Corporate Bond Markets: Emerging Challenges

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When any reference to the Indian debt market is made, government debt (which accounts for over 90% of the Indian debt market) is one thing that comes to mind instantaneously; corporate debt markets being relatively insignificant. With huge funding requirements in a fast-growing economy like India especially in the infrastructure space, it is neither sufficient nor entirely optimal for the government alone to assume such a dominant force in debt markets. This is more so because the government is constrained in its spending activity given the exigencies of lowering its fiscal deficit. Ideally, corporate entities through their participation in the corporate debt market need to be forthcoming in the mobilisation of funds for investment and growth. The introduction of Infrastructure Development Funds is a progressive move which will help in garnering funds for such funding.

In reality however, the current scenario in India is a complete opposite of the desired state of affairs. The corporate bond market in India is practically non-existent, and even here the more proactive participants remain various financial institutions rather than manufacturing or infrastructure companies. There is a definite preference for bank lending which is collateral based and is also attractive for banks, which in developed countries tend to subscribe to corporate debt rather than indulge in direct lending. Faced with a number of structural, policy and infrastructure issues, the bond market has been constrained. Indeed, when we examine the various sources of funding that corporates tap, the corporate debt market accounts for just about 5% of the funds portfolio, suggesting that there remains immense scope to develop the Indian corporate debt market. In this context, it is important to examine the challenges in the Indian corporate debt market along with some solutions.

What do the numbers say?

What we have before us here is a rather dormant market for primary issuances of corporate debt coupled with subdued secondary market registering limited trading. The performance of both markets numerically speaking has registered considerable improvement in growth terms over the last decade or so. However, a glance at just absolute volumes suggests that they remain tepid and we need to do a lot more in this regard in the area of policy.

Taking a look at the primary corporate debt market first – issuances are either in the form of public issuance or private placement. Public issuances in particular have seen commendable change, with issuances to the tune of Rs 1,500 crore in 2008-09 to Rs 16,982 crore in 2012-13, recording marked acceleration (growth of 83% CAGR during the period). Private placements of corporate debt, on the other hand have been more dominant, easily accounting for over 95% of primary corporate debt issuances. This segment too has seen robust growth of 19% (CAGR 2008-09 to 2012-13). There has been a distinct increase in the primary corporate bond market in the last two years. However, this has been more on account of greater FII interest on account of high interest rate differentials as well as SEBI's move to enhance their limits for trading. Also a number of public sector entities have come out with tax free bonds which have found takers in the market.

Moving to the secondary corporate debt market, turnover has increased from Rs 1.5 lakh crore in FY09 to Rs 7.4 lakh crore in FY13. However, given the constraints of liquidity, the full potential of trading activity in the secondary market is short of being realised. In fact, a comparison of turnover in the corporate debt market vis-à-vis that in equity or GSecs market does not give one an encouraging view. With a relatively small corporate bond market, market forces governing the access of funding avenues as well trading opportunities in the same assume a skewed position in the country.

The subdued performance of the corporate bond market can be attributed to a variety of reasons ranging from the lack of adequate participation, limited market-making, costs and time constraints and regulatory requirements.These challenges are examined in detail below.

Emerging Challenges in the Indian Corporate Debt Market

The presence of corporate bond market in India is limited compared with other countries, be it an emerging economy like China that has similar growth needs and financial structures and nascence or a developed market like the USA. The Indian corporate debt market has not been able to truly take-off of numerous challenges ranging from structural issues to institutional concerns and regulatory roadblocks. A view often taken is that as long as the fiscal deficit is high, there will be a lot of government paper in the system which will crowd out private corporate debt. And as a corollary, we need to reduce this level of debt so that banks as investors would

be more inclined towards corporate debt. While there is merit in this argument, reduction in government borrowing would happen only over a period of time. However, we need to address certain issues within the present system so that we are better prepared when there is less demand from the government side. Some of these pertinent challenges are discussed here -

1. Liquidity and Depth

One of the major challenges faced by the Indian corporate debt market is that of inadequate liquidity and depth. 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. Search costs, demand-supply mismatches in debt instruments and lack of transparent pricing have curtailed liquidity.

