Emerging Trends in Indian Debt Capital Market

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The Indian Debt Capital markets have been growing at a rapid pace (CAGR of 46%) over the past few years from INR 129 bn in 1995-96 to INR 594 bn in 1999-2000.

INR bn

	95-96	**%**	**96-97**	**%**	**97-98**	**%**	**98-99**	**%**	**99-00**	**%**
Public Issues	29.4	23	69.77	28	19.29	6	74.07	16	46.98	8
Private Placement	99.64	77	181.04	72	309.44	94	387.48	84	547.01	92
Total	**129.04**		**250.81**		**328.73**		**461.55**		**593.99**	

Source: Prime Database

As can be seen from the above table, most of the debt raised has been through the private placement route. The private placement market has developed in the last four years, growing from INR 100 bn in 1995-96 to INR 547 bn in 1999-2000. This has been made possible after the relaxation of the investment norms for banks by RBI & specifically, the removal of the limit of 5% on investments in debentures.

INR bn

	1997-98		**1998-99**		**1999-00**	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**
State Level Undertakings	67.26	22	94.79	24	165.26	30
All-India Fin. Inst. & Banks	121.82	39	186.14	48	145.39	27
Private Sector	76.24	25	72.31	19	125.95	23
Public Sector Undertakings	40.08	13	31.1	8	84.35	15
State Fin. Institutions	4.05	1	3.14	1	26.06	5
Total	309.44		387.48		547.01	

Source: Prime Database

One interesting feature has been the increasing amount of borrowings by State level undertakings (SLU) through the private placement market, which were the highest mobilisers in 1999-2000. Most of these funds have been for the infrastructure sectors, mainly power, roads and water resources. Another point to note is the low market share of Financial Institutions and Banks in 1999-2000.

There are several distinct trends which have emerged in the past few years and which will determine the course of Debt Capital Markets in the near future:

Credit Rating – flight to quality

The high NPA levels in the banking system on account of the quasi-recessionary conditions in the economy over the past few years has led to a polarisation in investments in the debt capital markets. There are no investors, even at higher credit spreads, in instruments below a certain credit quality (typically with a rating of 'A'). Similarly, short term instruments with a rating other than the highest, find no takers in the market.

There has been a clear shift toward investing in rated instruments, with investors preferring to invest only in highly rated instruments. In fact, most banks and mutual funds have internal norms specifying the minimum rating for investment (usually an 'AA-') and requiring proposals to invest in unrated instruments to take an approval from their Board. In the secondary market, unrated bonds typically trade at a discount to similar but rated credits.

One of reasons for investor apathy towards low-rated instruments is the long-drawn out legal process associated with recovery by sale of secured assets. When this process becomes simpler, the market for low-rated credits would also develop, giving them access to the debt capital markets, albeit at a price (higher credit spreads). Internationally, the high-yield bond market is highly developed, giving start-ups and relatively riskier ventures access to capital.

Over a period of time, the participants have also formed opinions on the ratings assigned by each of the rating agencies in India, which is reflected in the differential pricing of similar instruments carrying the same rating from different agencies.

Mutual funds as large investors

The fiscal sops given to mutual funds has lead to a surge in fund accretions, which has made mutual funds large investors in the private debt placement market. Though the Union Budget for 2000-01 increased the dividend tax, mutual funds with their large corpus and quick turn-around times continue to be important market participants. Without the drag of statutory requirements (CRR & SLR), the mutual fund threshold for returns on debt investments is much lower than banks. Aggressive bidding for highly rated debt by this segment has also caused spread compression in corporate paper.

Pricing corporate paper at a spread over G-Sec

Over the past few years, the debt market has also progressed to a better appreciation (and hence pricing) of credit and market risk. There has been a clear shift towards pricing corporate paper at a spread over G-Secs of similar maturity. This spread is basically to compensate the investor for the credit risk and the liquidity risk, i.e.

Spread over govt. paper = Credit premium + Liquidity premium

As the corporate bond market deepens and volumes pick up, the liquidity premium is expected to come down.

Compression of spreads

Over the past few years, corporate issuance spreads have moved in one direction - downwards.

This downward movement has been on account of:

- Aggressive bidding for highly rated debt by mutual funds.
- Increasing NPA levels have forced investors to move up the credit quality spectrum, thereby increasing demand for high quality ('AA' and above) credits and driving credit spreads down. Also, demand for bank credit has been contained, increasing liquidity and as a consequence, demand for corporate paper.

