Liquidity in Corporate Bond Markets – Decoding the paradox

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Liquidity in corporate bond markets have been widely debated and discussed at various fora, with contrasting views and suggestions emerging from market participants, regulators and policy makers. A vibrant, liquid corporate bond market facilitates transparent, market-based price discovery of credit risk and can be used as a benchmark for pricing similar transactions, for ensuring efficient allocation of resources through measurement of fund performance, and as a leading indicator for assessing the credit health of the economy. Investors demand additional compensation for holding less liquid assets in lieu of assuming liquidity risks. Such illiquidity premium may vary depending on market conditions and affects investor confidence, thereby leading to higher borrowing costs for the issuer.

In order to achieve the objective of USD 5 trillion economy, as set out by the Government of India, corporate India needs access to alternative debt financing channels in the form of domestic debt capital markets and reduce its dependency on traditional bank financing or foreign currency borrowings. Better liquidity leads to lower market-based borrowing costs, transparent price discovery and helps enhance investor participation. Thus, measures to enhance liquidity in corporate bond markets continue to be among the topmost policy priorities.

Comparison of liquidity relative to other asset classes

There are certain unique characteristics of corporate bond markets, which make them less amenable for anonymous, platform-based trading in secondary markets.

Firstly, unlike equities or foreign exchange, corporate bonds are not homogeneous assets. Each corporate debt security, even of the same issuer, has a unique coupon, maturity or issue size (hence, free float). Further, the investor demand for different debt securities of the same issuer may differ depending on whether it is trading at a premium or discount, whether it is secured or unsecured, whether it is eligible for ETF maturity buckets, end use constraints, or non-uniform MTM valuation considerations. Such heterogeneity impacts the liquidity of corporate debt securities and makes price comparison difficult across instruments.

Secondly, unlike government securities market, there are too many outstanding ISINs for corporate bonds. While there are regulations relating to capping of ISINs per maturity year per issuer, yet the issue size per ISIN continues to remain low. According to NSDL, there were 19,512 unique ISINs of corporate bonds as on June 30, 2022, aggregating to an outstanding amount of Rs. 38.66 trillion. On the other hand, as per data published by CCIL, there were only 101 unique ISINs for G-Secs (excluding special securities) against aggregate outstanding amount of Rs. 84.45 trillion. Out of the above, 38 ISINs of G-Secs had an outstanding issue size in excess of Rs. 1 trillion (equivalent of around USD 12.50 billion). However, for corporate bonds, one finds only a handful of corporate bond ISINs having an outstanding issue size in excess of Rs. 80 billion (equivalent of around USD 1 billion).

Thirdly, while a lot have been achieved in terms of standardisation of instrument characteristics for corporate bonds, there still remains several customisable parameters, including coupon frequency, collateral type/ cover, covenants, record dates, odd maturities, etc. Such variations make price comparison across instruments difficult and leads to reduced market liquidity.

The fragmented nature and heterogeneity of the corporate bond market, coupled with lack of standardization and information asymmetry, makes corporate debt securities inherently less liquid relative to other asset classes.

Market landscape for corporate bonds

The assets under management for end investors, including insurance companies and retirement funds have been increasing at a rapid pace. The investment regulations for specific investor segments, like PF trusts, NPS and insurers, provides for mandatory allocations towards corporate bonds as an overall percentage of their annual investible surplus or portfolio size. With increasing portfolio size and flows, such mandatory allocations have led to proportionate increase in demand for corporate bonds. Unfortunately, the primary market supply of corporate bonds have not kept pace with the corresponding demand growth from end investors, thereby leading to a scenario of too much demand chasing too less incremental supply. As an illustration, the AUM of NPS schemes have grown over 4x across the last 5 years and stood at Rs. 7.36 trillion on March 31, 2022, compared to Rs. 1.75 trillion as on March 31, 2017. However, according to PRIME Database, the annual debt private placement of corporate bonds declined during this period from Rs. 6.93 trillion in FY2017 to Rs. 6.27 trillion in FY2022.

In view of the low incremental primary market supply and limited opportunities for replacement or substitution of existing stock of corporate bonds, investors prefer to hold onto their existing stock instead of churning their portfolio, thereby leading to low free float in the secondary market. Such a market environment is conducive for low credit spreads, and low secondary market liquidity.

Liquidity in corporate bond markets are largely influenced by the credit rating thresholds, as stipulated under various investment regulations. For example, PF trusts and NPS schemes are required to mandatorily invest in listed corporate bonds rated AA and above by at least two credit rating agencies. As per IRDAI regulations, life insurance companies need to invest at least 75% of their corpus in sovereign debt and AAA rated securities. Corporate bond fund schemes of mutual funds need to allocate minimum 80% of their total assets to highest rated debt securities. This skews the demand appetite of investors disproportionately towards AAA rated securities and away from lower rated bonds.

