The Next Big Step for India's Capital Markets

Dr.Rajiv Kumar
Vice Chairman
NITI Aayog

Ajit Pai
Distinguished Expert
NITI Aayog

India's largest two stock exchanges, the BSE and NSE, have just broken into the top ten in the world in terms of market capitalization. These impressive metrics have been achieved while only a small sliver of India's citizens participate in the stock market. This is changing fast as the number of individual investors in India's capital markets grows at an unprecedented pace – there were 14.4 million new depository accounts added in FY21 to the 40.6 million at the end of FY20, delivering 35% growth. This accelerated further to 44% y/y in June 2021. The recent material acceleration in interest in stock markets has been enabled by the increased formalization of the economy - GST, the JAM trinity, and the transition to digital finance bringing an unprecedented number of enterprises and individuals into the formal economy. Less than 5% of citizens file tax returns even after the massive formalization through FY21. This proportion is likely to continue its rising trajectory, providing a long runway for further participation in capital markets.

The impact of formalization on enabling greater interest in capital markets has been further boosted by the relatively low interest rates provided by banks that is encouraging savers and investors to incrementally consider other higher return avenues. Generous recent returns from India's equity markets followed buoyant global trends as central banks flood liquidity into financial markets to offset the adverse economic impacts of Covid. These returns have stimulated incremental interest from those that have not participated actively in equity markets yet. This augurs well for the further development of Indian capital markets that have made steady and significant strides over the past couple of decades and risen rapidly in the world on many metrics. Ebullient equity markets are contributing to an acceleration in IPOs and other primary issues that could potentially imminently hit new records.

If supply of products and new avenues doesn't accelerate at a similar pace to match increased interest from investors, valuations might rise excessively, and end the virtuous cycle of growth in capital markets. Fortunately, there does not seem to be a dearth of upcoming equity issuance, which will absorb some of the capital flooding into equities and moderate the pace at which rising valuations will get stretched. The unprecedented increase in the number of institutional and individual investors contributes to improved trading volumes in the markets, reducing volatility, and encouraging further participation in capital markets from investors and issuers. The virtuous cycle appears to have commenced and may, we daresay, even see greater resilience to the eventual withdrawal of liquidity by global central banks, particularly the United States.

India's capital markets are approaching critical mass and likely to see a similar trajectory of penetration as the US capital markets did in the early 80s, about 40 years ago, driven by the popular adoption of mutual funds. Mutual funds AUM in the US as a percentage of GDP in the US climbed steadily to reach 15.6% of GDP in 1986, and then accelerated to 71.1% of GDP in less than 15 years. Despite a few corrections, mutual funds AUM in the US is currently at 113.8% of GDP. Mutual funds AUM in India as a percentage of GDP has been climbing steadily and approaching 15% in 2021. Given the ongoing formalization of the Indian economy and acceleration in new depository accounts currently underway, there are strong foundations in place for following a trajectory similar to the US.

The Indian economy has begun reaccelerating after an interruption caused by the second wave of the pandemic hitting the Indian economy harder than anticipated. The government has focused on making Indian enterprises more globally competitive by addressing the logistics and infrastructure bottlenecks, streamlining the compliance and regulatory burden, and also encouraging the path to more competitive scale with an order of magnitude recalibration in size definitions for MSMEs, simplifying the national labor laws, and launching the PLI schemes. It has further focused on accelerating strategic disinvestment and initiating asset monetization to bring greater efficiencies to the Indian economy. India's start-up ecosystem has created almost 50 unicorns (defined as technology-driven, disruptive, privately-owned start-up companies valued over $1 billion or Rs. 7,500 crores), with almost a quarter of them attaining unicorn status in 2021 despite a brutal second wave of the pandemic. Private equity, venture capital, and angel investing started taking off in India only 5-10 years ago, ensuring a rich pipeline for more unicorns. India's corporate sector has been deleveraging. Real estate is bouncing along the bottom and preparing for a sustained recovery. The steel and cement sectors, both impacted by a slowdown even prior to the pandemic, are setting new records even ahead of a sustained real estate recovery. Clearly, the drivers and pipeline for capital markets in India appear unprecedented in their breadth and depth.

In this scenario of rosy prospects for Indian equity markets, what could go wrong? How can we prolong this nascent bull market's virtuous cycle? Clearly, this bull market was initiated by liquidity support from global central banks. If fundamentals do not follow the bull run will eventually falter. Can we do something within India's capital markets to ensure that fundamentals are supported and the virtuous cycle only strengthens?

