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Rebooting Economy through Financial Market Reforms

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1. Confederation of Indian Industry (CII), The Mantosh Sondhi Centre; 23, Institutional Area, Lodi Road, New Delhi 110003, India, Tel: +91-11-24629994-7, Fax: +91-11-24626149; Email: info@cii.in; Web: www.cii.in; and

2. CARE Ratings Limited, 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022. Tel: +91-022- 6754 3456, Fax: +91-022-6754 3457, Email: care@careratings.com, Web: www.careratings.com

Foreword

The timelines for the Indian economy moving towards the $5 trillion mark have witnessed a temporary setback on account of the unparalleled economic crisis caused by the Covid-19 pandemic. The uncertainty over the control of the pandemic and the prospects of economic recovery pose a challenge for the country's aspirations. Nevertheless, despite the prevailing uncertainty and severe economic impact of the lockdown and associated restrictions, the inherent potential of the Indian economy remains sound. The attributes that the country possesses in term of size, political stability, progressive leadership and relatively lower exposure to external vulnerabilities stand in good stead.

The severe downturn in the Indian economy over the last 6 months has necessitated unprecedented measures by policy makers. Besides the immediate relief and support actions, a plethora of measures and reforms have been undertaken and announced during the national lockdown with the short, medium- and long-term growth agenda of the country in mind. The government has rightly appreciated the critical role infrastructure investment can come to play in the recovery and revival of the Indian economy. Infrastructure building, in addition to having a cascading positive impact across sectors and segments, would help address the critical infrastructure gaps that dilute our inherent advantages. The path towards the $5 trillion economy would entail sizeable investments.

CARE Ratings estimates that if the nation's economy grows at an annual average rate of 11.6% during the next six years, the country's GDP could reach $ 5 trillion by 2026-27. The fresh investments required to take the economy to this level would amount to nearly Rs. 500 Lakh Crores over the 7 year period 2021 to 2027. While a part of this investment would be borne by the central and state governments combined, the main enabler will be the financial sector viz. banks, debt capital markets and foreign capital.

The quantum of investment that is required to achieve the target economic growth rate would be largely contingent on the ability of the financial system to generate the resources. Indian banks, in recent years have been weighed down by high levels of stressed assets that required higher loan loss provisions which in turn has lowered their capital base, impeding further lending. Although, there were indications of improvement on this account the pandemic led relief measures offered by banks has raised fresh concerns over asset quality in the coming future which have been addressed appropriately through the restructuring scheme announced by the RBI.

Moreover, it is being increasingly acknowledged that the large investment required for infrastructure creation, cannot be met through banks given the long duration of such borrowings. The markets are required to play the important here. The financial market regulators and the government are cognizant of this and have been undertaking measures and reforms in a sustained manner to develop and deepen the debt capital markets based on evolving conditions, thereby reinforcing market confidence.

Even though the pandemic continues to spread in the country, inhibiting the conduct of normal activity, there are indications of improvements and a gradual increase in activity across regions and segments of the domestic economy. Progressive improvements can be expected as the easing of lockdown restrictions become widespread that would put the country back on the growth trajectory.

Mr. Nilesh Shah,
Chairman,
CII National Committee on Financial Markets

Mr. Ajay Mahajan,
Managing Director and CEO,
CARE Ratings Limited

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Chapter 1: Indian Economy's Potential

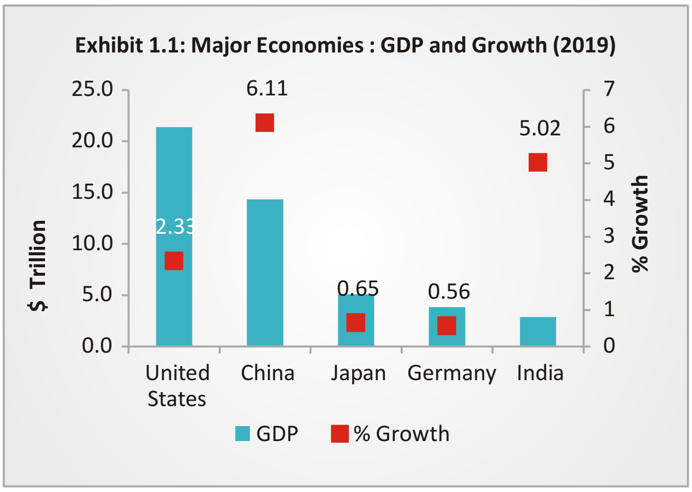
1.1 India's growth perspective before the pandemic

India's economy at $2.9 trillion was ranked as the world's 5th largest in 2019. Up until before the pandemic it was also amongst the fastest growing economies globally despite the slowing economic growth momentum in the preceding 2 years. The country has over the years emerged as a regional and global power aided in large measure by its sustained economic expansion. Despite challenges, the country's development trajectory is regarded as being strong.

India's stable democracy and political situation, large domestic market that insulates it to an extent from global economic cycles and low and sustainable external debt are viewed as factors supportive of the sustained growth potential of the country. At the same time, the country's economy is vulnerable to the pervasive poverty and income inequality and huge infrastructure gaps.

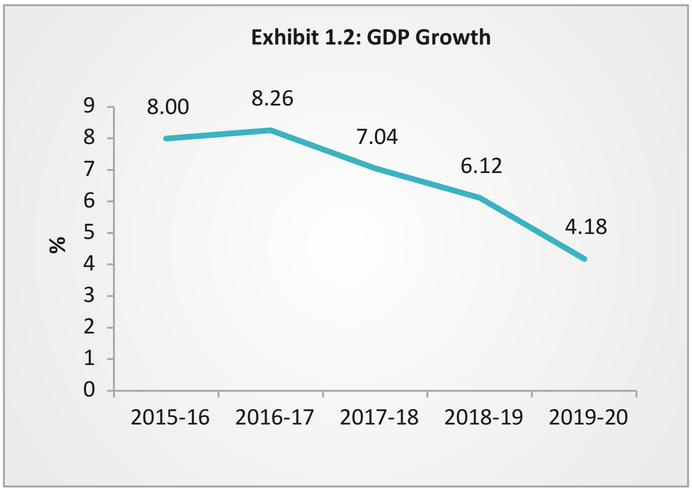
Before the pandemic struck, the India economy was on track to recovery from the growth slowdown of the preceding 2 financial years. The World Bank had then projected that the Indian economy would grow by 7% in 2020-21. Growth was expected to be supported by the accommodative monetary policy, lower corporate tax rates, implementation of structural reform measures and government programs to support the rural economies.

India amongst the fastest growing economies



Source: World Bank

India's GDP Growth: Economic slowdown prior to the pandemic



Source: MOSPI

1.2 Dream of a $ 5 trillion economy

The political leadership in 2019-20 laid out its objective to make the country a $5 trillion economy by 2025, which would make it the world's third largest economy. To attain this, India's economy would be required to grow by 8% per annual in each of the 5 years i.e. 2020-21 to 2024-25. To generate and sustain the envisaged growth, based on the evidence gathered from the other high growth economies, a growth model driven by a 'virtuous cycle' of savings, investments and exports was identified as being needed. Policies and measures that would support and facilitate that, were to be promoted. The Union Budget of 2020-21 that was announced in early February 2020 had measures that were expected to lay the foundation and roadmap for taking the country's economy towards the $5 trillion mark.

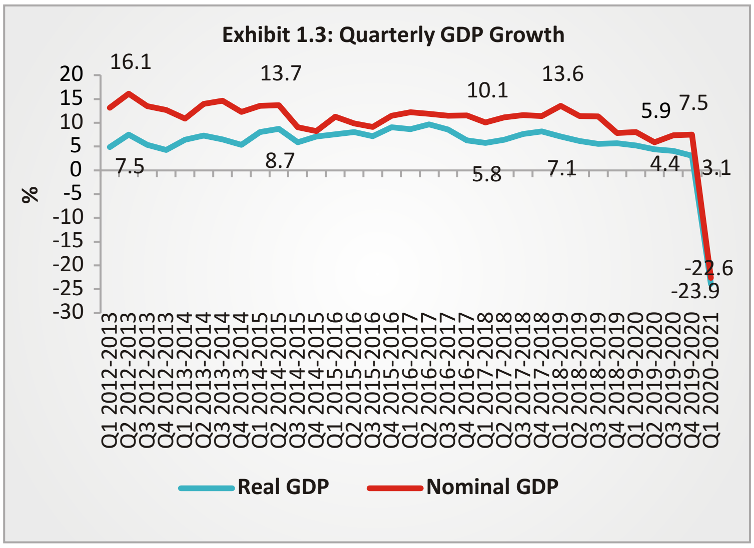
The pandemic and the resultant nationwide lockdown that was announced in March 2020 bought to a sudden halt the conduct of most business and commercial activity. With many of the restrictions on the conduct of normal economic activity still in place even after 6 months of the announcement of the lockdown the purported economic growth trajectory has been effectively derailed at least for the next 1-2 years.

Covid-19 has emerged as the biggest impediment towards the country moving towards a $5 trillion economy. The pandemic has led to an unparalleled global economic crisis with uncertain prospects about the recovery.

1.3 Covid-19 devastation of the Indian economy

While, the pandemic has led to a deep downturn to the global economy, the impact on the Indian economy has been particularly acute due to the country having imposed one of the most stringent lockdowns and restrictions amid the sustained surge in spread of the pandemic in the country.

The economic fall out of the lockdown on the Indian economy has been more severe than anticipated. India's GDP contracted by close to 24% during Apr-Jun'20 (Q1 2020-21), the lowest level on record. The fall in the domestic economy during this period was amongst the sharpest globally.



Source: MOSPI

Table 1.1: Sectoral Growth (year -on-year)

	Q1 2020-21 (% growth)
Agriculture, forestry & fishing	3.4
Mining & quarrying	-23.3
Manufacturing	-39.3
Electricity, gas, water supply & other utility services	-7.0
Construction	-50.3
Trade, hotels, transport, communication and services related to broadcasting	-47.0
Financial, real estate & professional services	-5.3
Public administration, defence and other services	-10.3

Source: MOSPI

The pain of the lockdown and stalling of economic activity has been felt across both the industrial and service sectors in the first 6 months of 2020-21. Both these sectors have witnessed a sharp decline in output. Capacity utilization in both the sector has seen a sharp dent. The agriculture sector has been the only bright spot in the domestic economy in this period.

Consumption, which is the mainstay of the Indian economy has sharply weakened due to the pandemic, further aggravating the weakness in the same in recent years. Subdued consumption has been having a bearing on private investments even before the pandemic. Investments as a proportion of the overall GDP have been restrained and on the downward trajectory for the major part of the last decade. It has worsened since the onset of the pandemic and has unfavorable implications for future growth prospects.

1.4 What to expect for 2020-21

The unlocking of restrictions imposed in March 2020 across the country has been gradual and uneven. The approach and continuity of the lockdown across regions will have a bearing on the resumption of business activity and the attainment of minimum capacity utilization across sectors. There is uncertainty on this count. An extended period of the lockdown will take a higher toll on the economy and would result in a slower recovery.

The deterioration in the domestic economy along with the spillover from the global recession is expected to lead to lower economic activity. Globally, policy makers have responded to the pandemic caused economic losses with huge doses of monetary and fiscal support by way of interest rate cuts, availability of liquidity in the financial system and increased government spending. This has helped businesses and households alike to an extent as is being reflected in the data readings of leading economic indicators of some advanced and developing economies alike. In India too, monetary policy has been accommodative. On fiscal stimulus side, the Government had announced packages worth INR20 lakh crores which has been more skewed towards the nature of reforms of the medium to long term nature. While there are expectations for further reforms to be introduced by the policy makers the nature of the same would be important in terms of the impact on the GDP prospects.

CARE Ratings forecast for India's GDP growth in 2020-21 is -8 to -8.2%. The projection rests on the assumption that there may not be any fresh round of fiscal stimulus and the government expenditure would at best be as projected in the Budget for the year. It is also assumed that the third and fourth quarters would show progressive improvement as the unlock process becomes widespread and economic activity moves towards the range of 50-70% of the pre-lockdown levels.

The decline in GDP growth by around 8% would also be associated with a decline in investments as well as consumption growth that will be affected by lower growth in income across all categories of consumers. The sharp fall in GDP growth in 2020-21 would however provide the cushion of a faster pace of growth in 2021-22 depending on the rate at which various sectors are able to increase their output.

The factors which are working well in the economy are more in the agricultural sector as well as the financial domain where a good monsoon as well as the efforts of the government and RBI to enhance the flow of credit has shown some positive tendencies.

- Agriculture and allied activities would be growing at 3.8% with both the kharif and rabi output being normal. The allied activities segment would be providing support during the period between the two seasons.
- Industrial growth would be largely negative: mining (-9.4%), manufacturing (-11.7%) and electricity -1.3%. We do see manufacturing turning positive in Q4 aided by a low base effect too.
- Growth in electricity, water, gas would be turning positive in Q3.
- Construction activity is expected to contract by around 24% for the year as private sector participation would be limited. More importantly the housing sector would be under pressure with build-up of inventory and there would be limited traction here. The same holds for commercial space. The government – both centre and states may have less bandwidth to provide the push to the infra sector given the constraints on the fiscal side.
- Trade, transport, hotels, communication would degrow by around 22% and this segment will witness negative growth across all the quarters. The GST collections which are the proxy that is used for trade, would be falling short significantly during the year. Hotels and transport would be affected by the pace of the unlock process and it is only in the fourth quarter can we expect resumption of some of these services and attainment of the 50% mark.
- Financial services, real estate and other services will grow by positive 1% - being pushed up by banking while real estate would be dragging growth down. The other services covering professional segment would maintain steady growth.
- The public administration, defence and other services segment would remain flat in the absence of a fiscal push and hence would not be contributing to GDP growth. While the government sector finances would show positive proclivities, the other services component would be in the negative territory which includes all the discretionary services which have around the same weight as the government sector. We also assume that the government will resort to some capex cuts towards the end of the year in the scenario of there being no new stimulus being announced.