Additionally, liquidity in financial markets and deepening of the same go hand-in-hand. 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.

2. Constrained institutional structure

The institutional framework of the corporate debt market is closely linked to liquidity. Secondary market liquidity can be improved by having an enabling institutional structure ranging from effective trading platforms to the market-making ability of primary dealers. China, Indonesia, and Thailand have undertaken reforms in their market microstructure by establishing market-makers, introducing modern trading platforms, and upgrading the payment and settlement systems. While such measures have been implemented in India, trading in Indian debt markets remains bunched in certain maturities. This, coupled with a concentration of 'buyand-hold' investors in domestic bond markets, continues to inhibit liquidity.

3. Limited number of players in the market –

Investor base in the corporate debt market is mostly confined to banks, insurance companies, provident funds, Primary Dealers (PDs) and pension funds. The participation of these financial institutions however, is constrained by regulatory norms. A major hindrance in this regard that caps participation of financial institutions in the corporate bond market is in the context of debt instruments and their credit ratings. Financial institutions such as insurance companies and pension funds tend to subscribe only to higher rated bonds, having AA and AAA ratings. This automatically limits the available expanse of debt instruments for these FIs and thereby also contracts their participation in the corporate debt market. Also to the extent these instruments are subscribed, these FIs tend to hold instruments until maturity, which again limits liquidity in the market.

Along with these FIs, there are retail participants, who have only recently showed interest in corporate bonds issued by infrastructure companies that entail tax incentives as in the last two years. With such a provision, however, not being made in the Budget of 2013-14, it remains to be seen if such retail response continues to be strong. Moreover, constraints such as minimum trade size, high transaction costs and illiquidity of bond markets hamper the involvement of retail investors in the corporate bond market space. The concern associated with credit rating of bond instruments is even more relevant for retail investors. Retail investors are reluctant to subscribe to the lower rated (speculative/non-investment grade) debt instruments, as the associated risk perception of default is considerably high for lower-rated paper that investors prefer to maintain small or zero trading positions in such instruments.

4. Inadequate Market-making

The growth of any market does depend on the existence of market-makers who are able to provide two way bid-ask quotes. Unlike GSecs market, the corporate bond market is not adequately supported by the presence of market-makers.

Having said that, the performance of market-makers is inherently determined by the characteristics of the corporate bond market itself – its width, depth and liquidity. While market-makers play a crucial role in adding to the diversity of debt markets, they in doing so assume a lot of risk. Hence, their activities need to be backed up by adequacy both in terms of available financial resources and the supply of securities. This is currently absent in the Indian corporate debt market. The lack of adequate compensation against current and potential risks hence, limits the number of financial entities that proactively participate and play the role of market-makers.

5. Financial familiarity and knowledge

Bank loans have historically been the most prominent source of funding; this may be attributed to not just the ease of access to bank funding, but also because there is a higher sense of familiarity with and better sense of understanding of bank loans as a financial instrument. Corporate debt, as an asset class however, lack such familiarity and understanding from investors. Internationally, individual investors participate in the bond markets through Mutual Funds. On the flip-side however, the pre-occupation of the mutual fund industry with wholesale investors and their hunt for Asset under Management have led to small investors being sidelined. Hence, direct participation from investors across the board (large and small, institutional and retail) is essential, based on financial knowledge of bond instruments.

6. Few instruments in the market

For a market to meet the diverse funding and hedging needs of the participants, there is a need for a wide array

of instruments and products. In the realm of government paper, several instruments like zero-coupon bonds, inflation-indexed bonds, capital-indexed bonds, floating rate bonds, STRIPS and bonds with call and put options, have been introduced. Such vibrancy and innovation is not particularly noticed in case of corporate bonds. While Credit Default Swaps (CDS) on corporate bonds were introduced to facilitate hedging of credit risk associated with corporate bonds, there were few takers for this product. This may be on attributed to lack of understanding of the derivative product and associated fear of risk and financial losses.