Yes! Our proposition is that the weakest link currently in India's growth story is that of debt capital markets. While India's corporate bonds outstanding have been growing, the pace has been decelerating, and the market is still highly illiquid (a function of being primarily a private placement market), does not attract sufficient risk capital, and has almost negligible retail participation. 82% of corporate bonds outstanding are rated AAA (highest safety) and 13% AA (high safety) for a combined 95%. Even investment grade bonds of A (adequate safety) and BBB (moderate safety) are together just 5% of the market. This compares with the mix in the US of less than 1% AAA, 5% AA, 26% A, and 39% BBB, with about a third of the market below investment grade. The European mix is 12% AAA, 9% AA, 28% A, and 34% BBB with 17% below investment grade, reflecting a slightly more conservative stance.

There is clearly a shortage of debt risk capital in the economy. It is estimated that just MSMEs in India, despite the eligibility of many of them for priority sector lending, have an unmet credit requirement of about Rs. 40-50 lakh crores. Those enterprises larger than MSMEs but not able to qualify for AAA or AA ratings are unable to place corporate bonds and are left to grow through their own internal resources, dilute prior ownership through fresh equity infusions, or struggle with reluctant and risk averse banks. This slows the growth of even the most competitive business models to well below potential, dampening their ability to make faster competitive strides by driving economies of scale and network externalities.

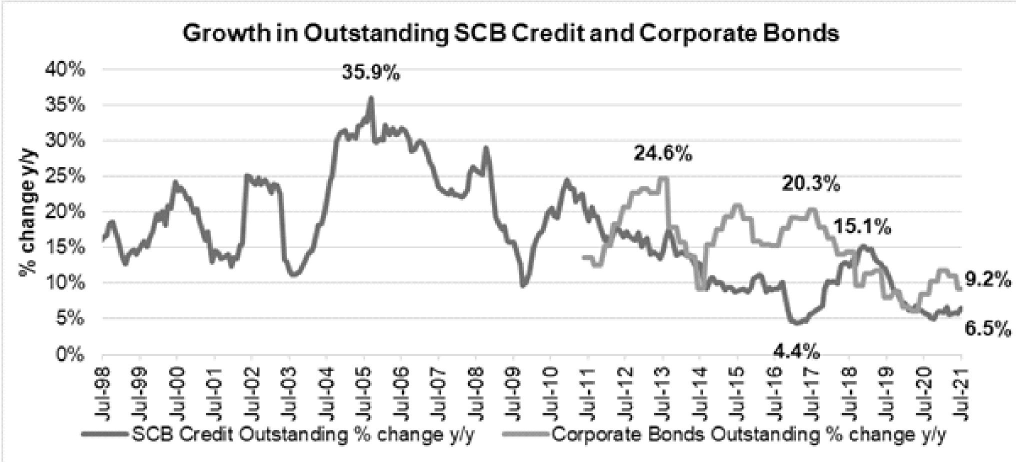
Credit has been a significant driver of growth in most developing economies. Many economies with rapidly rising GDP/capita have effectively used corporate bond markets to drive the growth of their largest corporations, letting their banks focus on more diversified lending. In India, the economy has historically been largely dependent on banks for its credit needs. India's banking sector credit is dominated by large loans to large corporations, in what some term as "lazy banking" and priority sector lending. Over the past fifteen years, growth in lending from India's scheduled commercial banks has been decelerating from 36% y/y in mid-FY06 to mid-single digits currently. This has been a result of both cleaning up of balance sheets and excessive risk aversion. Despite record customer deposits that are still growing faster than advances, the banking sector for a multitude of reasons, appears unable to effectively fulfill its intermediation function. Credit growth has remained well below levels required for the Indian economy to accelerate GDP growth closer to potential.

If corporates with large loans from banks were able to effectively shift their incremental borrowing to the debt capital markets, and corporates unable to get bank loans could get financing from bond markets, it would act as another channel for the liquidity sloshing around in equity markets thereby moderating the pace at which valuations get stretched. It would also help provide more of the much-needed fuel from the banking sector to MSMEs, broaden the base of the economic recovery, and help focus banks on more suitable markets with better diversified risk. The growth of mutual funds, ETFs, and systematic investments has been driven by equities. What needs to change is to increase debt in the mix, and initiate and gradually increase the penetration of high yield debt. Capital markets are the best suited source of risk capital at scale and suitable for long-term debt. With the proliferation of mutual funds and ETFs, capital markets are becoming more accessible to small investors with greater diversification needs. Systematic products improve potential penetration further with the flexibility of smaller periodic ticket size and outperformance over time due to diversification of timing risks.