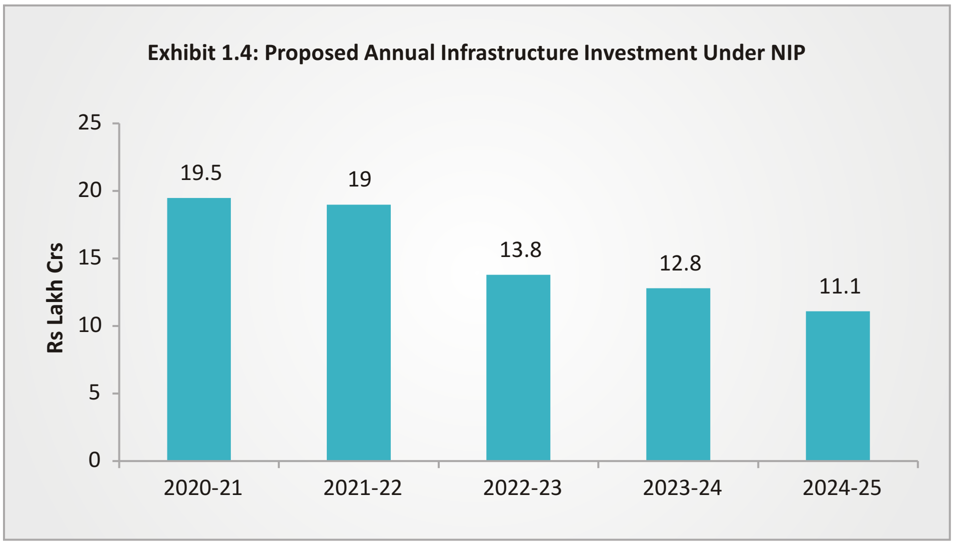
Downside risk to the outlook prevail and could materialize with a surge in Covid-19 and related lockdowns, intensification of the business and household financial stress, constraints in the banking sector and a stronger than expected global economic contraction.

1.5 Infrastructure Creation - Path forward for the Indian Economy

The deterioration in the economy and the impediments to growth creates an urgent infrastructure imperative. India is currently ranked 70 out of 140 countries for infrastructure quality in the global competitive index. Infrastructure building would have the much needed multiplier effect – it would generate employment and demand across sectors, improve the ease of doing business, improve competitiveness as well as quality of life.

Addressing the infrastructure gaps would be crucial to India retaining and supporting its position as one of the world's fastest-growing economies. Along with this, sustainable policies and reforms that would buttress the long term prospects would be crucial. The aspiration of becoming a $5 trillion economy would have to be led by infrastructure creation, which necessitates heavy investments for the same.

The government's ambitious infrastructure building target over the 6 year period (till 2024-25) detailed in the 'National Infrastructure Pipeline' (NIP) unveiled in end Dec'19 covering various sectors and regions indicates that it is relying on an 'infrastructure creation' led economic advancement. The NIP has envisaged an investment of Rs. 76.2 lakhs crores during 2020-21 – 2024-25.



Source: PIB

The government has rightly appreciated that this planned infrastructure building detailed in the 'National Investment Pipeline' would essentially have to be government led given the persistent lull in private investment in recent years. A large part (78%) of this infrastructure building is proposed to be undertaken by the central and state governments. The ability of the central and state governments to do so effectively and in a financially prudent manner is an area of challenge as well as concern.

Although the government has to its credit in recent times embarked on a series of measures to stimulate the investment cycle, there exist myriad issues (such as land acquisition, environmental clearance, delays in project implementation, procedural delays, enforcement of contracts and availability of funds among others) that comes in the way of infrastructure building. Ironing out of these would be necessary for the achievement of the set targets for infrastructure creation. The ability of the central and state government to finance these projects appears to be an uphill task given the sharp decline in economic activity and the resultant lower revenue collections which has severely strained the financial position of the central and state governments. Government revenues are likely to remain pressured in the coming years too with domestic economic growth expected to witness a gradual and staggered recovery in the next few years. Lower revenue generation could result in rationalization of expenditure towards infrastructure development given that over 75% of the government expenditure is committed in nature.

We have made projections for the investment requirements for infrastructure building needed to take the Indian economy towards the $ 5 trillion mark (Table 2). As per our baseline scenario

- The domestic economy is expected to return to positive economic growth from 2021-22 onwards.
- The country's GDP would reach $5 trillion in 2026-27 with an annual average growth of 11.6% during 2021-22 – 2026-27.
- The fresh investments (infra and manufacturing) required to achieve this GDP growth would have to progressively increase annually from Rs. 43 to 103 lakh crores during 2020-21 – 2026-27.
- The total investments during the 7 year period to 2026-27 would be Rs. 498 lakh crores.
- As a percentage of GDP, investments would, on an average, have to be 25% during 2020-21 – 2026-27.
- As per the NIP, the central and state government infrastructure investments would Rs.59 lakh crores during 2020-21 – 2024-25.
- The remaining financing of the infrastructure investment and non-infra investment would have to be come from the financial sector i.e. from banks, corporate bond markets and by way of foreign capital.

Table 1.2: Projections for Infrastructure Investments for a $5 Trillion Economy

	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27
GDP $ Trillion	2.6	2.9	3.2	3.6	4.0	4.5	5.1
Nominal GDP growth (%)	-3.0	11.0	11.0	11.5	11.8	12.0	12.3
Investments/GDP:%	22.0	24.0	25.0	25.5	26.0	26.5	27.0
Investments: Rs. Lakh crs	43.4	52.6	60.8	69.1	78.8	89.9	102.8

Source: CARE Ratings' calculation

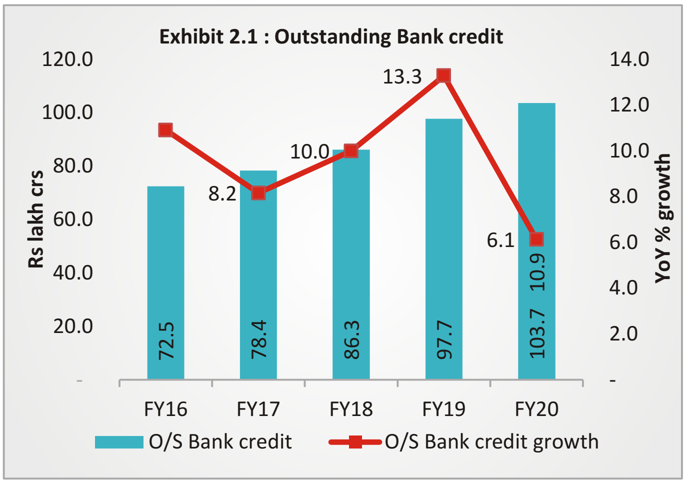
Chapter 2: Flows of Funds

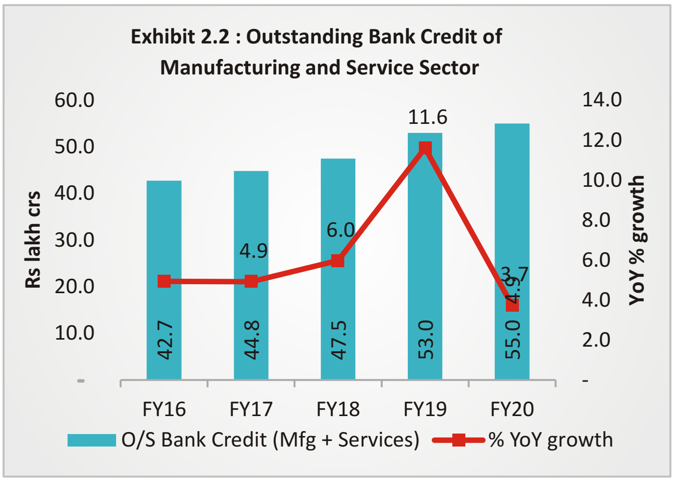
Financial markets are vital to the economic development of a country. They play a critical role in providing financial resources required for the long term infrastructure creation and sustainable development of the economy. In India, the various segments of the financial markets from where various entities raise financial resources are bank credit, corporate bonds, external commercial borrowings, equity markets via IPOs, FPOs, rights issue and foreign direct investment, among others. Over the years, each of these segments has registered robust growth and has played an important role in the overall infrastructure development of the Indian economy. The regulators and policy makers have on a continuous basis been undertaking various measures and policies for the development of the Indian securities market in terms of products, technology, participants, surveillance and enforcement. The performance of these various segments during the last 5 years has been highlighted below. Also, based on the computation of the investment requirement provided in Section 1.5, we provide projections of funds which will have to be raised from various segments of the financial markets in order to meet these requirements.

2.1 Banking Sector

2.1.1 Bank credit overview

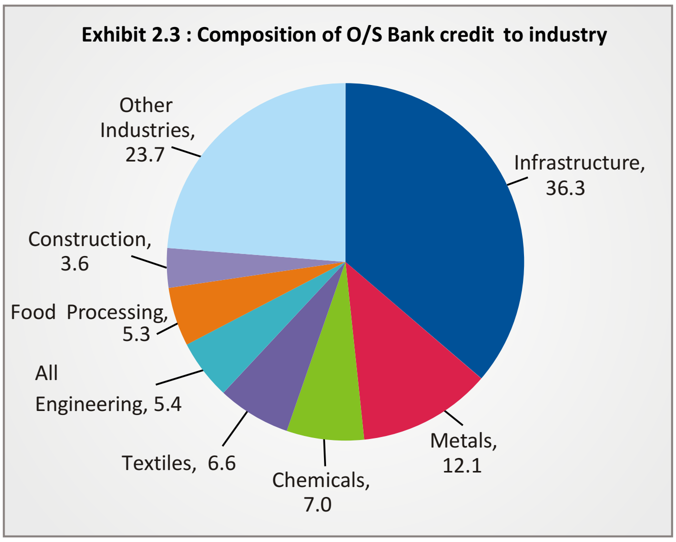
Bank credit continues to dominate other avenues to emerge as the most preferred source for the corporates. Although bank credit to corporates accounts for almost half of all outstanding financing sources of the corporates, in recent years the bank credit off-take has been subdued. This can be ascribed to the lingering concerns of poor asset quality which has consequently led to higher provisioning, lower profitability and falling capital requirements. This in turn has weighed on overall bank credit growth falling sharply in recent years on account of risk aversion by the lenders.

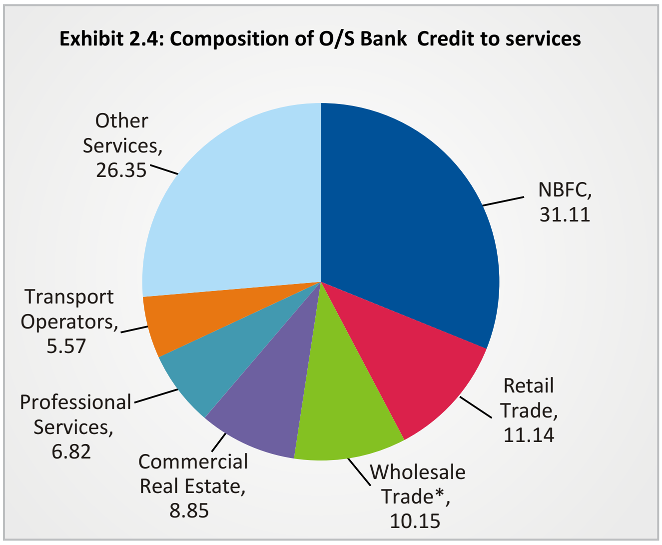




Source: RBI

Total outstanding bank credit of scheduled commercial banks stood at Rs 103.7 lakh crs as on year end 2019-20, almost half of India's nominal GDP. During the last 5 years, the growth in outstanding bank credit has been strong except for 2019-20, which registered a sharp deterioration. The growth in outstanding bank credit has almost halved from 13.3% in 2018-19 to 6.1% in 2019-20. During 2015-16-2017-18, the growth in bank credit can be chiefly ascribed to robust growth in retail loans (average growth: 17.8%) while the growth in bank credit to industry and services (shown in Exhibit 2.2) was subdued during the same period. In 2018-19, the strong bank credit growth can be attributed to a broad-based growth across segments. The bank credit growth of 6.1% in 2019-20 is the lowest in more than 2 decades and the bank credit growth to industry and services segment combined has been weak at 3.7%. In the last 5 years, the average bank credit growth to only the industrial segment has been 1.8% with negative growth in 2016-17 and less than 1% growth in 2016-17 and 2018-19. On the other hand, the average bank credit growth to the services segment has been robust at 13% with sharp moderation in growth recorded in 2019-20 (7.4%). The problems in the NBFC segment contributed to this slowdown in growth in credit to the services sector. The recent demand slowdown in the economy and falling capacity utilization has limited credit off-take in the economy. In addition, the muted credit growth to both industry and services sector can be corroborated with high GNPA ratios of the sector during the past few years. While the GNPA ratio of the industrial sector remained above 15% that of the services sector was stagnant at around 6% during 2016-17 – 2018-19.

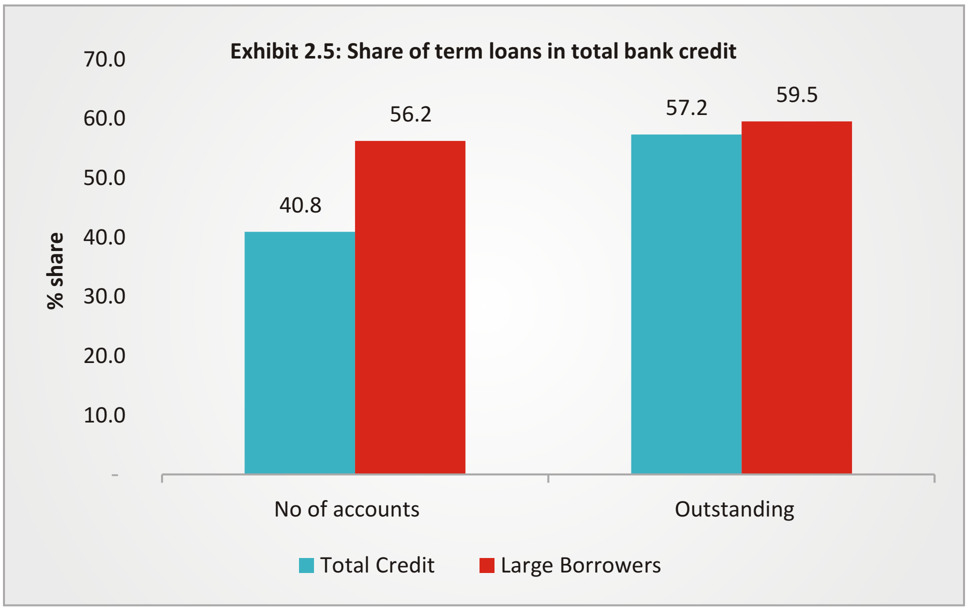




Source: RBI

Total outstanding bank credit to the industry and services segment stood at Rs 55 lakh crs as of 2019-20, which is 53% of total outstanding bank credit and this share has declined from almost 60% in 2015-16. The chart above shows the sector-wise break of bank credit to industries and services separately.

