Corporate Bond Market in India–A New Paradigm

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Background

India ranks behind many of the large global economies in terms of the size and depth of its corporate bond markets. For example, currently, the market capitalization of listed companies in the United States amounts to US dollars 26tn, where as the amount of corporate debt outstanding is US dollars 8.4tn. That is, the corporate bond market represents 25% of the total capital markets. Compared to this, while the market capitalization of Indian listed companies is US dollars 2.9tn, the amount of corporate debt outstanding amounts to only US dollars 290bn (a mere 9% of the total capital markets). And even within this, 80 - 90% of issuance is concentrated for bond issues rated AA+ or higher, with companies lower down the credit curve relying largely on bank finance.

Indian companies have predominantly relied on bank finance and equity markets as sources of capital. Such dependence is not sustainable in the long run, especially given the stress in the banking sector and more stringent capital requirements. The corporate bond market then becomes essential in supporting the range of financing requirements that arise from a rapidly growing Indian economy. Moreover, there are several inherent problems that market participants in the corporate bond market face. On the supply side, many of India's corporate bond issuers are highly leveraged themselves. On the demand side, there are several restrictions on players such as insurance companies and pension funds for investment.

Further, the need for corporate bond markets is inherent to a well functioning and financially stable economy. A well diversified economy with balanced distribution across bank lending and corporate bonds prevents deep financial crises. While regulators and the government are aware of such issues, they have had a hard time in addressing all the complex factors that make the functioning of an effective corporate bond market difficult in India.

If we consider lessons from the development of equity markets since the early 1990s, SEBI's role stands out in implementing regulations that promoted transparency, dematerialization, electronic trading, and investor protection. We now need a similar infrastructure and push for corporate bonds. Building blocks for development of a vibrant corporate bond market fall into two main categories: (i) investor protection; and (ii) liquidity. A strong foundation built on these fundamentals will attract sufficiently large number of investors and issuers.

Investor Protection

Enforcement of debt contracts and security rights remains the single biggest challenge. Even though the Recovery of Debts Due to Banks and Financial Institutions (RDBF) Act and Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act do address debt recovery, enforcement mechanisms generally, remain a challenge and impact investor appetite. In 2015, default by one company, Amtek Auto, on INR 8bn of debentures, led to investor panic and brought to a halt the entire market for AA (or lower rated) bonds for several months. Investor reaction was justified – feeling helpless in their inability to enforce their contractual rights.

In that respect, the Insolvency and Bankruptcy law passed by Parliament earlier this year is the single most important piece of legislation that can transform the Indian debt markets. Unlike previous laws which provided greater protection to banks or financial institutions, the Bankruptcy law provides equal rights to all classes of creditors and, outlines a clear mechanism for resolution. The key will be implementation, and market participants keenly await notification of the law, formation of the Insolvency and Bankruptcy Board of India and appointment of insolvency practitioners.

The corporate bond market is likely to remain a predominantly institutional market. While in the past, the private placement market was largely unregulated, SEBI has over the last few years, framed regulations around disclosure requirements, listing and more recently on e-bookbuilding. SEBI should continue to strengthen disclosure standards and transparency for private placements, both at time of issuance and on an ongoing basis. Mandatory appointment of lead arrangers should be evaluated to ensure independent due diligence and adherence to disclosure standards – if this is done, investors would also start demanding market making commitments out of lead arrangers to ensure greater secondary market liquidity.

Liquidity

Majority of corporate bonds continue to be placed privately. While there is no problem with the bond market being largely an institutional market with predominance of private placements, direct placement of bonds by issuers with end-investors results in low availability of bonds for trading in the secondary market, and no commitment from lead arrangers to provide secondary

market liquidity. Lead arrangers as intermediaries can play an important role in ensuring wide distribution and undertake market making activities.

An online trading platform should be implemented to offer greater transparency in the market and facilitate growth. Stock exchanges have launched bidding platforms for corporate bonds. The key benefits of an electronic book vis-à-vis over-the-telephone market, inter-alia, are improvements in efficiency, transparency in price discovery, and a reduction in the cost and time required for such issuances. NSE also recently developed the NSE Trade Repository for Indian corporate debt, which will provide consolidated information on over-the-counter deals in corporate bonds across exchanges.