Banks lending at tenor-linked PLR

One of the reasons for the development of the private placement market was the inability of banks to give loans to corporates at rates below their PLR. With banks now allowed to offer tenor-linked PLR, they would have higher flexibility in meeting corporate demand. The cost to the corporate would be only slightly higher when compared to the cost in the private placement market of rating fees, cost of creating security, arranger fees and the hassles of a market issue. Banks can also offer more flexibility with respect to drawdown vis-à-vis the capital markets. Loans at tenor-linked PLRs are therefore expected to offer high competition to the private placement market. However, highly rated corporates would continue accessing the private placement market due to the competitive rates available to them on account of the high investor demand for their paper.

Dematerialisation of debentures

The Parliament recently cleared an amendment in the Indian Stamp Act exempting Stamp duty on transfer of debentures through the Depository. Though the amendment has been made, there are divergent views held by debt market participants, since power of levy of stamp duty on transfer of debentures is a State subject, as outlined in the Constitution of India.

Once this issue is clarified, the hitherto illiquid bond market is expected to witness surge in volumes, with the inherent benefits of dematerialised settlements and holdings along with complete exemption of stamp duty.

Regulatory changes

The Companies (Second Amendment) Bill, 1999 (to be effective after promulgation of the Bill by Parliament) seeks to classify private placements as Public Issues, in case, the offer or invitation to subscribes for debentures is made to fifty persons or more. This amendment would reduce some of the flexibility associated with the private placement market.

RBI has also come out with draft guidelines on non-SLR investments by Banks. These include:

- Maximum tenure for investments capped at 5 years, higher tenures to be classified as advances
- Limitation in debentures to 10% of investments
- Valuation of debentures to a minimum of 50 b.p. over GoI securities

In case the proposed guidelines are implemented in their present form they would prove to be counter-productive for the growth of the debt markets. RBI had taken feedback from market participants and investors at large. The overwhelming response seems to be against introducing any such measures which would hinder the functioning and growth of debt markets.

Securitisation

Securitisation is an important form of borrowing that "leapfrogs" a straight debt issue if the issuer is a weak credit but has strong receivables. Rather than pay a substantial premium (high credit spread), it is cheaper for an issuer to transfer receivables of superior credits to service borrowing.

As one of the fastest growing forms of finance, securitisation is now a feature of most financial markets. In India, though a few deals have been concluded, on the whole this market has not taken off, on account of the lack of clarity on several regulatory / legal issues. Going forward, with increasing clarity on such issues, this market is expected to provide a big fillip to the debt markets as an important funding product.

Structured obligations

Though securitisation has not been able to take off in India, debt instruments with structured obligations has been able to make a modest beginning in India. Many corporates have managed to borrow at lower rates backed by structures such as guarantees, keep-well agreements, letter of awareness and letters of comfort.

Multinational companies have used this route widely to raise money for their Indian subsidiaries. One point of particular interest is the increasing number of borrowings by central government entities / PSUs backed by Letters of Comfort from their respective Ministries and state government entities backed by guarantees by the state governments.

New structures

The Indian market has progressed beyond plain-vanilla instruments to products like STRIPS, floating rate instruments, staggered pay-in structures and more recently, mortgage backed securities. In future, the Indian market is expected to develop / deepen with the introduction of several more structures / instruments. The development of the local derivatives market will go hand-in-hand with introduction of new and innovative products.

New investors

The permission granted to Provident Funds to invest in corporate bonds upto 10% of their corpus (Union Budget for 1999-00) has increased the total amount of funds available. Provident funds, due to their very nature of funds, can invest in long-tenor paper, which is expected to provide a fillip to the infrastructure sector. The new participants in the Insurance sector are also expected to be a similar source of funds in the future. These sources of long-term funds are expected to deepen the debt capital markets.

Infrastructure sector

A large part of the resource requirement for the infrastructure sector, in the future, is expected to be met through debt offerings in the capital markets. This is expected to increase competition for resources, since the requirement from the infrastructure sector is also expected to be very high.

Secondary market

The secondary market for corporate bonds remains largely a telephone market, with only a fraction of total deals reported on the NSE. With issues such as dematerialisation of debentures and stamp duty on transfer expected to be resolved shortly, the secondary market should grow exponentially in the future.

Conclusion

The Debt Capital Markets have progressed a long way over the past few years, not only in size but also in sophistication. The primary markets are expected to witness surge in volumes with the entry of new players from the insurance industry and with introduction of new instruments / products. Securitisation is also expected to take off - a small beginning has been made with the introduction of mortgage backed securities. The secondary market is expected to deepen with measures like dematerialisation and early resolution of stamp duty issues. Overall, one can expect all round development and growth in the Indian debt markets in the coming years.