- Within industries, bank credit to the infrastructure segment (which includes power, telecom, roads) accounts for little more than 1/3rd of the outstanding credit to the segment. 3 out of the last 5 years have registered a negative growth in outstanding bank credit to the sector. Metals which account for 12% of the bank credit to the industrial segment have recorded negative credit growth in the last 3 years (2017-18 - 2019-20). The limited off-take in bank credit growth to these two sectors can be ascribed to the high GNPA ratios (13.1% in infrastructure segment and 16.2% in metals).
- Within services, the share of NBFCs stands at little lower than 1/3rd as of 2019-20 followed by retail trade (11.1%), wholesale trade (10.2%) and commercial real-estate (8.9%). The bank credit growth towards NBFCs has been strong and has averaged around 21% during 2015-16-2019-20. This has led to increase in the share of bank credit to NBFCs from 22.9% in 2015-16 to 31.1% in 2019-20. Barring 2019-20, the growth in bank credit to the commercial real estate sector has been weak owing to the heightened concerns like inventory build-up, rising operational costs of the sector.



Source: RBI

Term loans are availed by the borrowed for medium to long term projects while the balance is availed for meeting working capital requirements. Almost 60% of outstanding bank credit is availed in the form of term loan. In terms of the number of accounts, 40% of the total accounts are held in the form of term loan. In case of large borrowers 56% of the accounts comprising of almost 60% of bank credit are term loans.

2.1.2 Insolvency Bankruptcy Code (IBC)

IBC is one of the most defining reforms passed in the year 2016 with an objective of timely resolution of insolvency and enable faster turnaround of business. Albeit its challenges, it has resulted in much faster resolution of the insolvency process, boosted investor confidence and encouraged fund flows into the market.

Table 2.1: Status of CIRP process as at June 30, 2020

Year/ Quarter	CIRP (beginning)	Admitted	Appeal/ Review	Withdrawal under Sec 12 A	Approval of RP	Commencement of Liquidation	End period
2016-17	0	37	1	0	0	0	36
2017-18	36	705	89	0	20	91	541
2018-19	541	1,151	130	94	81	305	1,082
2019-20	1,082	1,942	157	112	133	535	2,087
Jun-20	2,087	76	3	12	16	24	2,108
Recovery rate							**46.1**

Source: IBC

Since the provisions relating to the corporate insolvency resolution process (CIRP) have come into force, 3911 CIRPs have commenced by the end of June 2020. Of these 380 have been closed on appeal or review, 218 have been withdrawn, 955 have ended in orders for liquidation and 250 have ended in approval of resolution plans. The recovery rate of the IBC has been around 46% since inception. This rate was 43% during 2018-19, which as per RBI is notably higher than 14.5% through the SARFESI resolution mechanism, 3.5% through debt recovery tribunals and 5.3% through Lok Adalats.

Sector-wise breakup shows that manufacturing has a share of almost 40% in both the percentage of cases completed and ongoing cases. Wholesale and retail trade has a share of 10% in both the parameters while 9.3% of completed cases and 16.7% of ongoing cases are of the construction sector.

Table 2.2: Sector wise IBC cases as on June 30, 2020

Sector	Admitted	Completed	Ongoing
Manufacturing	1595	765	830
Food, beverages & tobacco processing	204	87	117
Chemicals	158	78	80
Electrical Machinery	115	65	50
Fabricated Metals	89	44	45
Machinery & Equipment	177	87	90
Textile, leathers, apparels	274	143	131
Wood, rubber	191	76	115
Basic metals	277	129	148
others	110	56	54
Real estate	186	64	122
Computer and related	114	49	65
Construction	421	168	353
Hotels	89	43	46
Trade	390	181	209
Electricity & Others	120	38	82
Transport, Storage	117	65	52
Others	402	191	211
Total	**3911**	**1803**	**2108**

Source: IBC

The IBC has been a very important part of the reforms in this segment as an efficient resolution mechanism has to be in place to ensure that the system is able to address the issue of quality of assets.

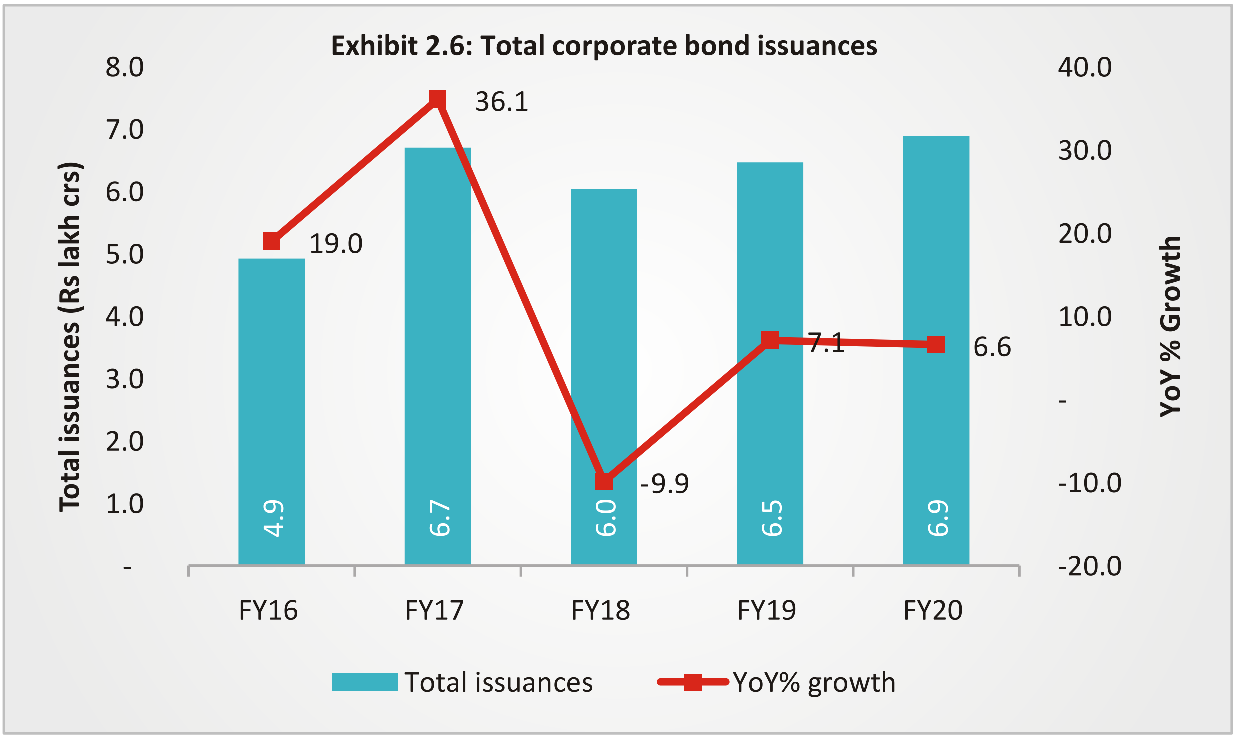
The Government of India has taken several measures to ameliorate the pains emanating from COVID-19 and one of them has been the passing of The Insolvency ad Bankruptcy Code (Amendment) Ordinance 2020. This ordinance suspends filing of applications for initiations of the insolvency proceeding against a company for any default during COVID-19 period. This was initially for a period of 6 months commencing from March 25, 2020 but has been further extended for 3 months. It insulates a company, which did not have a default as on March 25, 2020 but commits a default during COVID-19 period, from being pushed into insolvency proceedings.

2.2 Corporate Bonds

2.2.1 Corporate Bond Issuances and sectoral composition

With the Indian debt market being dominated by the Government Securities (G-secs) market, the corporate bond market is comparatively undersized. To put it in perspective, while outstanding Government securities stands at Rs 66.6 lakh crs as of September 2020, the outstanding corporate bond market is Rs 33.2 lakh crs as of June 2020. Conventional bank loans have traditionally been the predominant source of funds for businesses in the country that resulted in the corporate bond markets remaining largely stagnant. However, in recent years there has been a growing need for businesses to tap the bond markets given the constraints in the banking sector.

The issuance of corporate bonds is either by way of public issues and private placements. Private placement has all along been the preferred issuance route for corporate bonds. Over 90% of the corporate bond issuances have been through private placement. The public issuance of corporate bonds is yet to see any noteworthy pick up. The preference for private placement can be attributed to operation ease (lesser statutory disclosures compared with the lengthy disclosures and issuance process for public issuance), lower costs of issuance, ability to raise funds faster and custom made structures (to suit requirements of both the issuer and the investor). In addition, limited investor base also aids private placements.



Source: SEBI

Total corporate bond issuances have registered a sharp moderation in the last 3 years. In 2017-18, corporate bond issuances recorded a negative growth of (-)9.9% and has seen a steady growth of around 6-7% in the next

2 years. The growth in issuances in the last 2 years indicates a partial shift in corporate funding from banks to the bond markets, which can be ascribed to the constrained bank lending owing to high levels of stressed assets in the banking system and faster transmission of RBI policy rate cuts to the corporate bond market vis-à-vis lending rates.

Table 2.3 : Sectoral share of corporate bond issuances

	2015-16	2016-17	2017-18	2018-19	2019-20
Non-financial	27.1	43.4	24.6	18.5	29.8
• Manufacturing	4.0	2.7	2.9	2.1	5.8
• Mining	0.4	0.3	0.1	0.9	1.0
• Electricity	8.6	25.7	6.3	2.2	4.4
• Services (other than financial)	9.7	10.4	10.5	8.2	14.6
Wholesale & retail trading	1.8	1.0	1.1	0.1	2.4
Transport services	4.4	5.0	3.7	3.5	7.8
• Construction & real estate	4.5	4.2	4.7	5.2	4.1
Financial services	72.3	56.4	72.1	78.1	69.1
Banking services	11.1	8.4	8.2	5.1	5.4
Asset financing services	32.8	25.5	35.6	43.9	37.6
Other fund based financial services	2.4	1.7	2.6	3.6	5.7

Source: CMIE

In terms of the sectors that have been raising funds from the bond markets, the financial services sector accounts for around 70% of total bonds issued. However, in 2016-17, this share had declined to 56% and has spiked to 78% in 2018-19. These funds are used for on-lending purposes and hence supplements the banking system. The remaining is raised by the non-financial services sectors such as manufacturing, mining, electricity, construction and real estate and services (other than financial services). Within non-financial, notable funds are raised by transport services (7.8%) and manufacturing (5.8%).

2.2.2 Role of Mutual funds and other investors in Corporate Bonds

Out of the total assets under management (AUM) as of March 2020, 59% of the funds are deployed in debt funds while the balance is in equity funds. This share was notably higher at 67.2% in 2015-16. Within debt funds, 30% of the total amount deployed in debt funds have been into corporate bonds as of 2019-20 and has seen a decline from the peak of 38.1% in 2017-18.

Table 2.4: Deployment of mutual funds into corporate bonds (% share in debt funds)

	Real Estate	NBFC	Others
2015-16	0.4	8.6	21.9
2016-17	0.5	8.9	27.3
2017-18	0.5	9.3	28.2
2018-19	0.5	8.5	24.3
2019-20	0.4	7.2	22.7

Source: SEBI

Insurance companies (life plus general) have a total investment of around Rs 11.3 lakh crs as on March 31, 2019. Pension funds and provident funds are other investors into the corporate bonds who buy and hold securities and do not trade.

2.3 Equity markets

2.3.1 Overview

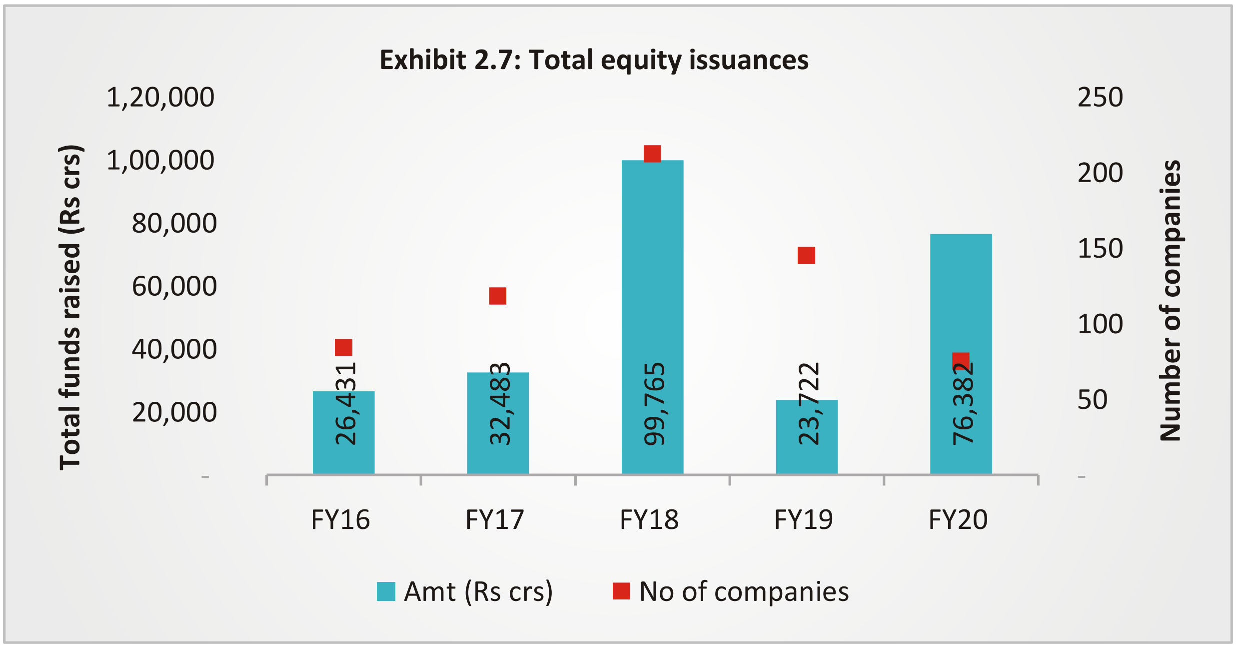
The role and importance of the equity market in a country's economic development and growth is undisputed. In addition to providing the much needed capital to firms, a developed and active stock market enhances the efficiency of the country's financial system and the allocation and utilization of its

financial resources. An efficient stock market instills discipline in firms to perform better and plays a crucial role of channeling finance to the most productive sectors of the economy. Equity markets also help garner savings of households, in particular, and serve as an alternative savings and investment avenue. Stock markets instruments equip such investors to diversify risks and maximize returns. These markets also serve as a source that helps households earn returns consistent with the prevailing inflation rate in the economy.