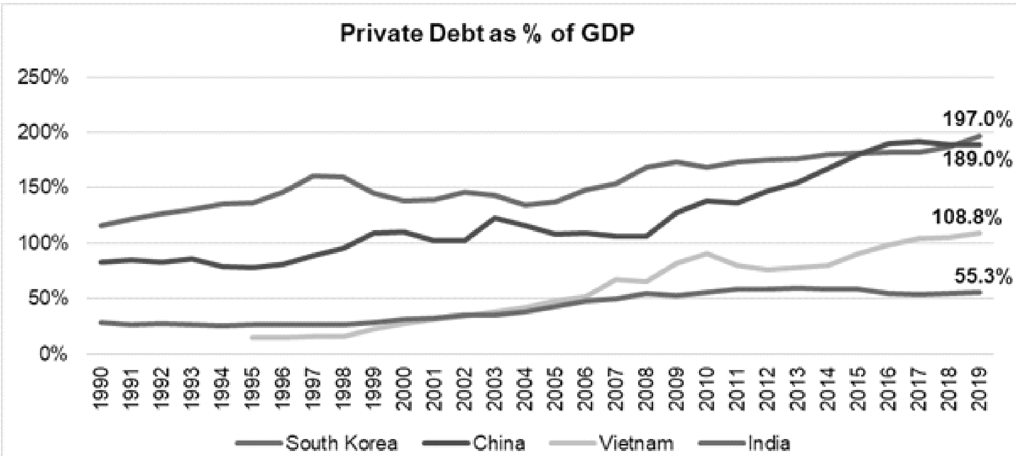
Insurance companies and banks predominantly own the highest safety and high safety corporate bonds (AAA and AA) despite their low yields, driven by regulators and supervisors. They are the largest holders of bonds currently. The government's efforts to encourage retail participation in the corporate bond market resulted in the Bharat Bond ETF, which still represents the highest rated bonds.

We are at a significant inflection point for India's capital markets and its economy. While markets are buoyant, will credit and debt markets step in to support the nascent economic reacceleration with better delivery of credit and risk capital in time? Will it be retail investors that will have to drive the next leg of growth of Indian capital markets, that of A and BBB rated bonds? It is well-established that return and risk are correlated. Will regulators and supervisors and most importantly investors realize that there is room in portfolios for slightly riskier corporate bonds, even if through SIPs or ETFs? Will intermediators design and promote products to help ensure this weak link doesn't interrupt or slow the reacceleration?

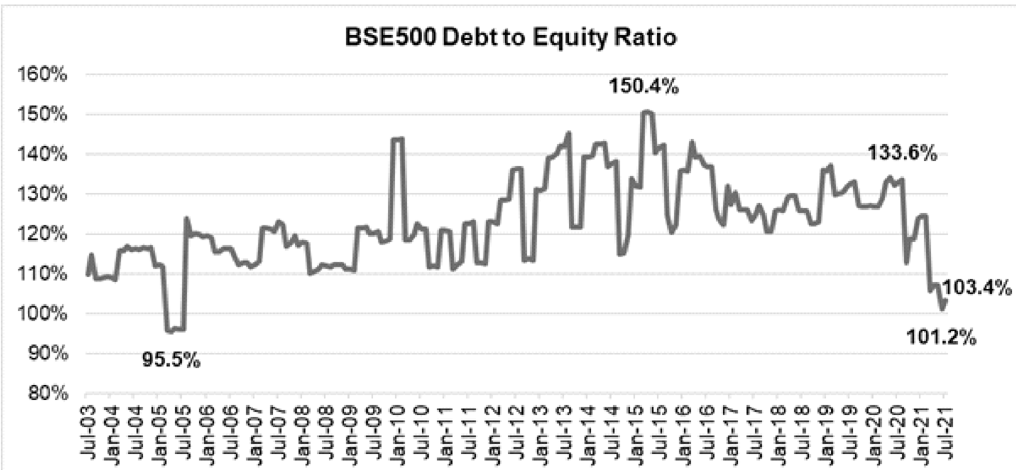
More questions than answers but a lot more rests on the development of India's debt capital markets than many observers would guess. Urgent development of the corporate bond markets is required to sustain the current buoyancy of markets and accelerate India's nascent recovery to sustainable double digit growth rates.



