Indian Capital Market: The Next 10 Years

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The capital market in India has perforce to play a very important role in the growth of the economy especially if we are thinking of achieving a growth rate closer to the double digit number for the next ten years. This is so because given the amount of funding that is required for investment in the manufacturing sector and infrastructure, the government will not be able to contribute significantly through the budgets and the onus will be mainly on the private sector to deliver.

While the financial institutional set up would be the prime supplier of funds to begin with, the capital market has to supplement the same progressively in larger quantities through both the debt and equity routes. Further, with cost of funds becoming progressively more expensive for corporates, there could be some inherent tendency to work towards lowering the dependence on institutional funding. Presently the interest spread could be between 2.5-3% at the lower end which is quite high. Therefore it would make sense for companies to save on such costs by also looking at the capital market; and equity may be balanced appropriately with debt through both banks and corporate debt market.

Global scene

The role of the capital market in the growth process has been very critical and important in most stories in the west. While banks do tend to be major players here too, there is also a culture of raising debt with participation coming from other institutions especially mutual funds and long term financial institutions like pensions and insurance in this segment. These models have worked well there and there is no reason why they should not in India. The capital market debt segment has the advantage of disintermediation where the cost is kept lower especially when companies have a good rating so that overall return on investment improves making more projects viable.

So far there has never been a severe pressure to work through the capital market from the borrowers' end. The regulators have worked on creating an enabling structure to help in the evolution of the capital market, and hence it will be more under the force of circumstance that companies both on the borrowing and lending sides would progressively dip into this market.

Entities involved in this process

Broadly speaking there are two categories of companies raising debt that go beyond the government. The first is manufacturing where there will be progressive demand for funds from the pressure of investment. Presently the demand is muted as growth has been low and there is excess capacity. But once demand picks up the requirement for funds will increase and the system has to be geared up for this challenge.

On the lending or investing side, there are large fund houses in the insurance, mutual funds and pension spaces that have to match maturities when investing their funds. Equity is attractive for mutual funds which look at relatively shorter maturities while debt is more appropriate for annuity based institutions. As insurance and pension funds expand, they will require avenues of deployment and given their own prudential exposures to equity, the choice has to be in corporate debt along with government securities.

Getting through the sources of finance

Three sources of finance exist today: banks, debt market and ECBs. Conventionally banks have been the main source of funds and companies have preferred this route as it is tested and tried and there is a certain comfort level which has been reached. They have not minded paying the spread of say 2-3% that is charged by banks for the comfort of getting a loan quickly as banking is a relationship based business. But if we are talking of say Rs 6-7 Lakh crore of funds as capital formation every year in industry, intuitively one can guess that around Rs 14-21,000 crore is being paid as an interest rate spread to banks which actually affects the profit and loss accounts of companies. By shifting a part of this finance to the disintermediation field, there are savings to be made.

This will be slow processes since as of now it is only the higher rated companies which can borrow in the market. This is so as several institutional investors including banks have restrictions on the debt that they can invest in based on the credit rating. A double 'A' rating is normally preferred and fund managers would be wary of going anywhere lower. Surprisingly even banks have internal rules that prohibit such investment while their own loans could be the below-investment category. These companies are already in the process of using commercial paper for short term requirements which is an interesting development. And as the market becomes less risk averse and willing to take on lower rated investment grade paper, there is definitely a case to believe that the debt market will be an important source of funding in the next decade or so.

The domestic capital market would have to however also face competition from the external commercial borrowings market. This segment too offers lower rates and relatively easier to manage and are assisted by overseas banks. However, again it is only the higher rated companies that have better access to this market. But the rupee has been fairly volatile in the last 3 years and given the timorous nature of the world economy and the fact that it would take at least 3-4 years for conditions to normalize in these developed countries, we have to be prepared for volatility in currency. This could, be a deterrent for companies looking for funding overseas and the fact that the cost of hedging is high especially in these uncertain times with interest rate also likely to remain at relatively high rates in India, fewer companies would access this segment in a big way.

Banks will probably never lose their hold on lending. But the constraints are twofold. The first is the issue of capital where the Basel III would be fully implemented by 2017. These compulsions will make capital allocation a challenge across various projects. Banks too would typically prefer to deal with working capital loans rather than term loans as the latter involves tenure and hence risk.

The second would be the choice of portfolio. Presently if one asks the question as to whether there is a strategic element in the approach of banks to maintaining a cleaner portfolio, the answer is yes. Private Banks tend to focus more on yet ail where the ticket size is ambler and also the probability of default, is lower, PSBs have ended up holding the more risky portfolio, thus skewing results. Therefore there would be some incentive to move away from term lending to corporates.