Equity markets are considered to be relatively risky compared with the debt market, but from the point of view of the issuer, it is critical as it determines also the amount of leverage that could be had from the lending institutions. Without equity, no project can be conceived. Therefore, a healthy equity market is a prerequisite for a buoyant capital market.

2.3.2 Total issuances

The domestic equity markets have helped companies mobilize significant amount of funds as can be seen from the chart on total equity issuances. Total equity issuances (IPOs, FPOs and rights) peaked at Rs 99,765 crs in 2017-18 but sharply fell in the next year. Total equity issuances rose again in 2019-20 to Rs 76,382 crs but were primarily driven by high quantum of rights issue. During 2015-16-2018-19, the share of issuances via IPOs/FPOs was around 80% with the balances being raised via the rights issue. But in 2019-20, this ratio has reversed with 73% of the issuances being made by Rights issue and balance by the IPO FPOs.

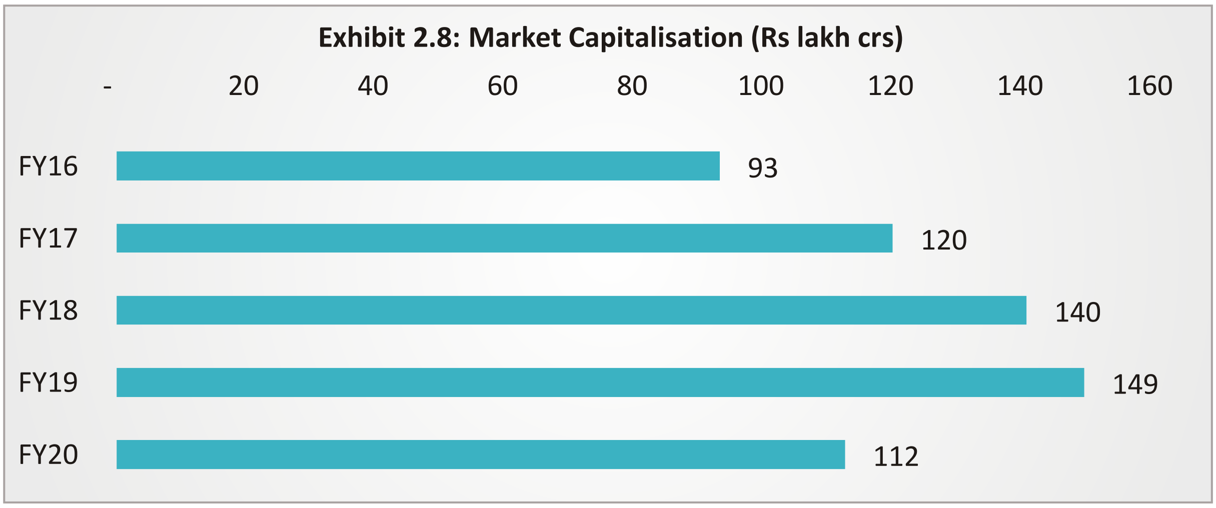


Source: SEBI

2.3.3 Market Capitalisation

The growth of the Indian equity markets is evident from the significant increase in its market capitalization over the years. During 2015-16 to 2018-19, the absolute growth in market capitalization of these companies was around 28% but the outbreak of the COVID-19 pandemic led to a steep fall in market-capitalization in March 2020. Therefore, the market capitalization declined by almost 25% in 2019-20. As a percentage of GDP, the market capitalization to GDP ratio has increased from 67.6% in 2015-16 to 82.1% in 2017-18 but has fallen to

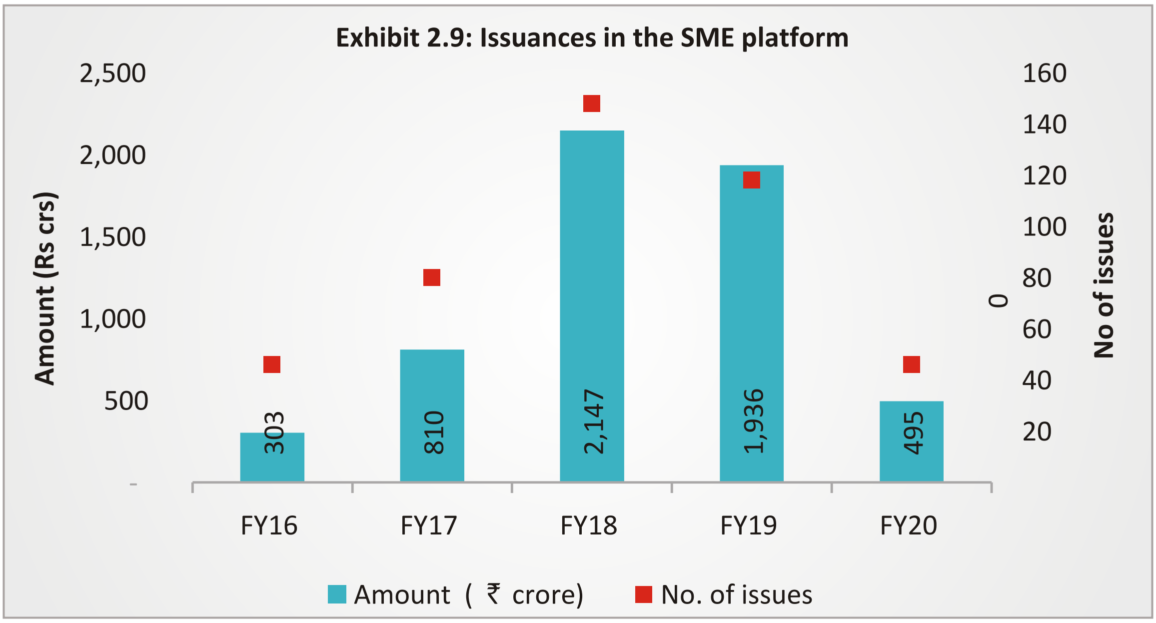
55.3% in 2019-20. Such a substantial increase in market capitalization of the Indian equity markets prior to 2019-20 can in part be attributed to the increasing number of companies accessing the country's stock markets by getting listed on the nation's stock exchanges.



Source: SEBI

2.3.4 Small and Medium Enterprises (SME) Exchange

The SME Exchanges have been established to enable the small and medium sized companies to gain sufficient visibility and thereby attract trading in their securities, given the difficulty faced by these companies in doing so when listed alongside securities of large companies in the main stock exchanges viz. BSE and NSE. Through the SME exchange platform, these companies which otherwise have to rely on promoter funds, and high cost debt, are able to raise the much needed funds at a lower cost burden. Although the SMEs have the option of listing on the main exchanges, the dedicated SME exchange makes it easier for them to do so as the listing norms and IPO process is simplified for them on this platform. Also, it makes it easier for interested investors to identify the SME stock on this exchange than on the main exchanges wherein they tend to get lost among the host of stocks of large companies. Total issuances of SMEs in 2017-18 and 2018-19 were high at around Rs 2,000 crs with 120-150 companies raising funds via the equity channel respectively. Barring these two years, the funds raised in 2015-16, 2016-17 and 2019-20 have been muted.



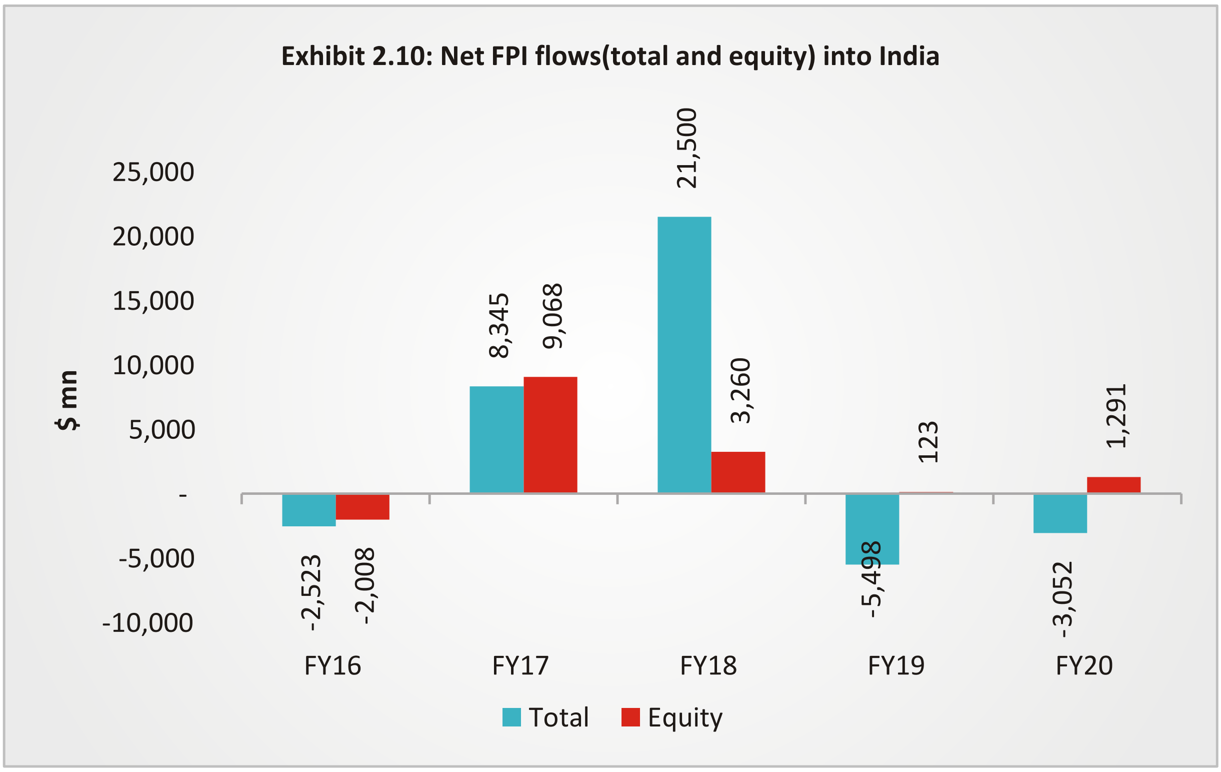
Source: SEBI

2.4 Foreign Inflows

2.4.1 Overview

The influence of foreign investments in the Indian capital markets has been well acknowledged. The fast paced growth seen in the Indian stock markets over the years has in large part been attributed to the increased foreign institutional investor (FII)/Foreign Portfolio Investors (FPIs) participation in the same. FPIs viz. pension funds, insurance companies and mutual funds are holders of a sizeable portion of domestic corporate securities.

Foreign portfolio investors (FPIs) are seen to be important not only for the growth and development of the domestic equity markets but also for the country's economic progress. They are regarded as the driver of the domestic equity markets.



Source: CMIE

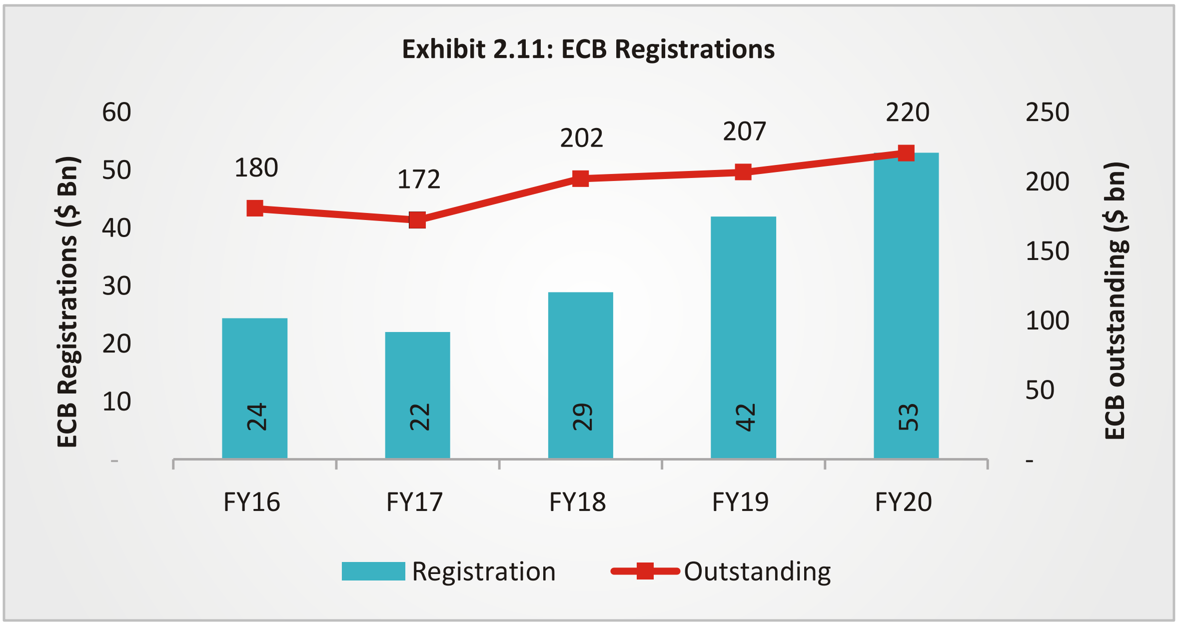
During the last 5 years, FPI have been net buyers in the Indian economy barring 2015-16 when there was an outflow of around $ 2 bn. Strong inflows from foreign investors were registered in 2016-17 and 2017-18 but in the subsequent two years the inflows have been muted. India's markets have emerged as attractive investment destination compared to the US and Europe in recent years owing to the ever increasing economic problems in these regions. Also, the monetary easing measures undertaken in these regions, since the global financial crisis, have resulted in money flowing into markets such as India which have been clocking relatively favorable growth rates.

