Developing the Fixed Income Market for Domestic Investors- Demand-side Enablers

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The development of bond markets, especially the Corporate Bond market segment has been the subject matter for multiple committees and working groups over the years. The RH Patil committee of 2004 followed by the HR Khan committee constituted more than a decade later in 2016 provide enough guideposts and suggestions towards the same. Over the years a large part of these recommendations have been implemented, while a few are yet to see the light. At the same time significant progress has been made in market infrastructure and regulations specially to smoothen the issuances and bring in higher transparency in matters such as trade reporting and information dissemination.

The amount of outstanding corporate bonds has grown from Rs 15 Trillion in 2013-14 to Rs 33 Trillion by 2019-20, reflecting a CAGR of around 14%. With outstanding bank credit slightly above Rs 100 trillion, the bond market size remains around 1/3rd of the loan market outstanding. It must also be pointed out that the recent few years have witnessed a decline in broader interest rates, thereby incentivizing bond issuances, given the smoother and relatively more instantaneous transmission of interest rate reduction into wholesale rates as compared to bank lending rates. Regulatory prescriptions have also promoted incremental bond market borrowings, especially by larger corporates.

Effectively supply-side measures have received larger and focused policy attention. At the same time, the demand side dynamics continue to receive lesser focus. A vibrant domestic debt market can only be built on the foundations of strong domestic demand emanating from diverse set of players, both institutional and retail. While long term investors such as pension and provident funds with directed investment mandates continue to focus on Sovereign securities and sovereign owned bonds, its largely the Mutual Funds who have provided impetus to the issuances of non-AAA bonds. However, recent credit events and the associated impact on client flows could effectively push back active participation from MF for some time. It is worthwhile to ponder over few, under appreciated facts that should receive attention from the perspective of attracting/ facilitating increased demand for bonds from domestic investors.

Higher retail participation

Measures to incentivize retail participation either directly or indirectly through Mutual Funds have clearly been inadequate. Taxation divergence across various asset classes need to be streamlined given that the current taxation regime has differential rates for long term capital gains for listed bonds and debt MF investments as well as for other asset classes. In the context that equity investments have for long, been incentivized though tax benefits such as Section 80C as well as a more lenient approach towards capital gains and dividend tax for a while, a similar approach with a stated sunset period can be thought through for debt investments. This can take the form of dedicated retail debt funds being considered under the tax deductions under Section 80C or a lower tax rate. Also, the capital gains incidence should not be at variance with the provision for listed bonds or the tenor for availing indexation be moved back to a year from 3 years.

Investment mandates of Insurance Pension and PF funds

Multiple committee reports have mentioned the requirement to permit more flexibility to invest in corporate bonds for long term institutional investors. The current investment framework continues to allocate more towards risk free assets and even within the corporate bond segment, predominantly in higher rated bonds. Given that these investors, unlike MF's have longer term liabilities, the ability to hold illiquid assets in the portfolios is inherently higher. As per IRDA report for the year ending March 19, Life insurance companies in the traditional plans continue to hold almost 57% of the portfolio in government securities and SDL. Similarly, the EPFO investment pattern and current investments continue to favor sovereign and sovereign backed/ private AAA securities. Permitting higher flexibility in the investment pattern for corporate bonds for such long-term investors is an essential requirement to promote wider investor demand for bonds. At the same time, in the absence of mark to market accounting, especially for PF investments, the securities are predominantly held to maturity, thereby inhibiting secondary trading volumes. Mutual Fund portfolios have operational requirements to maintain Daily NAV and honour routine redemptions and flows at the NAV's. This has led to this segment actively transacting in corporate bonds and thereby accounting for a larger chunk of secondary trading volumes.

Higher retail demand for Government securities

The requirement of maintaining directed investment mandate favoring sovereign securities may also stem from the large financing requirement of the central and state governments. Hence a necessary condition to liberalise investment norms for long term investors should be to simultaneously enlarge and diversify the base for investment in sovereign securities. Efforts to promote greater offshore investment through measures such as Bond Index Inclusion etc. need to be matched by efforts to offer retail investors more easy access to government securities, which Gilt Mutual Funds are best placed to provide. Providing retail investors, a direct access to Government securities through demat facilities also is an option that needs to be operationalized as providing a risk free and marketable debt asset for retail investors should be the first step towards eventually providing more diverse options including credit risk assets such as corporate bonds.

Uniform Valuation Norms

As the investment base widens for corporate bonds, to promote enhanced secondary market trading and liquidity including correct pricing, it is essential that same ISIN's be valued similarly across various participants that may be holding them. The above was one of the recommendations of the HR Khan committee and implementation of the same is awaited. Mandating mark to market valuation as well as uniform valuation should provide an impetus to the secondary market trading of bonds by various market segments.

Inter regulatory coordination

An essential step towards operationalizing necessary changes involves inter regulatory co ordination and uniform guidelines to market participants on matters impacting market development and other measures to widen the investor base. These issues have been flagged in the HR Khan Committee report and provide a suitable roadmap. At the same time, teething issues inhibiting market development in some of the implemented reform measures also need to be considered and addressed over time.

While the article has focused on potential demand side enablers a quick recap of issues surrounding recent supply side enablers are in order. The EBP platform while promoting enhanced disclosure has effectively not been a medium of price discovery except in flow trades (of PFI/PSU's) where the security terms are standard. However, it needs to be appreciated that corporate bond issuances, especially as we go down the rating curve involves pre trade negotiations and documentations especially with respect to covenants etc that involves the issuer/ Banker taking confirmation from potential investors prior to launch. However, in the current phase of falling interest rates, the allotment under the issuances have become a function of being able to place bids in the system first.. i.e 'Fastest fingers First' gets the allotment. In the process of democratizing the issuance process, the original investors are left at the mercy of the speed of their internet connection. Also, this may also promote undesirable practices as market players seek to establish dedicated lines etc. to gain a faster access. Also, the original investor who is not guaranteed allocation in a falling rate scenario, would be on the hook anyways in a rising rate scenario as traders looking to make a fast trade may not necessarily be as enthusiastic at that point. As the rate cycle turns, this may also lead to a reluctance on the issuers part as well as they may not be able to gauge market interest, which is assured today with the benefit of fixed coupon issues in a falling rate trajectory. Perhaps, restricting fixed coupon issues on EBP or providing certain discretion to issuers/bankers on allotment could be considered for making this system more robust. The role of Debenture trustees is another issue that needs to be relooked with the intent of enabling them to adequately address investor interest. Promoting more players in the field with well defined roles and backed by adequate physical and Human capital bandwidth is required. This may also require adequate trustee fees to be levied, perhaps supported by even conditional grants/support from the Investor Education Funds to enable the Trustees to adequately build up their infrastructure. The third area is the resolution framework for distressed debt. With the ICA and IBC framework yet to provide solutions (perhaps inhibited by the lockdown), it is necessary to review the frameworks applicable for various regulated entities to participate in the process. A uniform framework is a necessary requirement as the exposure to a failed entity could be held by the banks in the form of loans and bonds as well as exposure by other entities such as MF, Insurance and other players through bonds. An expeditious resolution is necessary to enhance recovery and preserve value and this is predicated on various market segments being able to participate in the resolution process without much hindrance in a timely manner.

Over time as the changes are sequenced in and necessary demand side incentives are enabled, the bond market could be better prepared to meet the enormous financing challenges ahead.