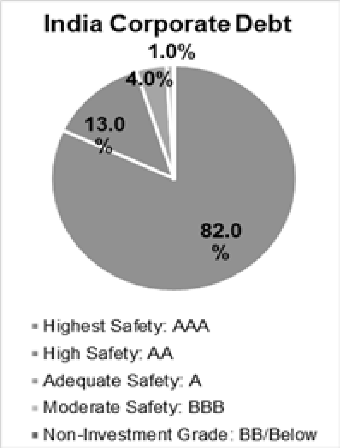
(Source: RBI, SEBI)

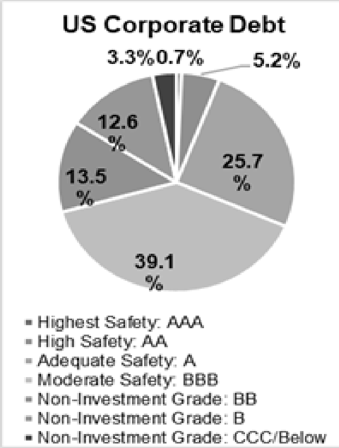


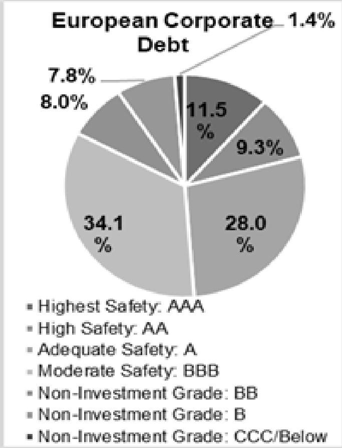
(Source: IMF, BIS)



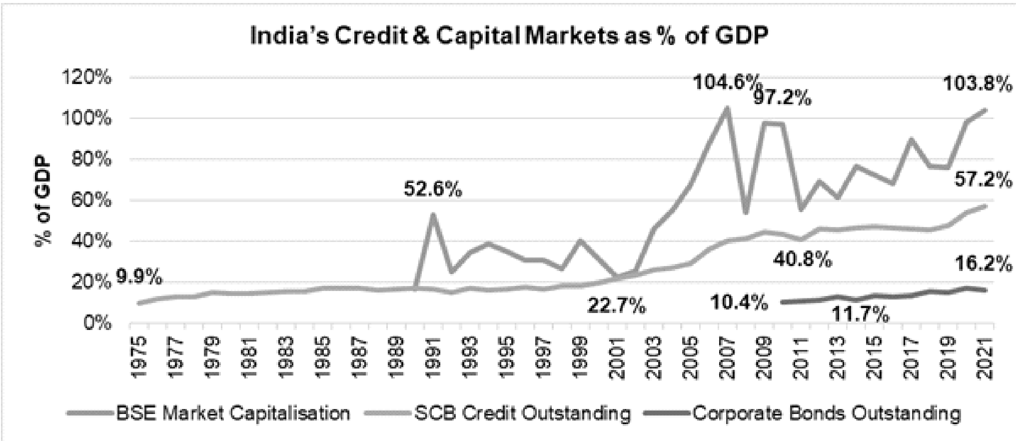
(Source: Bloomberg)