On the other side, it has been agreed that the Indian economy offers a lot of potential in future in terms of growth given the capacity that exists and the labor and capital resources to be leveraged. Therefore, the future growth story has been responsible for drawing in more FPI flows. However, the structural concerns of the Indian economy will pose serious challenge to FPI inflows.

2.4.2 External Commercial Borrowings

The reliance of corporate entities on borrowing via the ECB channel remains high during the last 5 years. ECB registrations have recorded a CAGR of 21.4% during 2015-16 to 2019-20 and the registrations of around $53 bn in 2019-20 were the highest during the last 5 years.

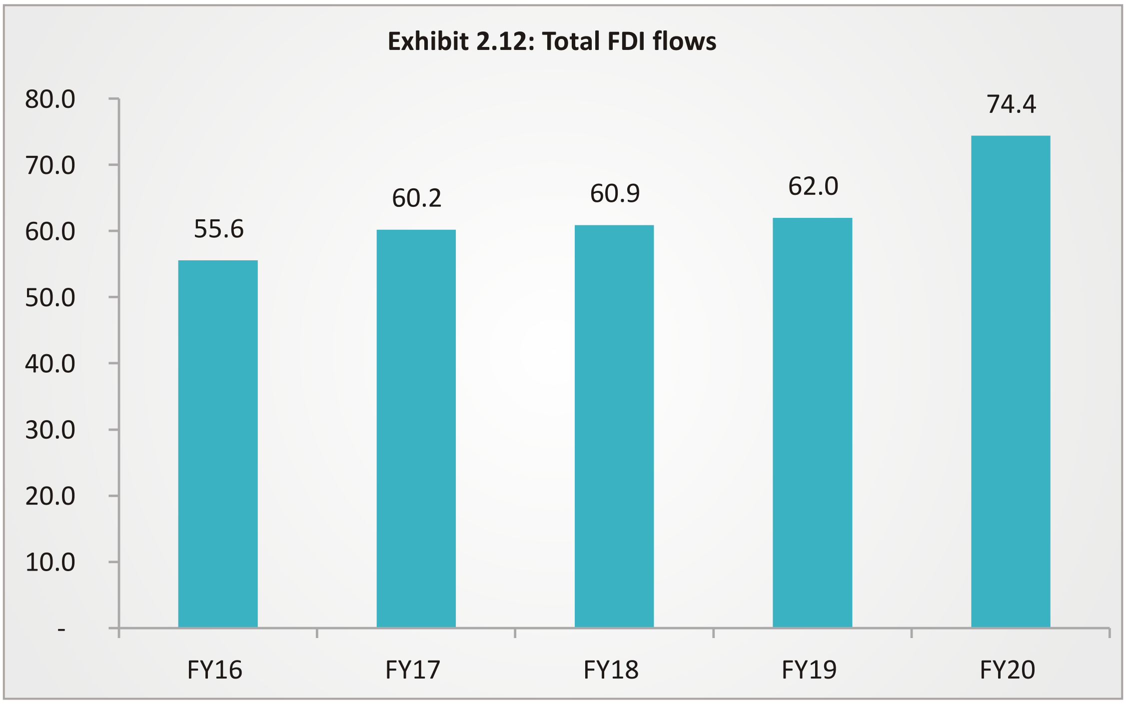
Increase in borrowing proposals via external sources could be ascribed to attractive borrowing cost in the advanced economies with countries adopting easy monetary policies to stem the economic slowdown against high domestic interest rates, tight liquidity conditions, and high cost of bank borrowings due to sluggish transmission in the rate cuts. Additionally, a series of rationalisation measures announced by the RBI such as lowering of the minimum tenure for borrowings, relaxation in rules of mandatory hedging, rationalization of end use provisions, expansion of the list of eligible borrowers, increase in borrowing limit, removal of sector-wise borrowing limits and rationalization of all in cost of borrowings enabled many corporates to easily access overseas funding. NBFCs were also permitted to use ECB route to raise external funds for on-lending purposes. The relative stability of the Indian Rupee has also been another driving factor for corporates to access external borrowings.



Source: RBI

2.4.3 Foreign Direct Investment

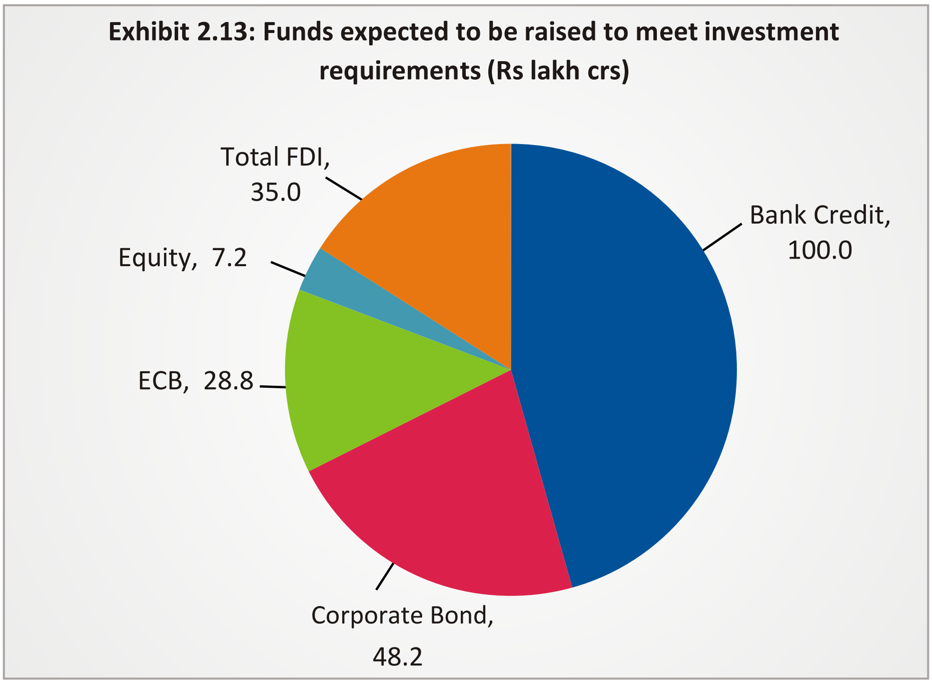
Foreign Direct Investment (FDI) into the Indian economy has been on a rise in the recent time period. During 2015-16-2019-20, the cumulative FDI inflows aggregated $313 bn which is 59% higher than the previous quinquennium. The CAGR of FDI equity inflows during the last 5 years has been 7.5%. The surge in FDI equity inflows can in part be attributed to opening up of various sectors by the government and allowing 100% FDI investment via automatic route, which eased the process of investment in the country.



Source: DPIIT

2.5 Resource Mobilization for the future

Based on the calculation done in Chapter 1, the country requires an average investment of around Rs 80 lakh crs during the period 2022-23 to 2026-27 for the economy to scale GDP of $5 trillion by the final year. Due to the disruption of COVID-19, we have estimated the flow of funds from various sources to be muted in 2020-21 and grow by a moderate pace in 2021-22. Thereafter, flow of funds from banks, corporate bond market, FDIs, ECBs and equity funds raised via IPOs will have to be robust in order to meet the investment requirements of the country in order to make it a $5 trillion economy. The total funds expected to be raised by corporate entities, both private and public sector is plotted below and aggregates around Rs 220 lakh crs during 2022-23 and 2026-27 with an average of Rs 45 lakh crs each year.



Source: CARE Ratings' calculation

- Almost 45% of the funds are expected to be raised for the investment purpose from the banking sector followed by corporate bonds (21%) and FDI flows (16%).
- The bank credit off-take is projected to pick-up sharply in 2022-23 and then gradually increase to by around 12-15% during 2023-24 - 2026-27.
- Foreign long term inflows via FDI equity and ECB will have to be robust during the 5 year – 2022-23 to 2026-27 and both will have to scale $100 bn by 2026-27.
- Corporates will have to raise around $50 bn during the 5 years at a steady growth rate of around 8% during this period.
- A part of the shortfall in funds required to meet the total investment will have to be done by the Government, both Centre and State. The Government wzill have to raise funds to meet the requirements of the National Infrastructure Pipeline.

Chapter 3: Credit Rating of Corporate Bonds

Credit rating agencies (CRAs) play a vital role in the financial system and holds systemic importance. They assess debt risk and its distribution in the system. CRAs help to reduce the information asymmetry between lenders and investors, on one side, and issuers on the other side, about the creditworthiness of companies. By doing so, the rating agencies help firms to access private capital at lower cost and investors take investment decisions by balancing their risks and returns. CRAs can thus by pricing risk appropriately help allocate capital efficiently across all sectors of the economy.

When funds are mobilized directly from savers and investors, who assume the credit risk, an independent assessment of creditworthiness of the borrower by an independent and competent credit rating agency becomes critical. The credit ratings assigned by rating agencies, which is an opinion on credit worthiness of borrowers and not a recommendation to buy, sell or hold the security is seen to be very influential. In case of issuers, ratings play a key role in determining the cost and conditions for access to the debt markets. For investors, ratings influence the investment decisions and the composition of their portfolios. Ratings are also used as a part of regulation to determine the suitability of certain debt and other financial instruments in the portfolio of certain institutional investors.

3.1 Role of Rating

As a regulatory requirement by SEBI, any amount of debt raised by companies must be rated by one of the credit rating agencies. Credit rating assesses risk in the financial system and plays a key role in enhancing growth in the market.

- **Reducing Information Asymmetry**
  Credit rating helps reduce the knowledge gap, or information asymmetry between borrowers (issuers) and lenders (investors). The essential subject matter of this information asymmetry is borrower's creditworthiness. A borrower knows its own creditworthiness better than a lender does. The credit rating bridges this gap.

- **Improving Market Function and Efficiency**
  Essentially, credit ratings reduce the ability of one investor to outperform another by making better judgments about

creditworthiness. In this view, ratings act as an equalizer in the fixed-income capital markets, helping to put investors on more equal footing, thereby minimizing variations in returns that can arise from differences in the ability to make sound credit judgments.

- **Advantage to investors**
  Credit Rating provides objective, independent and reliable opinion on credit quality which facilitates an informed investment decision. It gives superior information about the rated product and that too at low cost, which the investor otherwise would not be able to procure so easily. Thus the investor can easily recognize the risk involved and the expected advantage in the instrument by looking at the symbols.

- **Marketability of securities**
  Issuers seek ratings for a number of reasons, including to improve the marketability or pricing of their financial obligations, to improve the trust of their business counterparties or because they wish to sell securities to investors with preferences over ratings.

- Benefits for the issuer
  Credit rating enhances the ability of the borrower/issuer to access the money and capital markets for tapping larger volumes of resources from a wider range of investment options. It helps in procuring funds at a better interest rate and helps establish credibility among investors. Credit ratings also helps in imposing healthy discipline on corporate borrowers and encourages financial discipline

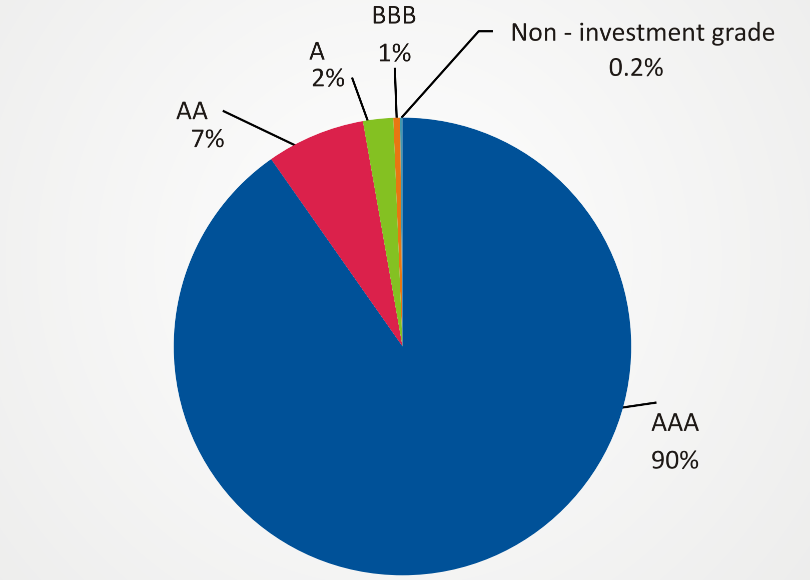
The role and importance of credit ratings has undergone changes under the Basel II adoption of banks capital requirements. The Basel norms for financial stability includes the credit ratings of CRAs for assigning risk weights for determining minimum capital charges for different categories of borrower.

The history of credit rating agencies in India dates back to over 3 decades. Credit rating agencies in the country are regulated and governed by the Securities and Exchange Board of India and its regulations. The role of CRAs has grown significantly with the advent of global financial integration.

