EBP-Opportunities and Challenges

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The corporate Bond market landscape has witnessed significant growth and multiple regulatory interventions in recent years with an objective of deepening the market. Following the HR Khan Committee report on development of Corporate Bond markets in Aug 16, regulatory bodies have moved to implement most of the suggestions. At the same time, changes in market conditions and evolving interest rate and liquidity conditions over the last few years have resulted in a distinct shift in the credit intermediation channels. Over the last few years, the share of incremental funding to corporates through Bank loans and corporate bonds respectively have shown distinct shift towards market based instruments. As per SEBI data, for the fiscal year 2016-17, the share of corporate bonds in incremental corporate funding is higher as compared to bank loans. It may be mentioned that the shift has coincided during a period where, bank risk aversion has increased due to the twin balance sheet issues and domestic interest rates and liquidity conditions eased materially. Over the last few months as wholesale rates have moved higher, the incremental recourse to bank loans have increased. However, the broad directional shift is more structural in nature and would be further aided by additional regulatory actions. Outstanding corporate bonds as on March 18 at Rs 27.42 Trillion have grown at a CAGR of around 17% over the last 6 years. The below chart denotes the shift to bonds over loans in incremental funding of corporates over the last few years.

	12-13	13-14	14-15	15-16	16-17
Bank Loans	63%	70%	57%	59%	49%
Corporate Bonds	37%	30%	43%	41%	51%

Source : SEBI

In terms of market support infrastructure, mandatory trade reporting, Integrated Trade Repository, uniform market convention, consolidation of ISIN with issuance limit and introduction of Tri-Party Repo on exchanges , to name a few stand out in terms of its impact on market. Recent discussion papers on amendment to SEBI Listing obligation and Disclosure Requirement regulations, 2015 and on Uniform pricing methodology for bonds issued in May 2018 seek to further provide an impetus to transparency in disclosure and fair pricing respectively.

At the same time, certain additional regulatory prescriptions have attracted a fair share of debate especially considering the overall context of market development and demand from the investor perspective. EBP for issuances of securities through private placement, RBI's large exposure framework, enhanced market borrowings by large corporates (2018-19 Budget announcement, followed by recent SEBI discussion paper) and minimum threshold of 65% exposure to lower rated bonds in credit risk category MF schemes need to be seen in the context of current market micro structure and stage of market development.

EBP: The EBP framework seeks to provide a transparent method for price discovery in private placements which accounted for 99.2% of issuances in 2017-18. Procedural issues with respect to the framework have impacted issuances, especially the stipulation of issuers receiving funds only a day post the pay-in. While regulators have resolved the issue by mandating an early funds transfer on settlement day, thereby ensuring same day credit to issuers, larger long term institutional entities still face the challenges of having clear funds by the 10.30 A.M deadline. While it is expected that these procedural issues get resolved, it is fair to debate if the current system is merely a 'Price Reporting' platform where bids get matched rather than a true 'price discovery' platform. Given the nature of corporate bonds where, issuer and issue specific features pre dominate in term of investors requiring additional covenants supported by legal due diligence in certain cases, the role of extensive pre deal bilateral negotiation and arranger involvement cannot be underestimated. A purely institutional market also makes the extent of pre deal negotiation vital. Unlike in cases of sovereign securities where the issuer and issue details are standardized, thereby making it more amenable to screen based price discovery, corporate bonds with its inherent diversity/complexity may pose challenges in terms of adaptability to screen based trading. As trade reporting is anyways mandatory the objective of price transparency and disclosure is maintained. At the same time, flow trades are perfectly amenable to price discovery through the bidding platform. Maybe providing an option to the issuer, with additional post trade reporting requirements may smoothen the issuances and over time also ensure more issuances through the electronic platform.

Large exposure framework and enhanced market borrowing: The basic premise behind both these regulations is to deepen the corporate bond market and to reduce the reliance on banks to finance corporates. In this context, SEBI has in the discussion paper sought to adopt a light touch and gradual approach to the same.

This seeks to gradually enhance the supply of bonds in tune with the market development. It is expected that similar to other global jurisdictions, the introduction of IBC could have the effect of widening the bond market over time. In the near term, as large exposure framework kicks in along with the enhanced market borrowing prescription, the supply of bonds would need to be adequately matched in terms of market demand. While the current market issuances is more skewed towards AA and above rated entities, the additional supply due to regulatory changes would have its own challenges. In the context of the present large mandatory investment by long term investors in SLR securities, this may also require suitable change in the investment framework for these entities. Given the long term liability structure and the mostly administered rate framework, institutional investors such as PF and insurance funds are most suited to fill the demand side equation. However, in a phase of challenging fiscal dynamics and the extant largely captive demand for SLR from these entities, can the government afford a material change in the current SLR oriented investment framework? At the same time, would banks substitute part of their loan book to bonds given these changes? Also would the MTM provision on bonds exposure impact demand from banks? The answer to some of these questions would determine the efficacy and smooth adoption of measures intended to nudge corporates to access more bond financing.

MF norms: Over the last few years, MF participation in the corporate bonds has increased manifold. The growth in credit focused funds has contributed largely to MF remaining active investors especially in the shorter end as well as in a larger share of non AAA incremental issuances. Currently the AUM of credit focused funds / strategies at more than Rs 1 Tr, rank them among the bigger private sector banks in terms of size. Recent regulatory changes have made it mandatory for credit risk focused products to invest a minimum 65% of AUM in AA and below rated bonds. While continued inflows into this category could ensure absorption of a part of lower rated bond issuances in this threshold category, the impact of the same in terms of credit spreads and risk based pricing may be sub optimal. In this context, it is debatable if incentives to retail investors in terms of lower dividend distribution taxes or reduced holding period for Long term capital gains would have been more optimal for increased adoption of debt MF and thereby larger investment appetite in non AAA/AA bonds.

Overall some of the ongoing regulatory measures and market infrastructure improvements could have a salutary impact in terms of deepening the bond markets. At the same time, the challenges remain in terms of sequencing changes in consonance with market development, market structure as well as in enhancing retail participation.