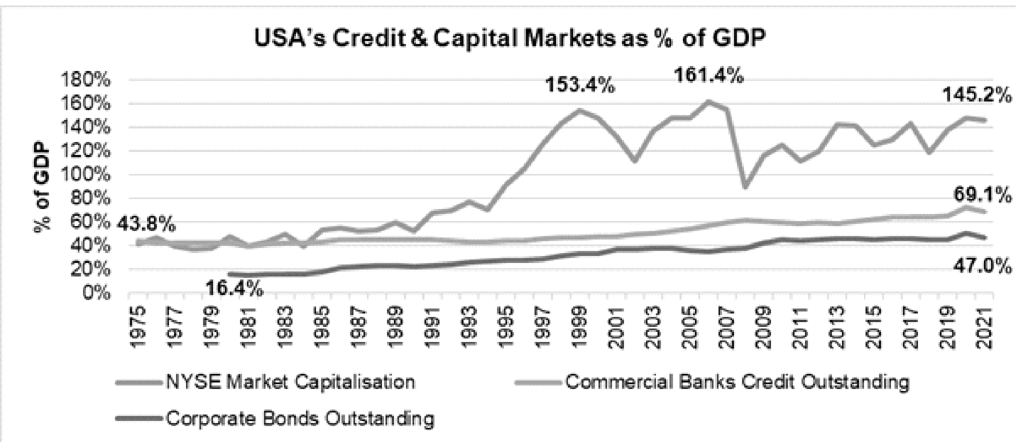




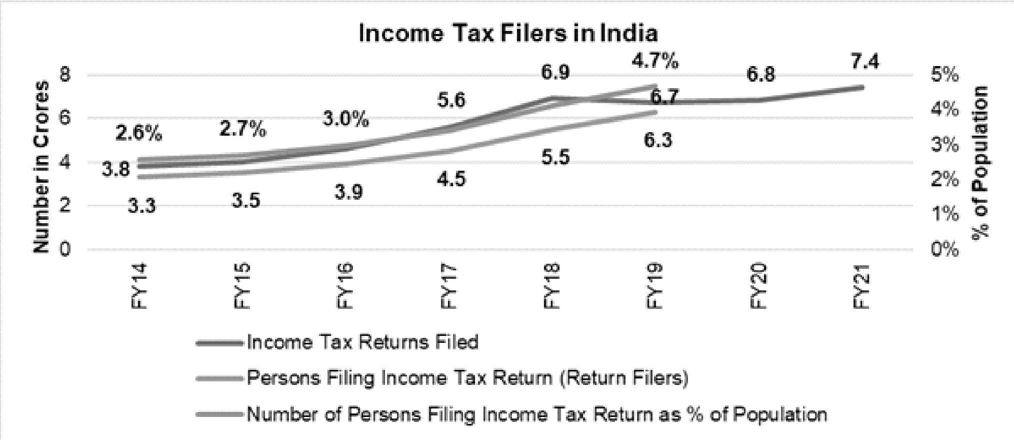
(Source: S&P Global Ratings, BWR, CII) *Note: Corporate Debt Outstanding as on April 1, 2020



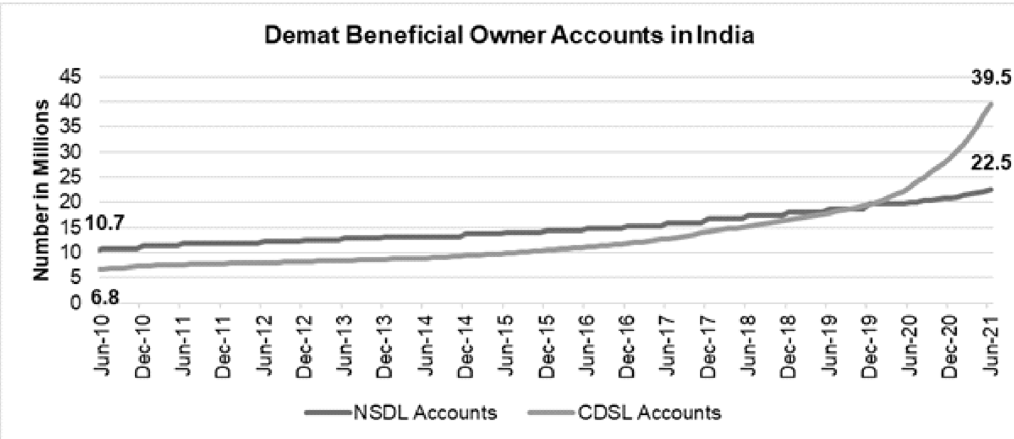
(Source: BSE, RBI, SEBI)



