India's Emerging Corporate Bond Market: Potential and Challenges

***Mr. D. R. Dogra**, MD & CEO, CARE Ratings*

Despite the remarkable progress made in the Indian financial markets over the years and with the country holding a place of prominence globally in the equity markets space, India's corporate bond markets have been by and large stagnant. They have not managed to build investor interest over the years and account for less than 5% of India's debt market. While some steps have been taken to make them more robust, there has been limited success.

This lack of progress and development in the country's corporate debt markets have all along been attributed to the host of issues and challenges that have besieged these markets. At the same time the highly favourable potential of this essential segment of the financial markets is well acknowledged.

The discussion here is centred on achieving the potential for the corporate bond markets and addressing the various issues and challenges that come in the way of the development and deepening of this segment of the Indian financial market.

Need and Potential

It is accepted today that the country's economic growth and development is dependant on the availability of adequate capital to meet its current and potential capital and funding requirements. This direct

India's Corporate Bond Markets have not managed to build investor interest over the years and account for less than 5% of India's debt market

dependence on capital for growth is all the more severe for a country like India which is primarily a developing country with a large population base. There are relatively large capital requirements to develop the economy. To put it in perspective, India needs $1 trillion alone for its underdeveloped infrastructure for the 5 year period till 2017 i.e. during the 12th five year plan period.

It is here that the various possible sources and avenues for funding the capital requirements come into focus. Traditionally, infrastructure project in the country have relied on government and bank funding. Given the inadequacies and limitations of both these sources, there is an urgent need to develop and promote alternate sources of funding for such projects. The government will be compelled to work within the FRBM norms of reining in the deficit and will not have elbow room to increase project spending. Private investments would thus necessarily have to play a greater role to fill this funding gap. Infact, the growing reliance on private investments can be gauged from the estimates of their contribution to the planned investment in the 12th five year plan period - private contribution is projected to be to the tune of one third (or $333 bn) of the planned investment. Herein lies the scope and potential for the country's corporate bond markets.

Even though, the corporate bond markets play an important role as an alternative source of funding, the bond markets account for less than 5% of the funds of Indian corporates. Businesses in the country are known to rely heavily on internal sources of funds (over 35 % of company funds in recent years as per the RBI data), to meet their finance requirements. Amongst its external sources, bank loans and advances comprise the largest quantum (at around 20%). These sources are however unable to wholly meet the finance demand of businesses, especially when it comes to longer term credit given the asset liability management issues. Given the growing need for large quantum of long term credit, the corporate bonds could serve as an effective and stable source of funds.

Moreover, the increased capital adequacy requirements that banks would have to adhere to in accordance with the implementation of the Basel III norms would necessarily limit the banks ability to provide capital to corporates and this would consequently increase the reliance of corporates on the bond markets. The urgency however can be gauged from the fact that India is presently in a low state of equilibrium and to move ahead, a big push is required which has to come from the infrastructure side with the requisite support from the financial sector, of which the bond market is an integral part.

A factor that can boost and aid in the development of India's corporate bond market is the existence of a well developed government securities (G-secs) market with a large investor base and sizeable amount of government debt. The country processes a reliable source for benchmark yield of risk (default)- free securities, a pre-requisite for a sound and vibrant corporate debt market. The G-sec market also ensures the existence of a developed structure for the debt segment in terms of market infrastructure and skilled personnel. However, the high diversion of funds into this segment has today come in the way of the development of the corporate debt market as banks typically prefer to invest in GSecs as they are risk free and also more convenient when it comes to meeting capital requirements. There evidently have to be changes made in the structure of these markets so as to grow the corporate debt segment.

Issues and Challenges

The country's corporate bond markets are beset by wide ranging problems and issues, all of which have curtailed the growth of this segment as an effective, alternative and stable source of funding for firms. Both the primary and secondary markets for corporate debt are fraught with a set of issues and shortcomings. Addressing these challenges would be necessary for the growth and development of the domestic corporate bond markets.