3.2 Ratings of bond issuances – CARE Portfolio

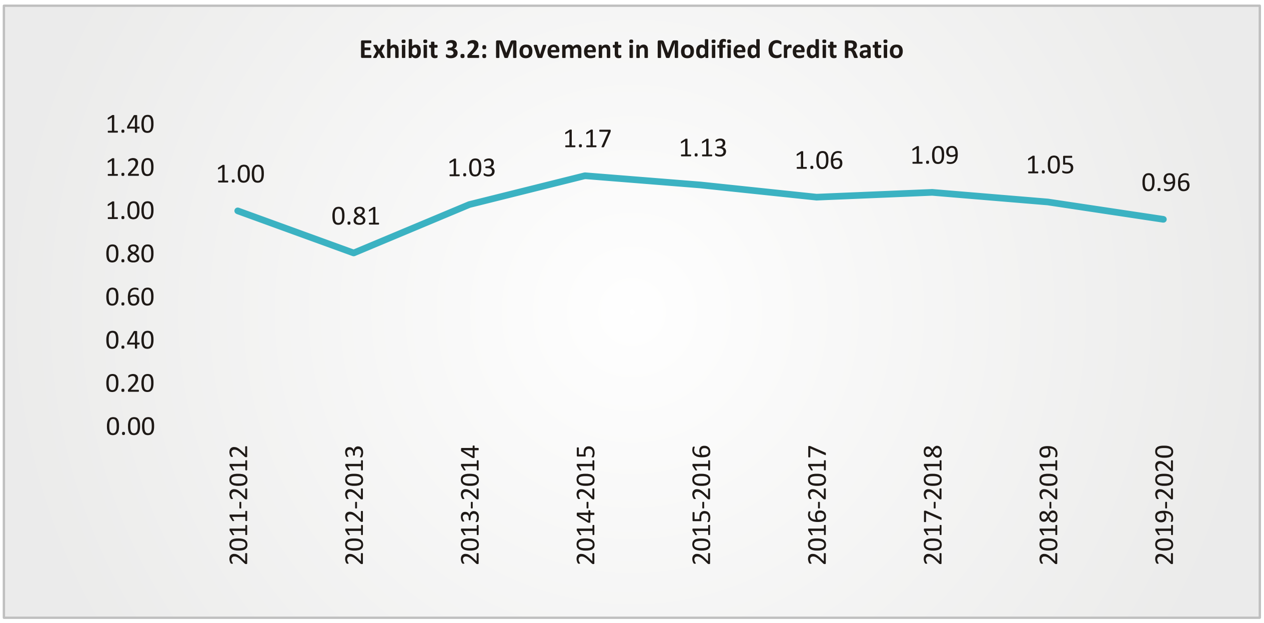
In 2019-20, 97% of the privately placed debt issuances rated by CARE Ratings carried credit rating of AA and above. Among these, majority of debt issuances were rated AAA (more than 90%) while 7% were rated AA by CARE Ratings. Nearly 2% carried credit rating of A during the year 2019-20.

Exhibit 3.1: CARE's Rating Categories 2019 - 20 (% Share)



Source: Prime Database, CARE Ratings' calculation

3.3: CARE Ratings' Assessment of Credit Quality - MCR



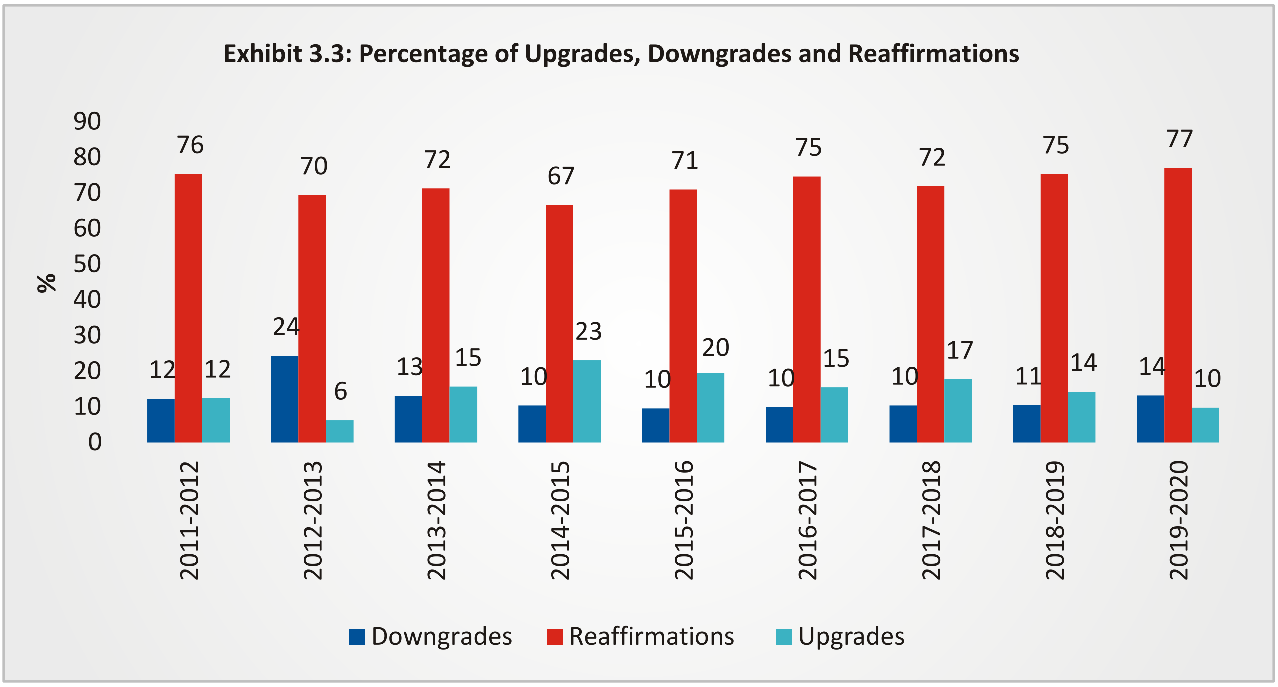
Source: CARE Ratings

The Modified Credit Ratio (MCR) is defined as the ratio of (upgrades and reaffirmations) to (downgrades and reaffirmations). An increase in MCR denotes an increase in proportion of upgrades vis-à-vis downgrades, whereas a decrease in MCR shows the reverse. In other words, an increase in the MCR implies an improving credit quality of the rated entities while a decline in the same signals deterioration in credit quality of the rated entities. An MCR closer to one indicates higher stability in the ratings, with a larger proportion of reaffirmations. The movement of the MCR consequent to the periodic review of the credit rating of the rated entities (which point out the improvement, stability or weakness in the financial profile of these entities over time) not only helps measure mobility in ratings but is also seen as being reflective of the changes in credit quality in the system given the large quantum and diverse set of entities rated by CARE Ratings.

The credit quality of the rated entities as measured by CARE Rating's 'modified credit ratio' (MCR) declined to a 7 year low in 2019-20. The decline in credit quality in 2019-20 was largely due to the weakness in the credit profile of large enterprises, which comprised of 71% of the entities whose ratings were reviewed during the year. Despite the moderation from year ago, the credit quality of entities with 'investment grade' rating in 2019-20 was seen as being fairly stable with higher number of reaffirmation of ratings. There has been a weakening in the credit quality of entities with 'below investment grade' ratings in 2019-20 from year ago. 77% of the entities saw their credit ratings being reaffirmed in 2019-20. There was a decline in the proportion of upgrades and an increase in downgrades in 2019-20 from year ago.

3.3.1 Proportion of Upgrades, Downgrades and Reaffirmations

In 2019-20, the majority of entities saw their credit ratings being reaffirmed. The share of rating reaffirmations at 77% was 2% higher than that of 2018-19. There was however a decline in the proportion of upgrades and an increase in downgrades in 2019-20 from year ago. Out of the total ratings reviewed in 2019-20, 14% saw a credit ratings downgrade, compared with 11% last year. On the other hand only 10% of the entities whose ratings were reviewed during the year witnessed rating upgrades versus 14% of year ago.



Source: CARE Ratings

Chapter 4: Policy Announcements and Recommendations

Over the period of time, various measures have been initiated by the regulators considering the need for development of markets. The economic growth hinges on strong and credible financial infrastructure - banking and capital markets. Taking cognizance of inevitable role of these two pillars, the government along with regulatory authorities viz. SEBI and RBI, have undertaken various measures to deepen the market in an attempt to attract issuers and investors. Budget proposals, various committee and working groups have been set up over the years in this regard. After the eruption of the COVID-19 pandemic and disruptions of economic activities, the government and regulators alike announced a slew of measures to mitigate any financial stress arising in the economy. Some of the prominent earlier and recent measures have been included here. A few suggestions have also been put forth for further development and strengthening of the system.

4.1: Banking

4.1.1 Recent measures related to Banking including response to COVID-19 pandemic

- **Amalgamation of PSUs:** Mergers of public sector banks was announced by the government. From now on there would be only 12 public sector banks.

- **Liquidity support to HFCs:** The regulator sanctioned additional liquidity support to housing finance companies of Rs 20,000 crs thereby increasing support to Rs 30,000 crs.

- **External Benchmarks:**
    - Banks were mandated to link all new floating rate personal or retail loans (housing, automobile, etc.) and floating rate loans to micro and small enterprises to an external benchmark from October 1, 2019, like Reserve Bank's policy repo rate, GoI

three/six months' treasury bill yield published by the Financial Benchmarks India Private Limited (FBIL) or any other benchmark market interest rate published by the FBIL.

- With a view to further strengthening monetary transmission, it was decided to link pricing of all new floating rate loans by SCBs for the medium enterprises also to the external benchmarks effective April 1, 2020.

- **Reclassification of NBFC on-lending:** Lending by banks to NBFCs for 'on-lending' under specific categories was made eligible for classification under priority sector lending up to the limits prescribed.

- **Export credit:** The sanctioned limits towards export credit for domestic SCBs were enhanced to boost credit to export sector.

- **Special OMOs (operation twist):** The Reserve Bank announced conducting simultaneous purchase of long-term and sale of short-term government securities under open market operations (OMOs). The aim is to bring down cost of borrowing for the government as well as corporates.

- **Revision in liquidity management framework:**

  - **Long-term repo operations (LTROs):** The RBI announced LTROs at fixed rate with a view to assuring banks about the availability of durable liquidity and facilitates the transmission of monetary policy actions and flow of credit to the economy.

  - **US dollar swap auctions:** The Reserve Bank announced to undertake 6-month US Dollar sell/buy swap auctions to provide US Dollar liquidity to the foreign exchange market.

  - **TLTRO 1.0:** The Reserve Bank announced conducting targeted long-term repo operations (TLTROs) at a floating rate linked to the policy repo rate. Liquidity availed under the scheme by banks had to be deployed in investment grade corporate bonds, commercial paper, and non-convertible debentures.

  - **TLTRO 2.0:** The Reserve Bank announced conducting targeted long-term repo operations (TLTROs) 2.0 at the policy repo rate. Liquidity availed under the scheme by banks is to be deployed in investment grade corporate bonds, commercial paper, and non-convertible debentures with at least 50 per cent of the total amount availed going to small and mid-sized NBFCs and MFIs.

  - Special Liquidity facility for Mutual Funds: to ease the liquidity pressure on mutual funds, it was decided to open a special liquidity facility for mutual funds (SLF-MF). Liquidity availed under the scheme by banks is to be deployed exclusively for meeting needs of mutual funds.

  - Extended regulatory benefits announced under the SLF-MF scheme to all banks, irrespective of whether they avail funding from the Reserve Bank or deploy their own resources to meet liquidity requirements of mutual funds.

  - **'On tap' TLTRO:** The RBI announced to conduct on tap TLTRO with tenors of up to three years for a total amount of up to Rs. 1,00,000 crore at a floating rate linked to the policy repo rate, which will be available till March 2021. The liquidity availed can be deployed in corporate bonds, commercial papers and NCDs issued by entities in specific sectors.

- **RBI's large exposure framework:** The RBI issued the large exposure framework for borrowings by large firm with an aim of limiting or capping banks' lending and thereby their exposure to large corporate entities. The framework stipulates the following key points:

  - **For Single counterparty:** The sum of all the exposure values of a bank to a single counterparty must not be higher than 20% of the bank's available eligible capital base at all times.

- **For group of connected counterparties:** The sum of all the exposure values of a bank to a group of connected counterparties must not be higher than 25% of the bank's available eligible capital base at all times.

- Banks' exposures to a single NBFC will be restricted to 15% of their eligible capital base

- Banks' exposures to a group of connected NBFCs or group of connected counterparties having NBFCs in the group will be restricted to 25% of their Tier I Capital.

- A bank's exposure under the Large Exposure Framework to a group of connected counterparties was increased from 25% to 30% of the eligible capital base of the bank. The increased limit will be applicable up to June 30, 2021.

- **Enhanced exposure limit:** The exposure limit of banks to a single NBFC (excluding gold loan companies) was harmonized with the general single counterparty limit under the Large Exposure Framework by increasing the limit on exposure to a single NBFC from 15% to 20% of bank's eligible capital base.

- Regional Rural Banks were allowed to issue perpetual debt instruments (PDIs) eligible for inclusion as Tier-I capital.

- **COVID related measures:** Certain regulatory measures were announced to mitigate the burden of debt servicing brought about by disruptions on account of COVID-19 pandemic and to ensure the continuity of viable businesses. The salient features included rescheduling of payments for term loans and working capital facilities, easing of working capital financing and exemption from classification of special mention account (SMA) and non-performing assets (NPA).

- **Deferment in timeline of Basel III norms:** The liquidity coverage ratio requirement for SCBs was brought down from 100% to 80% following the pandemic led disruptions. The requirement will be gradually restored back in two phases – 90% by October 1, 2020 and 100% by April 1, 2021.

4.1.2 Recommendations for Banking

- **Targeted liquidity measures:** In line with TLTRO 1.0 and TLTRO 2.0, the RBI should conduct more TLTROs, one of such being announced on October 9, 2020 targeting specific sectors. Vulnerable segments like auto, hospitality, real estate, aviation can be targeted. These can be dovetailed to include only primary market operations.

- **Various forms of credit enhancement** should be provided which will aid in lowering borrowing cost for the issuers.

- **Address governance issue in PSBs:** The government should introduce policy measures to address the governance, management, and operational issues faced by public-sector banks.

