Corporate Bonds - Why is it not moving?

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The financial markets in India have undergone significant changes ever since the major thrust for reforms started in 1992 – 93. Over the last 15 years there have been phases of liberalization which have taken the Indian financial market towards greater integration with the global financial markets. Measures have been taken to open up the economy for investment and trade, interest rates and exchange rates have been decontrolled and the regulatory regime has been strengthened with setting up of various financial market regulators. The micro-structure of the market is far better defined today and our systems for trading and settlement are at par with the best in the world. The financial market reforms and other market developments during the last decade or so have resulted in exponential growth in amounts raised, market capitalization, trading volumes as well as investor base. On the Debt side of the financial markets, the Government Securities is the most dominant part of the market and consists of securities issued by the Central and State Governments. The widening fiscal gap has seen Gross Government borrowings rise from Rs.13885 Cr in 1992-93 to Rs.306000 Cr in 2008-09. Net borrowing of the Centre grew from Rs.8461 Cr to Rs.261972 Cr during the same period. Similarly Net borrowing of all the states combined grew from Rs.3471 Cr in 1992-93 to Rs.103766 Cr in 2008-09. The estimated Net borrowing numbers for the Centre and the State Governments for the FY 2009-10 are at Rs.397957 Cr and Rs.147000 Cr respectively.

The demand for increased borrowing of the Government over the years required immediate changes to be made to both the way fresh issuances were made as well as the secondary market trades; to the underwriting and bidding process and also the settlement systems to mitigate risks existing in the systems. The biggest benefit which accrued out of these changes was the ease of transaction and a world class settlement system which further resulted in facilitating the formation of a vibrant secondary market for government securities. The fact that the regulatory framework requires investment by Banks, Insurance companies and retirement benefit funds in Government bonds for meeting statutory obligations has also helped growth of this market.

However, the sheer size of the government borrowing tends to crowd out all other forms of borrowing in debt instruments and some experts believe that this has been one of the major reasons for the Corporate Bond market remaining stunted despite a fairly vibrant government bond market. The Corporate Bond Market in India is still in its infancy, both in terms of the market participation and the structure required for efficient price discovery. The development of a “true credit culture” remains hindered as corporate borrowers continue to depend on bank finance and stock markets for funding. While globally bond markets are many more time the size of equity market, in India the size of corporate debt market has remained insignificant in comparison to that of equity. According to ADB Working Paper (2008), corporate debt market accounts for 4% of GDP in India, while the same accounts for 61% in Korea and 37% in Malaysia. The outstanding corporate debt composition is also skewed towards private placement (92%). The ratio of equity market capitalization to GDP increased from 32% in 1996 to 108% in March 2008. Over the same period, the bond market grew to 40 % of GDP from 21%. Out of that Government bond market represented 36% of GDP while the corporate bond accounted for a meager 4%. According to SEBI figures, India’s corporate bond turnover ratio was 70% in 2007. The corresponding figure for Government bonds in the same year was 104%. The same ratio in Japan was 500% while in Australia it was 600% for Government bonds.

The current financial crisis notwithstanding, India’s GDP is projected to grow at about 5% even according to conservative estimates and also India’s long term growth story remains intact. Robust investment in infrastructure and capital expenditure by the corporate sector are likely to be the major drivers of this growth story. A discussion paper of the Planning Commission estimates that India needs to invest around $495 billion between now and 2012 to ease the shortage of infrastructure. An infrastructure company needs money for long-term infrastructure projects with a high gestation period. In the Indian context, most of the Infrastructure financing is met through Equity Capital Markets or through Bank funding. A Commercial bank would normally be reluctant to meet the long term infrastructure financing need as it would adversely affect the asset liability maturity balance. The conduit of mobilizing money through External Commercial Borrowing and / or Foreign Currency Convertible Bond (FCCB) is no longer easily accessible in the wake of the liquidity tap drying up all over the world. The need for having an alternative non-banking funding channel for infrastructure in the form of Corporate Debt thus gains immense importance. However there is a regulatory asymmetry in the treatment of loans and bonds as a result of which banks continue to advance loans rather than subscribe to bonds issued by the same company. Banks are also not permitted to invest in unrated debt instruments and only 10% of their total Non-SLR investment is allowed in unlisted debt papers. Also since banks invest only in investment grade paper, a lower rated infrastructure company is not part of its investment horizon.

Although the Government and regulators recognize the fact that a well developed Corporate bond market is essential for financial system efficiency, stability and overall economic growth, reforms in the Corporate Bond Market have been slow and intermittent. Over the years, a number of studies have tried to explore the reasons for corporate bond market being underdeveloped (World Bank Study and Report of the High Level Expert Committee Chaired by Shri R.H.Patil). These studies have raised various issues that need to be addressed and also the recommended solutions and I have tried to touch upon some which I as a practitioner for many years think are critical.

A major part of the Primary corporate debt market is dominated by Banks, Financial Institutions, Infrastructure related institutions, Non-banking finance companies and PSUs. The gradual withdrawal of budgetary support to PSUs by the government since 1991 has increased their dependence on market borrowing. The preferred mode of raising capital by these institutions has been through the private placement route where the issue is offered to a group of large players not more than 49 in number.

