Indian Corporate Bond Market : Taking the road less traveled

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"Reliance Haryana SEZ aims to draw Rs 100,000 cr investment"- BS June 16, 2006
"Rail corridor needs Rs 25,000 cr"- Financial Express June16, 2006
"Maran unveils Rs 23,000 cr e-governance plan"- BS June 15, 2006

Every morning these are headlines that greet us and fill our day with optimism. While each number is staggering a quick summation of all these numbers is even more astounding, leaving one wondering sometimes, if it is all 'in the air' or if indeed true then are there resources to meet these requirements?

Before we grapple with the second question, a quick reality check with the help of some elementary economics. Let us start with the basic macroeconomic equilibrium equation that equates trade deficit and fiscal deficit to private surplus to do our back of the envelope calculation.

(S-I)=(G-T)+(X-M)[1]

The combined fiscal deficit of centre and state is currently at 7.5% of GDP while the trade deficit is 2.5% of GDP. Assuming a higher side domestic saving of 30% of GDP, the maximum savings available to support investment in the local economy is 20% of GDP.

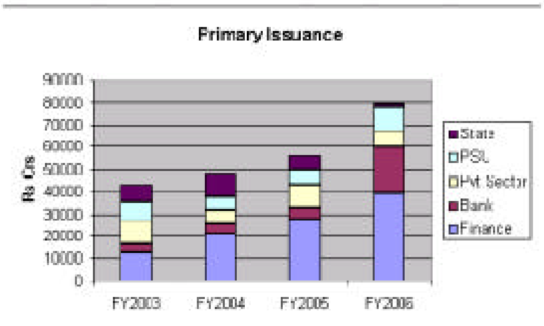
Based on India's average Incremental Capital Output Ratio of 4, the growth rate that we can muster is 5%! But that is not the trajectory we would like to take. In order to achieve a 10% growth trajectory, we would need external capital flows to the extent of 20% of GDP to support our growth targets unless we reduce our twin deficits and improve productivity of our savings.

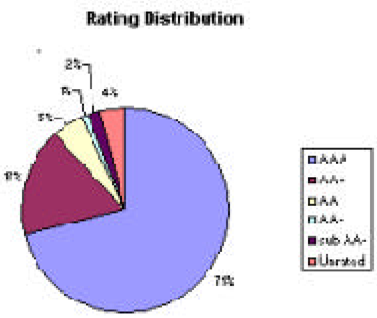
So the writing is on the wall…

It is clear that one needs to lose no time in addressing the second question- how do we mobilize resources? Needless to state the corporate bond market, as the primary source of debt capital formation is critical to make this great Indian dream come true. But the present state of the Indian corporate bond market is nothing great to write home about.

While there has been a marginal growth in the primary market issuance, most of that is accounted for by increased issuance of Tier II Capital by banks. In addition, Financial Institutions and Banks account for 75% of the issuances. In other words 'Corporates' both PSUs and Private sector have been able to mobilize very marginal debt capital from the Indian 'Corporate' Bond market.

It is also ironical that at a time when credit quality has improved and credit spreads have compressed, the share of "AAA" issuers has only increased

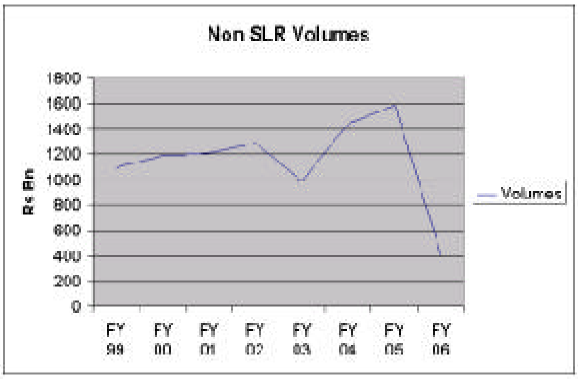




Source: FRIME Database

The secondary corporate bond market paints an even gloomier picture. The volumes have literally fallen off a cliff with the rising yields and widening credit spreads leaving existing investors on the sidelines as hapless bystanders. However, as credit spreads plateau, investors are likely to do 'value' buying, pushing up volumes as well.

[1] S: Savings I: Investments G: Govt. Expenditure T:Taxes X:Export M:Import



Source NSE WDM

MTM losses have kept banks that were active investors in the medium tenor segment, at bay. Domestic mutual funds on the other hand witnessed incremental flows only in their liquid schemes making them active investors in short tenor paper.

