Domestic and Overseas Bonds by Indian Corporates : New Challenges

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Indian corporate bond market is still evolving and needs to be further deepened. Indian financial architecture is characterised by over reliance on banking finance as a measure of debt finance by the corporates. The raising of bonds by Indian corporates is restricted to private placements by highly rated corporate houses, primarily to QIBs, with Banks and Life Insurance companies being the major investors in these issues. Currently the key challenges for the Corporate bond market in India are :

1. Rising yield due to enhanced government borrowing: The central government borrowing for 2008-09 shot up substantially to two and a half times[1] the initial budget estimates due to the three fiscal stimulus packages from December 2008 till February 2009 which was necessitated due the worst global financial crisis in 60 years. Though the Indian Banking and financial system remains robust, the Indian economy is today far more integrated to the global economy than it was in 1990s. The contagion effect from the global economy in the form of contraction of global trade, abatement of global demand and low investment appetite of foreign capital has forced the RBI to focus its attention more on financial stability and growth orientation in the near to medium term. The need for further fiscal stimulus for reviving and catalizing growth in domestic and rural demand and packages to specific sectors which are exposed to the external environment like textiles, leather, shipping, gems and jewellery would exacerbate the government borrowings in 2009-10 beyond the levels in 2008-09. The net market borrowings of the central government for the first half (April-September) 2009-10 is likely to be of the order of Rs 2,07,364[1] crores. However after adjusting for MSS unwinding (Rs 42,000[1] crores) and the RBIs support through OMO (Rs 80,000[1] crores), the net supply of fresh security is of the order of Rs 85, 364[1] crores.

   The enhanced government borrowing would lead to higher yields in soverign bonds and increase spreads due to higher liqudity risk thereby putting upward pressure on the corporate bond yields. To improve liqudity in the corporate bond market , AAA rated bonds could be made repoable instruments to start with.

2. Scope for improvement in demand for bond finance among corporates: The corporates in India traditionally borrow from the banks, and banks account for 90%[2] of financial assets. The corporate bond market can be improved with a uniform stamp duty structure across the states and the maximum payable should be scrapped, exemption of TDS being applicable to corporate bonds also, encouraging public issues of corporate bonds by improving the corporate governance standards of the Indian Corporates so as to convince the retail investors to shift their investment patterns from Bank deposits and mutual funds to direct investment in corporate bonds or through fixed income schemes in mutual funds. This would make the market more liquid and deepen it further. The disclosure norms for existing issuers in case of public issues also needs to be simplified further.

   Another feature that has hitherto hindered corporate bonds issues is credit ratings. Since most potential bond issuers either do not have the wherewithal of getting rated or do not have sufficiently robust financial disclosures to get an investment grade rating, they have tended to favor meeting their credit needs from banks. Banking, being more in the nature of a relationship business, would tend to look at the credit risk of these borrowers in a more holistic manner, and moreover price this as a premium in there lending rates. This tended to benefit both parties. This anomaly, however, is gradually receding with Basel II norms requiring an increasing number of bank credit exposures be rated.

3. Widening the investor base: Banks, Mutual funds, insurance companies and pension funds are the primary investors in corporate bonds. Mutual funds investments are primarily short term in nature . Among investors in the insurance sector, LIC represents, 98%[2] of the total investments in the corporate bonds market in India. Insurance companies have to invest 65%[2] of the total investments in public sector bonds, they can invest in approved investments which are in AA or above rated papers. Bonds below AA can be held in unapproved assets which can be a maximum of 15%[2] of the total portfolio and are subject to exposure norms for sectors and companies. Enhancing the insurance penetration in India is a key challenge so as to increase the investible portfolio.Pension funds have similar restrictions in investments and invest

primarily in sovereign risk bonds. Insurance companies and pension funds can invest for the long term and their investment mandate can gradually be relaxed as per rating based guidelines so that they could invest in corporate bonds.

4. Relaxation of Exchange controls to encourage FII investment: As 'green shoots' of recovery begin to appear in the global financial system and the Indian electorate have given a clear mandate in favor of political stability, coupled with the Government's intent to usher in a new round of economic reforms, the Indian economy is expected to be back on the growth path sooner rather than later and the slowdown is likely to abate in the second half of FY 10 unless some negative Black swan[3] event occurs in the global markets. The risk appetite of investors is steadily improving which can be gauged from the rising yields of the Treasury Bonds in the US rising from the lows of 2.05% in December 2008 to close to 4% currently for a 10 year tenor bond. The dollar has also depreciated in the recent days which is a sign that the demand for dollars as a safe currency is declining steadily and the investors are moving towards riskier assets . The investment limits in corporate bonds for FII has been enhanced to USD 15 bln and in Gsecs to USD 5 bln and is a positive measure to deepen the corporate bond markets in India.