- **Bond issuances by NBFCs:** NBFCs should be allowed an on-tap facility for issuance of non-convertible debentures (NCDs) to the retail market. The offering of these bonds should be through an easy- to-operate and less costly procedure.

- **Tax deductions on NPA provisions:** The government should allow banks to claim 100% tax deduction for bad and doubtful debt provisions to assuage the difficulties in recovering NPAs.

- **Removal/reduction in withholding tax:** At present, interest payments by domestic borrowers to NBFCs and HFCs face a 10% withholding tax. This needs to be brought down.

- **Boost ECBs:** Existing 5% tax concession can be extended to interest earned on INR denominated external commercial borrowings (ECBs).

4.2: Debt Market

4.2.1 Challenges in the Indian corporate bond market

Although, the Indian corporate bond market has been in existence since a long time, it has remained a small part of the Indian financial market. Despite having a well-functioning government debt market, which is regarded as a pre-requisite for the development of a vibrant corporate debt market (as it provides the benchmark rates), India's corporate debt market has not followed in the steps of its government debt markets.

The country's corporate debt market is characterized by myriad problems that severely constrain the growth and development of this segment. Addressing these challenges would be necessary for the growth and development of the domestic corporate bond markets. Some of the key issues that have held back the market are discussed here.

1. **Dominance of private placements:**

   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 issues and the relatively stringent regulatory requirements associated with public issues that entail costs and time on the part of the issuers (borrowers) of debt. Unlike public issuances, private placements do not require statutory disclosures. Also, the lack of adequate participation further prompts private placement. 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.

   Private placement in the primary markets can in part be held responsible for the low level of retail participation in the country's corporate debt markets. As bonds in private placement are placed with institutional investors who generally hold them till maturity, the secondary market liquidity is limited for these. Moreover it is not mandatory to list privately placed debt on the stock exchanges. As such, private placement in the primary markets adversely impacts market depth in the secondary market and results in muted trading in the corporate debt markets with transactions taking place only among the large/big players. With majority of the 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 lack 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. Private placement leads to a vicious circle i.e. the lack of transparency- lack of investors – lack of liquidity.

   To encourage public placement of issues, there is need for a transformation in the institutional architecture. There should be large number of public placements of high volume and good quality debt papers of varying maturity. This would add to the debt in the market. The disclosure norms and listing requirement need to be reduced. This would in turn lower the cost and time associated with public issuances. Although SEBI has initiated measures for simplifying listing requirements, more needs to done viz. the rationalization of the stamp duty structure across the country to encourage public issuances of corporate debt.

2. **Low liquidity and market depth**

   One of the major challenges faced by the Indian corporate debt market is that of inadequate liquidity and depth. The secondary markets for corporate bonds are severely constrained by the lack of liquidity. The lack of liquidity in these markets has been an inhibiting factor for its development. Besides 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 sees some investor interest. The low investor base also increases the cost of issuance.

Liquidity in bond markets is driven by the volume of debt offered by issuers in the primary market on an on-going basis coupled with the circulation of bonds in the secondary market supported by active investor participation.

Several factors influence the liquidity or the lack of liquidity in the Indian corporate bond markets. Firstly, is the limited issuer and investor base. Bulk of bond issuers in the corporate bond market consists of banks and financial institutions. With more than 90% of bond placements being private, availability of bonds for trading in secondary market is pre-empted by a handful of investors and this limits the price discovery in the secondary market. Secondly, investor profile and market regulation further limits secondary market liquidity. With key investors like insurance companies preferring to hold till maturity and limited activity from pension funds and FIIs in corporate bond market owing to policy limitation, only mutual funds and Banks are left to trade and offer volume in the secondary market. Search costs, demand-supply mismatches in debt instruments and issue in pricing have curtailed liquidity.

Liquidity in the financial markets and deepening of the same proceed in parallel. In case of India, primary issuances continue to remain moderate, which implies that the pool of available instruments that may be traded is also small. Also, trading is often restricted to specific maturity baskets, which translates into trading in these limited securities. Chronically, less liquid markets grapple with other self-reinforced issues such as narrow investor base, insufficient infrastructure and low transparency levels.

3. **Limited investor base**

The limited investor base for corporate bonds can in part be attributed to the investor preference for government securities. The huge quantum of government borrowings i.e. supply of GSec, 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 outs investments from the corporate debt segment. The GSec have emerged as an attractive investment avenue for its holders, registering high turnover and exponential growth over the years. In sharp contrast, the turnover in the secondary markets for corporate debt is negligible, at around 10-11% of the turnover of the government securities market.

The investment guidelines of Insurance companies, provident and pensions funds thus need to be revised as the existing mandate of these institutions do not permit large investment in corporate bonds. Moreover, the specific characteristics of infrastructure bonds like long duration and high coupon make these bonds attractive for insurance and pension companies.

4. **Regulatory restrictions**

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 based on internal guidelines. 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.

5. **Ease of transacting**

Constraints such as minimum trade size, high transaction costs and illiquidity of bond markets have been detrimental to investor participation in the country's bond markets. In addition to that, the absence of a standard stamp duty rate across the country as well the maximum amount payable and the charging of TDS (tax deduction at source) on corporate bonds is considered to be cumbersome and to adversely impact efficiency. TDS is deducted on accrued interest every fiscal year for all market participants barring insurance companies and mutual funds. This differential treatment meted out to insurance companies and mutual funds makes it difficult to introduce uniform computerized trading system. There is need for a comprehensive regulatory framework that is conducive to the deepening of the domestic corporate bond markets.

6. **Market Makers**

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 G-sec 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. Market makers assume a lot of risk and need to be encouraged and provided with backing and incentives in terms of finances and supply of securities, for the much needed development in these markets.

7. **Lack of awareness and risk aversion**

Investors are seen to be prone to excessive risk aversion. Secondary market trading just as in case of primary issuance of corporate bonds is heavily biased in favour of higher rated papers i.e. those carrying a rating of AAA or AA+. Investors, taking into account risk aversion thus, are unwilling to trade in lower rated papers.

Also, investors (retail) participation in the Indian corporate bond markets remains low due to absence of knowledge and understanding of bonds as an asset class. Inadequate information or information asymmetry pertaining to the issuer and instrument have been factors that keep retail investors at bay.

Efforts need to be made at the regulatory level, by financial institutions and stock exchanges to build awareness about debt instruments as an asset class. Credit rating agencies too can play a crucial role by providing for the fundamental information asymmetry between market participants through their independent third party assessment.

8. **Lack of effective credit enhancements**

The Indian corporate debt market faces a poignant structural issue of credit risk and the nature of credit enhancements. For instance, if the private sector participates in infrastructure financing, it may essentially be regarded as project financing with each project being a Special Purpose Vehicle (SPV) and funding may thus be based on cash flows of individual projects. Herein, there is trouble of not obtaining a good rating, which culminates in difficulty in raising funds through the market, making credit enhancements vital. The introduction of appropriate credit enhancements enables each debt instrument to obtain a suitable credit rating, which in turn facilitates clearer distinction amongst instruments by market participants.

4.2.2 Debt market related policy measures

A. Measures Undertaken during 2005-11

- High Level Committee on Corporate Bonds and Securitization in 2005 recommended certain measures on legal, regulatory, tax and market designs issues, to be implemented jointly by the Government, RBI and SEBI.
- SEBI permitted BSE and NSE to set up a reporting platform to capture all information related to trading in corporate bonds.
- The Fixed Income Money Market and Derivatives Association of India (FIMMDA) proposed to set up a reporting platform for corporate bonds and also dissemination of information on corporate.
- SEBI permitted recognized stock exchanges having nationwide access to set up corporate bond trading platform.
- The government issued clarity on regulatory jurisdiction and market design.
- SEBI reduced the shut period in corporate bonds to align it with that applicable for Government Securities.
- SEBI reduced tradable lots in corporate bonds in respect of all entities including Qualified Institutional Investors to Rs 1 lakh and made amendments to the listing agreement for debentures to ensure that electronic payment and clearing services are used.
- SEBI decided to make it mandatory for all new issues of corporate bonds to have an actual day count convention similar to that followed in respect of dated Government Securities.

- SEBI made amendments to the listing agreement for debentures to ensure that electronic payment and clearing services are used.
- In May 2009, SEBI simplified listing agreements for debt securities.
- The limit for investment by registered FIIs in long term infra-bonds was raised from US $ 5 bn to US $ 25 bn in March 2011.

B. Khan Committee report -Recommendations and Action undertaken

- **Consolidation and re-issuance of debt –** SEBI in April'17 laid down a specified framework for consolidation and re-issuance of debt securities by reducing the number of International Securities Identification (ISIN) allocated to a single corporate to a maximum of 12 in a year. This has been done in order to reduce fragmentation in the primary market and to enhance liquidity in the secondary market
- **Investment in unlisted securities -**In order to enhance the investor base in unlisted debt securities and securitized debt instruments, SEBI has permitted FPIs (Foreign Portfolio Investors) to invest in these securities to the extent of Rs 35,000 crore. However, only 31.65% of the total limits assigned to these securities has been utilized as on November 14, 2017.
- FPIs allowed trading directly in corporate bond markets without involving brokers as is allowed for domestic institutions such as banks, insurance companies and pension funds.
- **Permitting brokers in repo in corporate bonds-** Brokers registered with SEBI and authorized as market makers in corporate bond market have been permitted to undertake repo/reverse repo contracts in corporate debt securities. This was undertaken so that brokers could meet their funding and securities requirement arising out of marking making activities.
- RBI removes restrictions on seamless transfer of G-Secs between depositories and RBI.
- A framework for issuance of rupee denominated bonds overseas(Masala Bonds) was put in place in September 2015 to provide an additional avenue for banks to raise Additional Tier 1 and Tier 2 capital. It was also proposed to permit banks to issue rupee denominated bonds overseas under the extant framework of incentivizing issuance of long term bonds by banks for financing infrastructure and affordable housing.
- **Standardization of corporate bond issuance**
    - As suggested by market participants, SEBI may have a re-look at the guidelines issued in October 2013 so as to clarify on day count convention, shut period, basis for yield calculation, calculation of coupon interest and redemption with intervening holidays with illustrations. The date of payment may be specified as the date on a Mumbai business day, the day on which RBI and money markets function.
- **Recommendation for Introduction of Electronic Dealing Platform for repo in corporate bonds:** Corporate Bonds and Securitization Advisory Committee (CoBoSAC) of SEBI has sought recommendation for introduction of electronic dealing platforms for repo in corporate bonds in order to develop the repo market.
- **Measures to facilitate greater market liquidity**
    - Market making scheme in government securities: A market making scheme by Primary dealers has been devised in consultation with the Government of India.
    - Acceptance of corporate bonds under Liquidity Adjustment Facility (LAF) of RBI: RBI is considering corporate bonds as eligible collateral for liquidity operations.
    - Removal of 7 day restriction for lending by listed companies in market repo in Government Securities (G-Secs).

C. Insolvency and Bankruptcy Code (IBC), 2016

- The Code, passed in May 2016 in Lok Sabha, creates time-bound processes for insolvency resolution of companies and individuals. The law is expected to ensure timely settlement of insolvency, enable faster turnaround of business and create a database of serial default. These processes will be completed within 180 days. If insolvency cannot be resolved, the assets of the borrowers may be sold to repay credit. The IBC can help deepen the corporate bond market. It will help boost investor confidence and encourage fund flows into these markets, particularly in low rated instruments.

- In response to the pandemic, the government had, on June 5, come out with an ordinance to prohibit the initiation of insolvency proceedings for defaults arising during the six months from March 25, 2020 which has now been extended till December 2020.

D. Recent developments in the corporate bond market

- **Consolidation and reissuance of debt:** SEBI in April 2017 laid down a specified framework for consolidation and reissuance of debt securities by reducing the number of International Securities Identification Number (ISIN) allocated to a single corporate to a maximum of 12 in a year. The aim was to reduce the fragmentation in the primary market and to enhance liquidity in the secondary market.

- **Investment in unlisted companies:** In order to enhance the investor base in unlisted debt securities and securitized debt instruments, SEBI has permitted FPIs to invest in these securities to the extent of Rs. 35,000 crore.

- **Permitting brokers in repo in corporate bonds:** Brokers registered with SEBI and authorized as market makers in the corporate bond market have been permitted to undertake repo/reverse repo contracts in the corporate debt securities. The measure was announced to facilitate brokers to meet their funding and securities requirement arising out of market making activities.

- **Repo platform to boost corporate bonds:** The National Stock Exchange and the Bombay Stock Exchange have launched electronic platforms for tripartite repurchase agreements (repo) in corporate bonds, which are expected to improve the liquidity of, and investor appetite for, these securities.

- FPIs were allowed to trade directly in corporate bond markets without involving brokers as it is allowed for domestic institutions such as banks, insurance companies and pension funds.

- **Corporate Bonds under LAF:** The RBI in consultation with SEBI is considering accepting corporate bonds as collateral for liquidity adjustment.

- **Large corporate guidelines of SEBI:** SEBI on 20th July 2019 made it mandatory for large corporates to meet 25% of their financing needs through bond market. This is applicable to any corporate (excluding scheduled commercial bank) which as on March 31st has outstanding long term borrowing above Rs. 100 crore and has been rated AA and above. These are applicable to the long term funding requirement above 1 year and securities should be listed as per SEBI guidelines.

- **Withdrawal of FPI investment limit in the corporate bond:** In February 2019, the RBI withdrew a 20% limit on investment by FPIs in corporate bond of an entity with a view to encourage more foreign investment. Earlier, no FPI was permitted to have an exposure of more than 20% of its corporate bond portfolio to a single corporate.

- The short-term investment limit for FPIs in both corporate bonds and government securities were revised to 30% from the existing 20%.

- **Increase in FPI limit in corporate bonds:** The limit for FPI in corporate bonds was raised to 9% of outstanding stocks to 15% (Union budget 2020-21).

- **FPI investment under VRR -** Investment cap for FPIs under voluntary retention route (VRR) scheme was increased to Rs. 1,50,000 crore from the existing Rs. 75,000 crore. FPIs under the VRR scheme were also permitted to transfer their investments made under the general investment limit to VRR. Exchange traded funds that invest only in debt instruments were allowed under VRR.