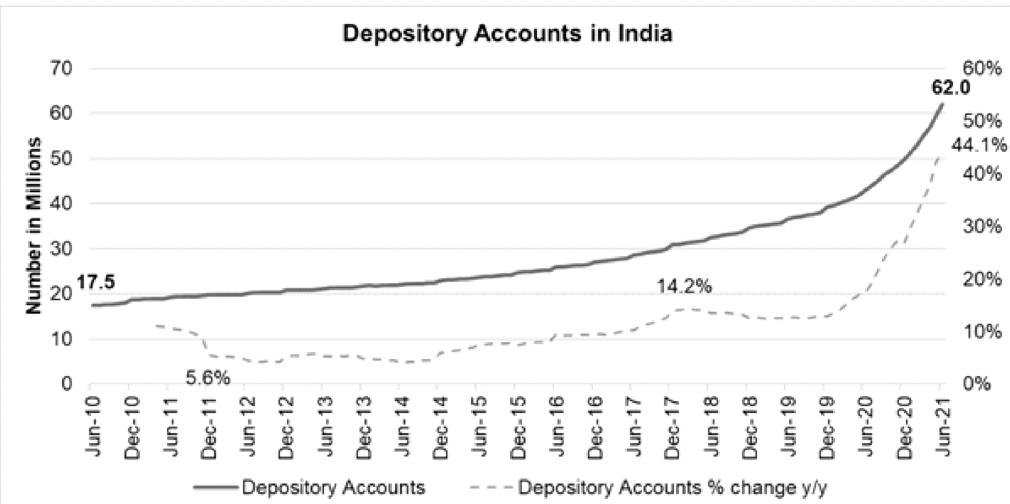
(Source: NYSE, US Federal Reserve, SIFMA, Bloomberg)



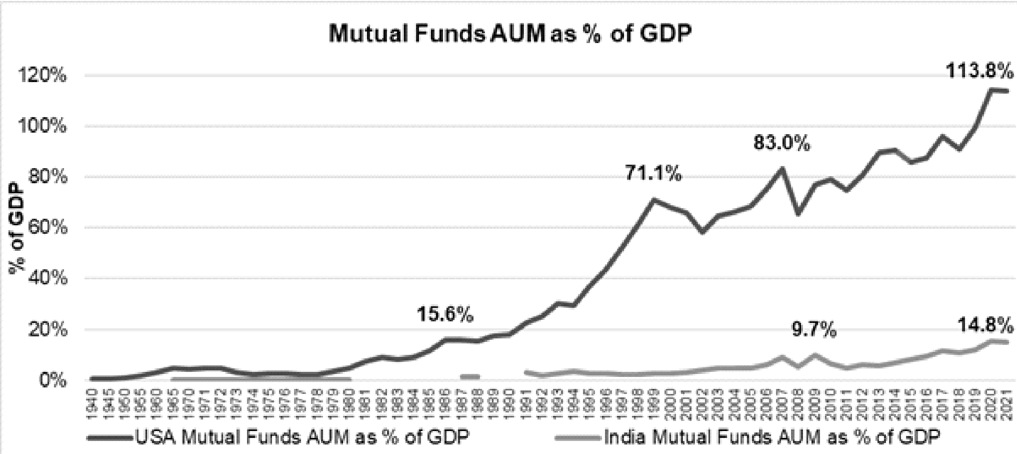
(Source: Central Board of Direct Taxes)



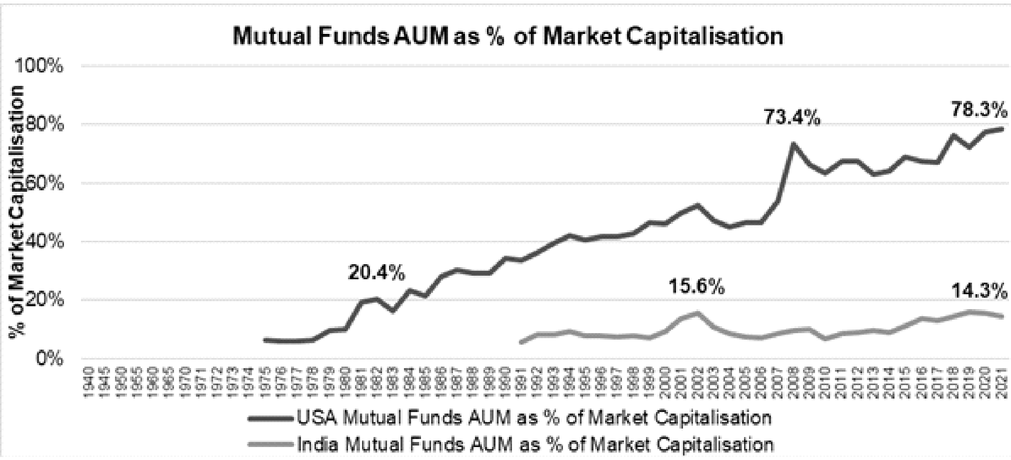
(Source: NSDL, CDSL)



(Source: NSDL, CDSL)



(Source: Investment Company Institute, Bloomberg, MOSPI, US Federal Reserve)



(Source: Investment Company Institute, Bloomberg, BSE, NYSE)