First, private placements tend to dominate the landscape of the corporate debt market in India. In case of the primary markets, nearly all of the debt raised (over 90%) is privately placed and public issues of bonds is rather miniscule, thereby limiting the quantum of bonds

available for circulation and trading in the secondary markets. The reasons for this includes lack of adequate participation in public issue and the relatively stringent regulatory requirements associated with public issues that entail costs and time on the part of the issuers (borrowers) of debt. Also, these markets are seen to be dominated by financial institutions i.e. NBFC and other financial institutions, which further make it difficult for corporates, especially those who do not enjoy high credit rating to source funds from public bond issues.

Second, the secondary markets for corporate bonds are severely constrained by the lack of liquidity and transparency. The lack of liquidity in these markets has been an inhibiting factor for its development. To add to that, the investor base is limited. It is the institutional investors such as banks, insurers and pension funds that dominate these markets. And all these players are typically long term investors who buy and hold and do not enter the secondary market. Retail investors are almost absent from these markets. Moreover, it is only the higher rated papers, bearing ratings of AAA or AA+, that see some investor interest. The low investor base also increases the cost of issuance.

As a result of the above two, i.e. a majority of debt being privately placed and the consequent lower availability of bonds for trading in the secondary markets, the price discovery process is not satisfactory. The corporate bond markets lacks a benchmark yield curve across maturities, chiefly owing to lower availability of bonds by favoured/trusted issuers, which in turn impacts pricing and liquidity in the secondary markets.

Third, the limited investor base for corporate bonds can also be attributed to the investor preference for government securities. The huge quantum of government borrowings i.e. supply of G-secs, coupled with regulatory requirements of mandatory investments in these by various financial institutions effectively leaves lesser amount of money in the markets and thereby crowds out investments from the corporate debt segment. The G-secs have emerged as an attractive investment avenue for its holders, registering high turnover and exponential growth of around 20% (CAGR) in the last 4 -5 years. In sharp contrast, the turnover in the secondary markets for corporate debt is negligible, at around 5% of the turnover of the government securities market. It would indeed be a challenge to initiate a shift in investor preference from G-secs to corporate bonds.

Further, there are several regulatory restrictions that curtail investments of institutional investors in the corporate bond markets. Banks for one are not permitted to invest in below investment grade securities. Likewise, insurance companies and pension firms are constrained by various norms that stipulate/ govern their investment in corporate bonds, which severely limit their investment options in such bonds.

Fourth, although there exists a fairly well developed market infrastructure for G-secs, we need similar structures to strengthen market structure for corporate bonds. Participants need to have access to live pricing and trading markets along with ease in transacting. This would help enhance transparency and strengthen the markets. The setting up of such platforms on stock exchanges will definitely help to create interest and facilitate participation, though it needs to be supplemented with an education drive across the retail segment.

Fifth, the absence of a standard stamp duty rate across the country as well the maximum amount payable and the charging of TDS on corporate bonds are major impediments for the developments of the nation's corporate bond markets. There is thus need for a comprehensive regulatory framework that is conducive to the deepening of the domestic corporate bond markets.

Sixth, market makers are essential to the development of any market as they assume the risk by providing both 'buy and sell' quotes. They help markets grow and evolve. This has been witnessed in both the equity and GSec segments where market makers have added value by enhancing the depth of the markets. The Indian corporate debt market segment does not have market makers who could add diversity to the markets.

Markets makers should be encouraged in the corporate debt market space and provided with backing and incentives in terms of

finances and supply of securities, for the much needed development in these markets.

Seventh, there is a distinct lack of awareness, knowledge and understanding of bonds as an asset class is also a reason for low retail participation. Inadequate information or information asymmetry pertaining to the issuer and instrument have been factors that keep retail investors at bay. Two challenges are in educating the investors about these markets and then bridging the information asymmetry gap. For the first, there has to be an outreach programme launched by the regulator and exchanges and for the second, the credit rating agencies have a role to play. Credit rating agencies could help bridge the information asymmetry through their independent third party assessment.

Various aspects associated with these securities such as minimum lot size, high transaction costs and illiquidity too hamper the involvement of retail investors in these markets.