Of course, a primary impediment to the development of a bond market in India – whether sovereign or corporate – is the lack of a sovereign yield curve, which is deep and liquid at multiple maturities, which can be used to properly price credit, liquidity and maturity risks for all other instruments. Together with the other operational distortions of prices described above. The Ministry of Finance and the RBI are addressing some of these issues.

As a measure of developing the market infrastructure for bonds, RBI in its annual policy review for 2009-10 has given a timeline for the launching of STRIPS(Separate trading for Registered Interest and Principal) in the current financial year for G-Secs. Avalability of STRIPS across the term structure would enable a sovereign zero coupon yield curve. As STRIPS market deepens it should be expanded to include corporate bonds as well which would facilitate funding infrastructure sector projects which have a long tenor and require substantial debt finance.

Overseas Bonds

On 2nd of April 2009, at the London summit of the G-20 nations, the leaders of G-20 pledged to do whatever necessary to 'restore confidence, growth and jobs; repair the financial system to restore lending; strengthen financial regulation to rebuild trust; fund and reform our international financial institutions to overcome this crisis and prevent future ones; promote global trade and investment and reject protectionism, to underpin prosperity; and build an inclusive , green and sustainable recovery'[4]. This pledge underlines the fact that a global crisis requires a global solution. The positive outcomes of the G-20 summit and the less than expected capital requirements of systematically important banks as per the stress tests conducted by the US Treasury Department, the fiscal stimulus of USD 787 bln dollars in the US could stabilize aggregate demand in the US economy and the major global economies could be out of recession by the end of 2009. These factors have led to a rally in the equity markets globally in April and May 2009.

Notwithstanding the recent positive developments, the process of deleveraging, stabilization of asset prices and the restoration of normalcy in credit spreads is likely to take some more time. Banks and financial institutions are still in the process of recognizing losses arising out of off balance sheet exposures. Due to these reasons availability of global finance still remains a concern. However with the global co-ordinated approach in building a global financial regulatory framework, a more robust financial system is likely to emerge with more controls and oversight on the investments and risk management practices of the shadow financial institutions globally.

'The Exchange Control Board regulations were relaxed in 2004 to allow Indian corporates to issue euro bonds in foreign currency primarily to finance foreign acquisitions.'[2]

The bond market is largely unavailable to majority of corporates in India because of them being below investment grade rating globally. However some corporates with above investment grade rating have been able to access this market mainly to raise debt finance to acquire assets overseas.

Foreign Currency Convertible Bonds(FCCB) market for raising finance overseas is likely to pick up pace when the equity markets stabilize and investment appetite returns to normal. Currently, however, RBI has extended the window for buyback of FCCBs for Indian Corporates till 31st December 2009, these are available at a discount in the markets currently and offer substantial financial benefits for the corporates through FCCB buyback. The RBI has further liberalized the FCCB buyback norms by permitting 'under the approval route to buyback at a minimum discount of 25% through internal accruals upto USD 50 mn, 35% discount of book value for redemption amount more than USD 50 mn till USD 75 mn and 50% discount of book value for redemption amount more than USD 75 mn and up to USD 100 mn'[1]. Until 15th April 2009, RBI had approved 18[1] proposals for buyback involving USD 765 mn[1] with discount ranging from 25% to 50%.

Foreign Currency Exchangeable Bonds(FCEB) is yet to take off and would help large corporate houses to unlock the value of their unlisted companies. This route could pick up for acquisition financing by Indian Corporates once normalcy in the finanical markets returns.

Conclusion

The need for expeditious development and deepening of the corporate bond market in India is the need of the hour as the Banking system in India is overstretched given the strained availabililty of global finance today. A healthy bond market with relaxed exchange controls would facilitate interest among the FIIs to facilitate the gross capital formation process in the country by participating in infrastructure finance, facilitation of utility services by investment in municipal bonds, funding education and healthcare, development of new technology for the future and clean energy. It would also go a long way in fulfilling the rising ambition of Indian corporates to venture abroad and buy strategic assets and become global corporates.

References

[1] 'Annual Policy Statement for the year 2009-10' by Dr D. Subbarao, www.rbi.org.in

[2] The development of India's Corporate Debt Market for February 2008 published by ICMA Centre, University of Reading

[3] The Black Swan by Nassim Nicholas Taleb

[4] 'The Global Plan for Recovery and Reform' 2nd April 2009, www.londonsummit.gov.uk final communique