While the Corporate Bond market comprises of various active players like Banks, Primary Dealers, Insurance Companies, Provident & Pension Funds and Mutual Funds, most of the issuances end up getting invested by either the Insurance Companies or Retirement Benefit Funds segment. Prior to 2004-05, banks were one of the larger investing segments. However, since the withdrawal of Held to Maturity (HTM) norms for corporate bonds, this segment has dried up. The effect of such withdrawal has been that banks today have to provide for Mark to Market losses on their entire Corporate bond portfolio. Further, there is hardly any distinction between differently rated credits as far as loan pricing is concerned whereas Corporate Bonds because of compulsory credit rating requirements end up getting priced at market related credit spreads. Sub-PLR lending (at cheaper rates), insignificant borrowing cost (for issuers), ease in documentation requirements and lack of MTM requirements apart from the regulatory asymmetry mentioned above have resulted in banks opting for providing loans as compared to investing in corporate bond pertaining to the same credit. Banks further have to hold corporate bonds in AFS portfolio and have restrictions in terms of holding period. Insurance Companies are mandated by IRDA to invest in top rated companies only. This reduces acceptability of lower rated credits in the country. Provident Funds and retirement funds are also regulated to invest a limited portion of their investible surplus in corporate debt and that too which is rated by two credit rating agencies, thus increasing the cost of issuance. The regulators need to introduce measures to ease issuance process, reduce cost of issuance and at the same time widen investor base. Retail investors for the present have been shying away due to the differential in returns on small saving rates and bonds of similar maturities and the illiquidity and lack of exit route in the bond market.

It is mandatory to rate corporate paper before they can be issued. This is independent of whether the bonds are publicly issued or privately placed. Some instruments need to be listed to include a set of investors. Cost as well as time to issue tends to increase when an issue is rated and listed. Detailed listing requirements and disclosures and marketing requirements makes the public issue of bond expensive and private placement tends to become the preferred alternative for most issuers. If the corporate bond market is to develop, attention will have to be given to minimize the issuance cost and the time taken to make public issue. There is a need to rationalize and reduce the stamp duty applicable for bond issuances in order to attract issuers. Efforts have been made by the regulators to streamline the process in recent months and to make the disclosure norms simpler without compromising on the transparency.

Market makers play a very important role in development of any bond market. They provide psychological support as well as entry - exit options to investors to buy or sell bonds whenever desired by the investors. The market making in corporate bonds is necessary as the market is in a nascent stage and it would require the psychological comfort in the beginning. The Primary Dealer (PDs) system prevalent in the wholesale Government securities market is time tested and functioning efficiently. While improvement is always an on-going process, it is widely believed that Primary Dealers have brought in liquidity by offering two way quotes (bid-ask rates) in the secondary market. The same PD infrastructure can be utilized for development of market making capabilities in the Corporate bond market.

A repo market is an important constituent of a well functioning corporate debt market. In a repo trade, a market participant pledges a corporate paper in exchange for funds for a specific period and at a rate determined by the market. Secondary market trading cannot take place unless there are enough dealers offering quotes in the market. Since dealers operate with funded portfolios, they will be able to offer quotes at low spreads only if they are able to carry their stocks at a low cost. Repos allow them to do this by enabling them to borrow against the securities in their inventory. It gives an opportunity to investors who have illiquid corporate bonds to recycle the same and borrow money against these securities. Steps are being initiated by the regulators to introduce exchange clearing house based settlement system for corporate bond settlements which may over a period of time enable repo in corporate bonds. It is expected to bring in the required liquidity into the market.

The CCIL OM system for government securities has been very successful in bringing about increase in trading volumes and also resolves the settlement issues after its introduction in year 2005. A similar order-matching and guaranteed settlement system model needs to be developed for Corporate bond market as it will reduce counter party and settlement risks and bring in the necessary efficiency. The platform will also bring in transparency and reduce the anomalies prevailing in prices. Though reporting platforms of FIMMDA and Stock Exchanges are already in place, there are still issues of different players reporting deals on different platforms and many deals still do not get reported. Investors tend to shy away till they are assured transparency and efficiency in price discovery and timely information dissemination.

FII investment in corporate debt is limited at present to USD 1.5 billion without any tenor restrictions. New auction system in allocating the investment attracted number of new players with good appetite. FII participation in debt market has helped many emerging markets. In order to encourage flow of funds the sub limit needs to be removed and the limit should be on an overall basis fixed for debt instruments including government securities.

Various day count convention like Actual / Actual, Actual / 365 etc still exists in the corporate bond market. Leap year interpretation and practices differ among various issuers. Standardization in terms of day count convention like government securities is desirable in order to enhance acceptability of corporate bonds.

Current shut period in corporate bonds ranges from 15 days to one month, a period when trading volumes tend to dry up. With almost 100% issuances now in demat form, there is a need to reduce the same in line with government securities market.

TDS on interest income from corporate bonds is not uniformly applicable to all the investors. While insurance companies and mutual funds are exempt from the provisions of TDS all other market players are subject to it in respect of interest paid on corporate bonds. An automated computerized trading system and a meaningful price discovery process cannot be introduced because of the differing TDS treatment for different market player. For better market efficiency it is desirable to have a uniform TDS rule for all the market players.

Conclusion

The corporate bond market is locked in a low level equilibrium trap by a vicious cycle. Compared to international scenario the Indian corporate bond market is quite underdeveloped. For instance as per data from ADB Working Paper 2008, India's corporate bond market in absolute terms is miniscule at USD 45 billion in March 2008 compared to USD 570 billion for Republic of Korea and USD 175 billion for China in the same period. This existing stock of outstanding corporate bonds is not sufficient to create a deep and liquid secondary market. Costly issuance process with rigid norms for self registration, poor price discovery etc. are deterrent for issuers to access primary market.Lower outstanding issues of corporate bonds results in low liquidity in secondary market. Issuers are unsure that price discovery will be efficient and fair. As a result issuers who are capable are more comfortable with accessing the private placement route where terms can be negotiated from a position of strength in ones' favor.

While regulatory interest and actions clearly demonstrate favor for development of the Corporate Bond market, addressing some of the issues mentioned above at an early date will ensure attainment of the final goal of "a liquid and a vibrant corporate bond market."