The way forward

There is basically a five-point prescription here. First, the issue of regulatory overlap should be addressed. SEBI regulates the capital market, while RBI oversees banks. IRDA decides on how insurance funds operate while the PFRDA regulates the pension funds. The motivations for each and every authority are different as they seek to maintain the credibility of their domain. But this has come in the way of the debt market as the participants. There is need for concerted and co-ordinated action on the part of these regulatory authorities for the overall development of financial markets (particularly bond markets) in the country whilst retaining their independence and decision making capacity within their domains.

Second, banks have to play a key role in the development of the debt market. Today, companies prefer to borrow from banks and vice-versa. This has inhibited the growth of the debt market. Banks prefer these conventional channels as it helps them to eschew the issues of marking-to-market (MTM) for its bond portfolio. A way out is to route all long term borrowings into bond issues by making debt instruments more attractive with appropriate convertibility and exercise (call/put) options and supporting credit enhancements.

Third, market development requires introduction of simple products. It is suggested that the bond market, both for Gsecs and corporate bonds, should go for simple, 3 months, 1 year or 2 year products with simple futures products too. There is also need for multiple hedgers, traders and arbitragers to build on the liquidity in the market. On trading system, debt market should have an order matching system much like the one for equities and for gilts. Corporate bond market remains a broker driven market. Order matching system results in greater transparency. To develop the corporate bond market many people have suggested that Indian debt market has this order matching system.

Fourth, administrative issues relating to issuance of debt needs to be addressed next. Presently, the plethora of disclosures does act as a deterrent and we need to revisit this area considering that most of these companies are well known for the investing community. The high cost of disclosures has been one reason for preference from private placements instead of public offers which has come in the way of the development of this market. The procurement of credit rating, which is mandatory, does bridge the information asymmetry that exists between potential investors and the borrower, which can be used to reduce the number of disclosures.

Corporate bond market remains a broker driven market. Order matching system results in greater transparency. To develop the corporate bond market many people have suggested that Indian debt market has this order matching system

Also, there should be rationalization of stamp duty to be paid for both the corporate bond and securitization markets and such standardization will address the concerns of potential

issuers of debt. It should be realized that corporates will be indifferent to raising money through the debt market or banks, provided the costs - both monetary and convenience are low.

Last, the secondary market is not well developed as yet as there has been a tendency for lenders to follow the policy of - buy and hold, which ensures that such paper does not enter the secondary market for sale. A way out to increase activity would be to offer tax incentives as is offered on equity sale in terms of capital gains so that there will be more activity in this market. In terms of borrowers, the involvement of retail segment is essential as has been observed in case of the equity segment. Currently, the retail segment is not present directly in a big way and comes in more through the mutual fund route. This definitely needs to change which will happen once there is more paper in the market and there is more investor education.

The story of the under-development of the corporate debt market is quite old now. While a lot of these recommendations have been made in the past and some implemented, there has not been much progress. However, it is felt that given the large quantity of funds that are needed to push forward the growth rate of the economy to the 8% plus region, we do need to see heightened activity here or else the steady state growth path cannot be achieved as the existing channels of long term funding i.e. banks, FDI, ECBs have their own limitations and we may be close to reaching the sustainable limits within these domains. One may tend to believe that developing the corporate bond market is a necessity and no longer just an option.

D R Dogra
MD & CEO
CARE Ratings

Mr. D R Dogra has over 34 years of rich experience in credit rating, commercial banking and extensive knowledge about functioning of the corporate sector. Being one of CARE's first employees and an integral part of the top management since 1993, he has overseen the strategic growth and development of the company over the years. His passion and dedication is greatly responsible for the successful growth and development of CARE from a small spin off to a leading credit rating agency in the country.

Mr. Dogra holds a post-graduate degree in Management from FMS, University of Delhi. He is a gold medalist in his Post-Graduate Degree in Agriculture from Himachal Pradesh University. He is also a Certified Associate of the Indian Institute of Bankers. Prior to joining CARE, Mr. Dogra held several positions in a leading Bank for over 15 years.