It is important to note that the factors influencing liquidity of AAA rated instruments are vastly different from those impacting the liquidity of non-AAA rated papers. The universe of potential investors for AAA rated instruments is much larger compared to non-AAA rated securities. The investor appetite for AAA rated debt securities primarily depend upon exposure limits, fund flows or redemptions and overall outlook on interest rates and credit spreads. Over the last few years, the primary issuance market have become more concentrated, with a handful of AAA rated issuers contributing to the bulk of the incremental supply. Issuers often raise bonds from primary market through successive issuances in similar maturity buckets, thereby leading to constraints relating to exposure limits for investors, which impacts the incremental appetite or liquidity of such papers.

On the other hand, the potential investors for lower rated instruments are relatively less in number, and such investor appetite is a function of availability of credit approvals, investment mandate of the fund scheme (in terms of target yield, investor positioning, credit risk profile and liquidity expectations of the fund) and the ownership/ parentage and corporate governance standards of the issuer.

One of the key reasons for the low liquidity in corporate bond markets may be attributed to the differential pools of liquidity that are available for primary and secondary markets. Certain large institutional investors prefer investing in corporate bonds only through the primary markets, as it offers them large size through an exchange-based price discovery via EBP mechanism. Investing in primary markets not only facilitate quick deployment of funds, but it also helps justify the price discovery process. In other words, certain large pools of institutional liquidity may be deployed solely through primary markets and may not necessarily find their way into the secondary markets. Hence, any isolated analysis of liquidity of corporate bonds would be incomplete and one needs to consider a cumulative view of both primary market and secondary market activity.

Measures for enhancing liquidity in corporate bond markets

Several regulatory measures have been initiated to address liquidity in corporate bond markets. In order to enhance the transparency and liquidity in secondary markets, SEBI has introduced the Request-for-Quote (RfQ) platform of stock exchanges for corporate bonds, and have mandated mutual funds to execute minimum 25% of their total secondary market trades by value through the RfQ platform. IRDAI has also similarly stipulated insurers to execute 10% of their total secondary market trades in corporate bonds through the RfQ platform.

The centralized database for corporate bonds/ debentures is a commendable initiative towards enhancing market transparency by making most relevant instrument-level information available at a single place. The level of granularity of disclosures for private placement of non-convertible securities, as stipulated under SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021, provides comprehensive financial and business information to investors.

Further, SEBI has already issued the discussion paper for market making in corporate bonds. The market making framework is based on the fundamental assumption that a liquid secondary market would help reduce the cost of borrowing for the issuer over the long term and hence, the issuer needs to establish incentives for market makers of its bonds, similar to the concept of primary dealership for government securities market. However, issuers may often prefer that its bonds are closely held by single or limited investors, as it would facilitate quicker consent solicitation or approval from debentureholders for covenant relaxations, less complicated buyback negotiations, if any, or other associated corporate events.

In order to incentivize market participants to actively participate in corporate bond markets, the transaction costs need to be reduced. Different components of transaction costs may include bid-offer spreads, impact cost for executing large size transactions, and funding costs (availability of repo markets). Introduction of anonymous, electronic trading platform with guaranteed, DvP-3 settlement can help investors buy or sell large positions anonymously without impacting secondary market levels significantly. Additionally, an investor would incur additional costs due to information asymmetry, which leads to higher cost of due diligence at the time of initial investment and higher cost of monitoring or surveillance, once the investment has been concluded. Greater the diversity of market participants, better the liquidity.

It is equally important to address the requirements of the non-institutional pools of liquidity. Given the prevailing low interest rates on other fixed income instruments, such non-institutional pools of liquidity are keen to seek higher yields through investment in corporate bonds. The recent SEBI discussion paper proposing to regulate the online bond trading platforms is aimed at ensuring orderly growth of such emerging channels of liquidity in a transparent manner.

Conclusion

In summary, one needs to acknowledge the unique characteristics and heterogeneity of corporate bond markets, which inherently impacts the liquidity of such instruments relative to government securities, forex or equity markets. Several regulatory measures have already been initiated till date with a view to improving liquidity in corporate bond markets and the impact of the same needs to be watched out. The liquidity of corporate bonds may be enhanced by ensuring wider diversity of investor base and issuers, introduction of anonymous trading and guaranteed settlement for high rated bonds, development of corporate bond repo markets, mandating large institutional investors to invest certain minimum percentage of their annual corporate bond investments through secondary markets, reducing information asymmetry through timely and comprehensive disclosures and attracting new pools of non-institutional liquidity to these markets.