- **Tax incentives** have been announced in Union Budget (2020-21) to deepen the corporate bond market

    - Concessional tax rate of 5% on interest income earned by FPIs from investments in GSec and certain corporate bonds to be extended up to June 30, 2023
    - Interest on municipal bonds to be included under the under the concessional tax regime of 5%
    - Relaxing the interest rate cap on all corporate bonds to qualify for 5% withholding tax rate
    - Concessional tax rate of 5% on interest income payable to non-residents has been extended on money borrowed in foreign currency and rupee denominated bonds issued up to June 30, 2023
    - 4% tax withholding rate to the interest payment on bonds listed on the International Financial Service Centre's exchange

- Netting legislation to expand the scope of corporate default swaps markets (Union budget 2020-21)
- **Setting up of Credit Guarantee Enhancement Corporation:** Budget 2019 had announced setting up of credit guarantee Enhancement Corporation with an objective to provide bank lending to infrastructure projects.
- To deepen the corporate tri-party repo market in corporate debt securities, the Government is to work with regulators RBI/SEBI to enable stock exchanges to allow AA rated bonds as collaterals.
- Units of debt exchange traded fund (ETF) were permitted as eligible security for repo.
- **Introduction of FAR for NRIs:** A separate route, viz., fully accessible route (FAR) for investment by non-residents in specified securities issued by the Government of India (GoI) was introduced.
- **Extension of Partial credit guarantee scheme under Aatmanirbhar Bharat:** The partial credit guarantee scheme will be extended to cover borrowings of lower rated NBFCs, HFCs and MFIs.

4.2.3 Recommendations for Corporate bond market

- **Incentivize public issuances:** For increasing the public issuance of corporate debt the disclosure norms and listing requirement need to be reduced. This would in turn lower the cost and time associated with public issuances. Although SEBI has initiated measures for simplifying listing requirements, more needs to done.
- **Rationalization of stamp duty** structure across the country and fixation of stamp duties based on tenor and issuance value to encourage public offerings of corporate debt still needs to be addressed.
- **Offer tax incentives** as is offered on equity sale in terms of capital gains to attract retail investors in corporate debt markets.
- **Timely disclosure/communication** of rating information that includes ratings assigned and changes/ migration of the same should be made available in the public domain through a centralized database.
- **Relaxation of investment guidelines** for institutional investors like insurance companies, pension/ provident funds to invest in corporate bonds.
- **Restructuring of bonds:** The restructuring of corporate bonds under specific conditions can be considered. This could prevent companies from being declared defaulters under exceptional conditions and could help both investors and issuers
- **Quantitative easing:** The RBI could buy corporate bonds as a part of quantitative easing. This would help in deepening the markets.

- **Funding for NBFCs:** The government should extend additional funding sources (i.e., special refinancing windows) to NBFCs to reduce overdependence on banks and address the current liquidity crunch.

- **Introduce tax free infrastructure bonds** that will fund long term capital requirement of the infrastructure projects as an alternate source to bank loans.

- **Create a market for Junk Bonds:** The junk bonds (bonds rated "BB" or lower) have been important worldwide fund raising instrument for the lower rated companies. Junk bonds have been used when a company has been facing a financial crisis, during mergers and acquisitions. It is also be used by the growing companies, which have initially lower bond rating but have been gradually improving it. A market for such bonds would serve as an alternative investment vehicle in companies with lower credit ratings but are regarded as rising stars

- **Market-making in corporate bonds:** Lack of adequate market making has one of the major impediments to the growth and development of the corporate debt market. The devised market making scheme should be further developed and effectively implemented.

- **Further increase in FPI limits:** FPI investment limits in the corporate bonds and debt VRR should be increased further

- **Measures to deepen secondary market:** The secondary market has remained shallow. Measures to deepen the secondary market are required which will also eventually aid deepening of the corporate bond market.

4.3 Equity markets

4.3.1 Recent Developments in the Indian equity markets

SEBI (Securities and Exchange Board of India) is the apex body that is tasked with the regulation of the Stock Exchanges and the orderly growth of Indian securities market. The mandate of the regulator is protection of interests of investors, market development and regulation.

SEBI has since its inception (in April 1992) undertaken various measures and policies for the development of the Indian securities market in terms of products, technology, participants, surveillance and enforcement. The regulator has adopted global best practices and standards as well as innovative custom solutions for the domestic market.

In order to ensure integration with the global markets and regulatory systems, SEBI is required to constantly undertake developmental and policy measures.

Some of the latest policy measures initiated by SEBI with regard to different segments and participants have been included here.

To refine the primary markets and boost investor confidence

- **Eased norms for buy back of shares –** allowing buybacks resulting in post-buyback debt-to-equity ratio of up to 2:1, except for companies for which a higher ratio has been notified under the Companies Act, based on both standalone and consolidated basis.

- **Relaxations provided to companies undergoing Corporate Insolvency Resolution Process (CIRP) under Insolvency and Bankruptcy Code (IBC) –**

    - Acquisitions pursuant to an approved resolution plan have been exempted from the proviso that prohibits acquisition beyond maximum permissible non-public shareholding,

    - Corporate governance norms such as composition of board of directors, frequency of meetings of directors, composition of various board committees, etc. have been relaxed, provided that the role and responsibilities of the board of directors is fulfilled by the interim resolution professional or resolution professionals

- Exit option provided to the existing public shareholders at a price specified in the resolution plan, subject to certain conditions (shareholders are given exit at a price not less than the liquidation value after paying off dues, and such exit price is not less than the price paid to the promoters and details along with justification for the exit price have been disclosed to the stock exchanges).

- **Transfer of shares only in dematerialized form** to improve ease, convenience and safety of transactions for investors.

- **Reducing the time period for listing of issues -** from T+6 days to T+3 days by introducing the use of Unified Payment Interface (UPI) with facility of blocking Funds (ASBA facility), as a new payment mechanism for retail investor applications submitted through intermediaries. This would make the shares available for trading faster benefiting both issuers and investors.

- **Allowing counter offer by promoter in reverse book building (RBB) process -** If the price discovered through RBB in case of voluntary delisting is not accepted by the promoters, a counter offer can be provided and the same can be successful if it is accepted by public shareholders such that the promoter shareholding reaches 90%.

- **Flexibility to change Offer for sale (OFS) size-** fresh filing of offer document with the company board will be required, when there is a change in either the number of shares offered for sale or the estimated issue size, by more than 50% from the current 20%.

- **Distribution of cash benefits through depositories in addition to registrars.** The option will widen the choice for investors with its benefits such as shorter turnaround time for receiving benefits, ability to get consolidated statements of all such benefits and to receive alerts (SMS/e-mails), etc.

- **Exit to public shareholders pursuant to compulsory delisting –** within three months of delisting from recognized stock exchange. The delisting regulation has been amended.

- **Participation of Mutual Funds in Commodity Derivatives Market** in India has been permitted by SEBI on the condition that no Mutual fund schemes shall invest in physical goods except in 'gold' through Gold ETFs.

- **Upfront collection of margins:** In order to align and streamline the risk management framework of both cash and derivatives segments, operational guidelines were issued to stock exchanges and clearing corporations to adopt a framework to enable verification of upfront collection of margins from clients in cash and derivatives segments.

- **Permitting Banks to Deal in Offshore Non-Deliverable Rupee Derivative Markets (Offshore NDF Rupee Market):** The banks which operate International Financial Services Centre (IFSC) Banking Units (IBUs) were permitted to participate in the NDF market with effect from June 1, 2020.

- **Currency Future and Options Contracts (involving Indian Rupee) on Exchanges in International Financial Services Centres (IFSC):** SEBI capped gross open position limit at $1-billion equivalent per trading member or client level for rupee derivatives launched at stock exchanges in GIFT City IFSC. The move is to bring offshore rupee trading to GIFT City.

- **Revision of criteria for entering the risk-reduction Mode:** As part of efforts to bolster their risk management capabilities, The criteria for entering the risk-reduction mode for brokers with regard to operationalization of the interoperability among clearing corporations has been revised. Stock brokers shall mandatorily put in risk-reduction mode when 90 per cent of the stock broker's collateral available for adjustment against margins gets utilized on account of trades that fall under the margining system.

- **Options in Goods:** SEBI allowed stock exchanges to launch 'option in goods' in their commodity derivatives segment. This is in addition to 'options on commodity futures'. SEBI has also permitted exchanges to allow option on goods and options on futures with the same underlying commodities simultaneously.

- **Common Application Form for FPIs:** SEBI come out with a common application form for registration of FPIs in order to enhance operational flexibility and ease of access to Indian capital market.

- Facilitating transaction in Mutual Fund schemes through the Stock Exchange Infrastructure: SEBI allowed investors to directly access the infrastructure of stock exchanges for purchasing and redeeming mutual fund units directly from mutual fund and asset management companies. The move is aimed at further increasing the reach of the platform.

- **Review of Post-Default Curing Period for CRAs:** Credit rating agencies (CRAs) were allowed to deviate from the 90-day period required to upgrade the rating of an entity from default to non-investment grade. The credit rating agencies were allowed to take the decision on case-to-case basis.

- **Fund of funds under Aatmanirbhar Bharat package:** Fund of funds with corpus of Rs. 10,000 crore would be created for equity funding of MSMEs with growth potential and viability.

To maintain competitive edge in the secondary markets

- **Inter-operability among Clearing Corporations -** by linking of multiple clearing corporations and allowing market participants to consolidate their clearing and settlement functions at a single clearing corporation, irrespective of the stock exchange on which the trade is executed. This would lead to efficient allocation of capital for the market participants, thereby saving on cost as well as provide better execution of trades.

- **Revision in haircut on central government securities (GSec) accepted as collateral from clearing members by clearing corporations –** from 10% earlier to 2-10% for different securities based on their liquidity and residual maturity.

- **Commencement of operations by a newly recognized stock exchange/clearing corporation –** with a minimum of 25 trading partners from the earlier requirement of 50 trading partners.

- **Commencement of operations by a newly recognized clearing corporation -** with a minimum of 10 clearing members from the earlier requirement of minimum of 25 clearing members.

- **Measures to strengthen Algorithmic Trading and Co-location / Proximity Hosting framework –** such as managed co-location service to facilitate small and medium sized members, manage latency for co-location and proximity hosting to bring in greater transparency.

- **Cyber Security –** SEBI has laid down a detailed framework with regard to cyber security and cyber resilience that stock exchanges, clearing corporations and depositories are required to adopt.

- **Transaction in Corporate Bonds/Commercial Papers through RFQ platform and enhancing transparency pertaining to debt schemes:** In order to boost the liquidity on the exchanges for secondary market bond transactions, mutual funds were directed to undertake at least 10 per cent of their secondary markets trades in corporate bonds through the Request for Quote (RFQ) platform of stock exchanges from October 01, 2020. SEBI also mandated mutual funds to disclose their portfolio every 15 days.

- **Allowing Offer for Sale (OFS) and Rights Entitlements (RE) transactions during trading window closure period:** Transactions of offer for sale (OFS) and rights entitlement during the trading window closure period were permitted.

4.3.2 Recommendations for Equity markets

- More MSMEs need to be encouraged to raise funds from markets. Funds of fund scheme announced by the government in Aatmanirbhar package is a right move in this direction.

- Privatization of PSUs is a good move undertaken by the government recently and going ahead more such privatization should be done to improve the efficacy of these entities.
- Increase in limit and duration of guarantees extended to the MSMEs to raise funds from the equity markets
- The government needs to monetize assets through privatization/disinvestment and other innovative methods like floating of ETFs and setting up of an investment holding company to raise funds. A holding company structure will allow flexibility in decision making of timing, sequencing, valuation and borrowing against stock.
- With respect to LTCG on listed equity, the LTCG tax of 10% should be withdrawn. The LTCG on listed equities held for more than three years should be made exempt. The extension of the holding period and tax exemption would boost capital markets, especially long term and strategic investors.
- In order to streamline the entry and exit from capital markets, the current delisting guidelines which require reverse book building for price discovery should be relooked at. This coupled with a mandatory minority squeeze out will make our markets globally competitive.
- The governance for unlisted companies needs to be made more robust. This will protect the minority shareholders of unlisted companies which are not backed by a proper shareholder agreement.
- Capital Market Infrastructure Institutions (MIIs) are an important element of the market and are self-regulated organizations. There is a need to increase the foreign ownership limit to 74% with a cap of 49% on FDI holding. This move will help attract higher foreign investment.
- Threshold limit in equity-oriented mutual funds to be restored to 50%. Reducing the threshold limit of equities from 65% to 50% for being regarded as 'equity-oriented fund' would encourage more investors with lower risk appetite to invest in equity mutual funds.
- Bring down the rate of TDS for NRIs on short term capital gains from debt schemes from 30% to 15% at par with TDS rate for equity schemes.
- Uniformity in tax treatment of infrastructure debt funds of mutual funds and infrastructure debt funds of NBFCs.
- Eliminate double taxation of Security Transaction Tax (STT) on equity-oriented funds and ETFs.

Although these measures provide for the much needed impetus and are a move in the right direction, the deepening and development of these markets would need sustained concerted efforts by the entire institutions framework to address and iron out the prevailing issues and challenges pertaining to these markets.

Paper prepared by CARE Ratings

Coordinator : Madan Sabnavis, Chief Economist

Authors : Kavita Chacko, Senior Economist
: Dr Rucha Ranadive, Economist
: Sushant Hede, Associate Economist

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CARE Ratings Limited

4th Floor, Godrej Coliseum, Somaiya Hospital Road,
Off Eastern Express Highway, Sion (East), Mumbai - 400022.
Tel: +91-22-6754 3456 I Fax: +91-22- 6754 3457
Website: www.careratings.com I E-mail: care@careratings.com
CIN - L67190MH1993PLC071691

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Confederation of Indian Industry

The Mantosh Sondhi Centre

23, Institutional Area, Lodi Road, New Delhi – 110 003 (India)

T: 91 11 45771000 / 24629994-7 I F: 91 11 24626149 I E: info@cii.in I W: www.cii.in

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