In addition to an electronic trading platform, the RBI and SEBI should set up a central clearing mechanism where funds and securities are settled on a net basis (delivery vs payment 3 – DVP3). A DVP3 clearing system will lead to multifold jump in trading volumes, and ease access for investors, especially FPIs.

Secondary market trading and liquidity is also impacted by the absence of a repo market in corporate bonds. Though bilateral repo in corporate bonds is currently allowed, volumes have remained negligible. There is need for a repo in corporate bonds – and a central system, like the CBLO mechanism for Government bonds, would be the solution.

Small issue sizes (fragmentation) have been another problem that has been highlighted time and again which leads to low liquidity. Issuers have shied away from re-opening or tapping existing bonds – either to avoid bunching up of cash flows, or because they do not see an immediate benefit. While there has been some talk of limiting the number of issues a company can do in a year, regulatory restrictions tend to be more negative for the market in the longer term. Investor behavior (through greater inclination to invest in larger bond issues) and development of local bond indices which only include bonds above a certain size will incentivize issuers to do larger sized bond offering. Tightening of disclosure standards would also encourage issuers towards larger sized bond issues and reduce fragmentation and low liquidity.

Regulatory restrictions on investments create friction and costs to the economy as a whole. Current restrictions such as the requirement for Foreign Portfolio Investors (FPIs) to invest in debt with a minimum maturity of three years restrict market growth. Similarly, the limits prescribed by IRDA and PFRDA for investments by insurance companies and pension funds discourage the development of a yield curve across the credit spectrum. While these regulations serve to protect small investors as well as India's foreign exchange flows, easing them would enable market forces to play out which could improve the effectiveness of the debt markets vis-a-vis the equity and bank financing markets. To start with, the RBI and SEBI should consider allowing FPIs to invest in lower rated bonds (rated AA or below) without any tenor restrictions. This will help achieve greater credit intermediation, and direct liquidity towards lower rated bonds.

The regulatory framework requires investors in to invest in government and AAA rated public sector bonds despite lower returns (e.g. pension fund and insurance company investment mandates are biased towards government bonds). Further, even though mutual fund investment in corporate bonds has notably increased over the last five years, majority of these investments have been concentrated in bonds with maturities up to three years.

At this time, IRDA and PFRDA may find it difficult to relax norms towards investment in lower rated paper. However, as the market develops through greater investor protection and liquidity, the regulators should consider easing limits on lower rated bonds.

As rupee interest rates move lower, investors will be inclined to go down the credit curve in the hunt for yield. Mutual funds should consider offering schemes which are marketed only to higher net worth individuals (say, minimum investment of INR 5 lacs), and where bulk of the investment is going into higher yielding bonds.

Finally, as highlighted in RBI's paper on "Corporate Debt Market: What needs to be done – A Reaffirmation", the absence of a reliable benchmark yield curve has exacerbated the illiquidity of the corporate bond market. The Fixed Income Money Market and Derivatives Association (FIMMDA) publishes a credit spread for each rating and issuer class. However, because various types of corporations constitute the same rating grade, the FIMMDA spread cannot be easily translated to price corporate bonds in the primary and secondary markets. In order to address the wide range of corporates in each rating grade and adopt a proper yield curve benchmark, it is recommended that RBI and SEBI prescribe the use of bond valuations prepared by an independent agency for all institutional investors (the Crisil bond matrix is a good valuation source).

Conclusion

Several initiatives have already been undertaken, and a strong foundation is coming into place. Some further nudges from the regulators will ensure the necessary building blocks to help develop a market that is large enough to sustain India's diverse financing needs. The Insolvency and Bankruptcy law will provide an institutional framework for financial distress and all focus is on its implementation. In closing, an efficient electronic trading platform, central clearing on DVP3 basis, and an active repo market can lead to a vibrant and robust corporate bond market in a few years.

Views expressed are personal