7. Preference for Public Debt

A prime concern in the debt market is the impact of increases in the supply of government paper on liquidity pressures in the secondary markets (increasing sale of government securities is a monetary tool that withdraws/ absorbs free currency from the system). Additionally, there is also the risk of dominance in the government securities market by a few large banks and institutions. Concentration in the subscription profile of government securities could lead to systemic pressures, particularly in stressed economic conditions, thereby increasing funding costs to finance government operations. In addition to the presence of a lot of illiquid securities, mandatory subscription of G-Secs by primary dealers is a strain especially when the market is bearish.

8. Pricing of risk and compensations

Most issuances in the Indian market pay very negligible fees or in most cases, no fees at all. Thus, the "arrangers" of debt issues in most cases attempt to sell the issued securities on a backto-back basis to investors or hold these on the books only in cases where there is a positive interest rate or spread trading view. This situation, along with the considerable information asymmetry and lack of public information has also led to the development of a class of "arrangers" who distribute debt paper to smaller, non-wholesale investors.

9. Lack of appropriate 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. It is vital to resolve issues of asymmetric information or inaccurate credit assessment in the debt market.

10. Infrastructural constraints and high transactions costs

Market infrastructure is another factor that has to be addressed – be it technology, speed, trading platforms, settlement and clearance bodies that impact primary issuances and secondary market transactions are yet to become seamless. In the primary market for instance, public issues are rare because of excessive disclosure requirements—new SEBI proposals are designed to simplify the process. Disclosure requirements for public issues are viewed by potential market participants as excessive and the issue process is slow, which with high marketing and other costs makes public issues very expensive. The slow issuance process also makes issues risky, as the price is fixed throughout the offer period. Two other issues that have come in the way of easing the processes are the absence of a standard stamp duty rate across the nation as well as the maximum amount payable. Similarly, in the secondary market, minimum participation limits, fees and/or brokerage, etc. limits individual investor participation.

Way forward

These challenges have been persistent in nature and need to be addressed immediately, in order that they do not become chronic. The way forward lies in liquidity enhancements, financial innovation and regulatory modifications which have been discussed in brief here -

- Liquidity may be enhanced with the help of active participation of dealers, traders, borrowers and lenders. Foreign investors in particular can add to liquidity in domestic bond markets by widening the investor base and increasing heterogeneity.
- More market-makers need to be identified. A prospective group being investment banks that have helped corporates to raise money from the market, particularly because they are aware of prevailing market conditions.
- Credit-enhancement options need to be made available to ensure better trading. Equipped with the ability to distinguish between different credit-enhancements, investors might consider picking some lower-rated investment grade bonds, which might currently not be subscribed to.
- Support from varied market bodies, such as FIMMDA, is crucial for information dissemination. FIMMDA has established and operates reporting platforms for corporate bonds, Commercial Papers (CPs) and Certificates of Deposit (CDs). This collaboration between the regulator and market participants has laid the foundation for enhanced vibrancy in the market.
- There is need to ensure administrative ease with regard to ease of disclosure, procurement of credit rating, rationalisation and uniformity in tax regime. An automated, instead of broker-driven network of trading can ensure transparency and efficiency in secondary market and help widen investor base.
- Banks today hold onto excess SLR paper to the extent of 4-5% voluntarily (either for flexibility in lending or for maintenance of stability and liquidity in their portfolio).

The availability of more investment avenues in corporate bond market can help release this additional liquidity into mainstream market.

- Regulatory overlap may be overcome with co-ordinated norms between regulators such as SEBI, IRDA, PFRDA, SEBI. The aim is to help overall development of financial markets (particularly bond markets) in the country whilst retaining independence and sovereign decision making capacity domains of each regulator.
- Ensuring delivery from credit rating agencies that can aid reduction in information asymmetry. CRAs can also help bring greater number of borrowers such as SMEs, MFIs, Mutual Funds, etc. under the ratings ambit.

Given the growth and financing needs of the country, there is immense scope for Indian corporate debt market to develop and grow; for this however the challenges discussed here need to be addressed immediately and simultaneously rather than in a phased and dispersed fashion as it has been until now. A different approach may be called for.