (57%), MH (54%), KA (43%) & TN (37%)

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