Hence, one can see a migration to the use of the capital market for debt, and this is where SEBI has already provided an enabling framework. The issue is more of getting in subscribers for debt and a transfer mechanism in the form of a sale. There is evidently need to have some innovation in these markets.

The area of infrastructure is of course well known. FDI is a way but constrained by the policy environment. While, we have had DFIs in the pat, this cushion has gone with their turning into commercial banks as the models were not workable. Subsequently we have had some specialized infra finance companies. Of late, however, IDFC which was started for infra finance, has chosen the banking route. Therefore, the debt market would be the way to go.

Getting the debt market moving

The issues concerning the debt market are well known. Players in the long end would buy and hold. Those who buy cannot sell and hence the issuers are few as are buyers. Asking insurance companies to buy lower rated bonds is not fair as they have to tread safely as their function is to insure and not take risk. The same holds for pension funds. What is the way out?

We have to move towards the international standards where there are derivatives which are used. We need to have more active use of credit default swaps to create insurance for the lender. The RBI has launched he same but this has not quite taken off. A reason is that most of the debt is anyway secure because of the higher rating and the need to go in for a swap does not exist. We need to create structures for such products where CDS is written on lower rated debt of infra companies. Banks have been allowed to give partial guarantee and adding a CDS will make it more comfortable for the investor.

RBI has been making way for such transition from bank to market based borrowing and their recent circulars and draft reports on large exposures also suggests that not only will banks not be able to carry the onus on its own, but prudential norms would be hard to stick to given the quantum of funds that we are talking of.

Another way to make the debt market work for lower rated paper is to have aggregators who bundle similar rated paper and then market the same in the secondary market so that the packages are transferable at market prices. This can start at the wholesale level and then be broken up into retail lots as and when they get involved. It would be analogous to a mutual fund investing in debt of a certain investment grade with the units being marked on the exchange. Hence say 10 papers of companies which are all rated BBB+ would get packaged in one package which trades on the exchanges. Typically such packages with lower rating should command a higher return – like the junk bonds.

At any rate this segment of the market has to evolve and grow and the pressure of circumstance will lead to further innovation and evolution.

Where is the equity culture?

The equity market has been ignored for long. While the secondary market still acts as the barometer of economic buoyancy, there has not been a corresponding boom in the equity segment. In fact, one reason why we focus a lot on the secondary market even through tax concessions is to create an equity culture in the economy for both the company as well as potential investors. This unfortunately has not really happened and companies have been referring to debt most of the time. There are issues of ownership too here where proprietors would not like to divest much of their share to retain ownership rights. But progressively going forward companies would scale up through use of equity to balance the deb portfolio and to maintain prudent debt-equity ratio that are acceptable to the lenders.

In fact given that the Indian stock market is one of the more attractive markets in the world with foreign investment coming in large numbers is indicative of the strength of the system. Presently companies have gained through good valuation as such flows have helped specific stocks. It is clear that we have to take these companies to the next stage and level where they are able to actually garner funds in the market with these valuations.

What changes would be seen?

First, there would be new instruments that have to be in the market and used more frequently. These will be linked primarily to risk management and those like IRFs, CDS, etc. would become more important as companies use them to effectively address issues of credit risk and market risk.

Second, the stock exchanges have to popularize the debt segment in a bigger way by providing effective trading platforms. Today one can trade in equity but the complexity of debt instruments comes in the way of easy trading given tenure, coupon value, return, nomenclature etc. harmonization and ease of trade would be essential.

Third, companies should also be driven to the equity market to raise funds, which will become necessary as demand for credit outstrips supply. The debt equity ratio will have to be watched out for. Banks need to set limits forcibly on this ratio and hence enhance equity in the company.

Fourth, regulation has to be proactive and flexible so that the enabling changes are made whenever required. In fact, banks should move towards guaranteeing infra bonds rather than lending directly to them to save on capital, cut risk and transfer the same to the market. Besides increasing their fee income, they will save on capital and also lower their NPAs which tend to be high in this segment.

To conclude, we have probably reached the end limit when the existing structure can address the requirements of long term funds. With prudential norms coming in every sphere, we have to move to the next level of market oriented financial system. While this will happen more by compulsion rather than design, the regulatory structures have to be created and remain proactive. All financial markets stories have a crisis of different magnitude embedded and the response is not to go back, but ahead. The stock market crises that we witnessed in the nineties did teach us lessons and while there is no guarantee that such corrections do not take place in any market (happened for derivatives in 2008 in the US), we need to keep them ticking.