That left PFs and Insurance companies as the mainstay for the bond market. Given their investment guidelines, they have been investing primarily in top rated PSU/Nationalised Bank bonds. As a result, primary issuance got completely segmented forcing corporates to rely more on relatively cheaper ECBs and Bank financing.

This acute polarization has meant that the corporate bond market has been able to meet the needs of a narrow base of issuers and investors alike. This has resulted in many of the top rated issuers hitting investment limits thereby hindering their growth.

Time to turn over a new leaf

Given the large resource requirements the country needs, this is a far from desirable situation. No wonder that development of corporate bond market has taken so much of attention of the Central Government and is catching the imagination of regulators, industry associations alike.

The Patil Committee report has recommended a comprehensive set of measures to improve the market microstructure as well as suggestions to increase primary and secondary market activities.

Given the existing situation and the distant desired end state, there are certain broad areas that need to be addressed quickly to kick-start the corporate bond market

Investor Democracy

Maximum diversity of interest rate/credit views, tenor preferences and risk appetite amongst investors is the potent combination for a vibrant and resilient corporate bond market.

However, in the corporate bond market today, the existing investor segments namely Domestic MFs, Banks, PFs and Insurance companies tend to stick to mutually exclusive tenors preferring the higher rated papers driven by their respective investment guidelines. Hence their portfolios are very homogenous and their investor behaviour 'herd like'. This reflects in the polarized set of issuers tapping the market.

In order to instill democracy one would need to unshackle restrictions for existing investors while encouraging newer classes of investors to participate.

A ship is safe in harbor, but that's not what ships are for (William Shedd)

Provident Fund investment guidelines currently require them to invest up to 90% in Central/State and Public Sector securities. They are also required not to sell these securities before maturity unless there have been more than two downgrades. PFs are estimated to have a corpus of Rs 5000 billion.

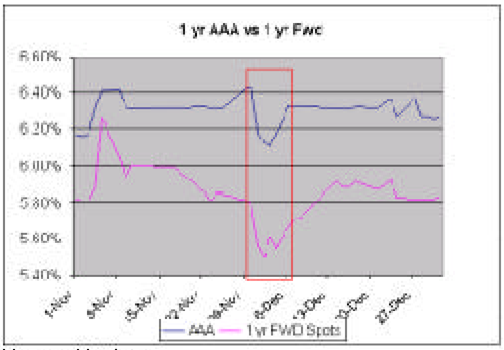
As a first step, in order to encourage mid and small cap companies to tap the bond market, it is important to recommend investment limits linked to 'credit rating' and lower threshold rating for investment to 'A'. PFs should be allowed to trade in the secondary market actively and this would encourage PFs to approach independent professional advisors and money managers to maximize returns.

Similarly, Banks, Insurance companies and Domestic mutual funds should be allowed to invest in unrated/unlisted paper since they understand 'risk' the best. The banks can be encouraged further to increase exposure by providing for a lower capital adequacy for credit in a 'bond' form given that they are more liquid.

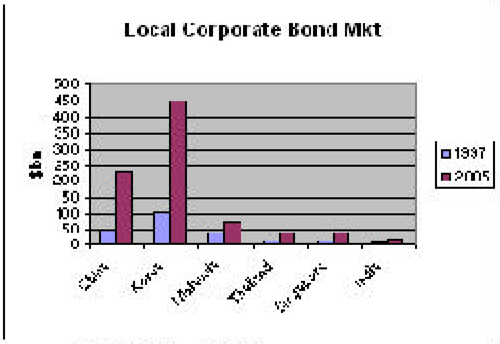
Opening the doors for friends

Foreign Institutional Investors have been instrumental in providing the much-needed diversity for our equity markets and they are likely to have a similar impact on the local bond market. In the era of globalization, capital knows no boundaries and flows across the world only seeking optimum risk adjusted returns.

While we have encouraged FII participation in equity markets we have been more circumspect about increasing their activity in debt markets assuming that they take minimal risks and profit from the ‘interest rate arbitrage’.
Nothing can be farther from the truth given that akin to equities they assume credit and currency risks. In early December 2004, for a brief period the corporate bond limits were removed for FIIs in India. This witnessed a slew of short-term issuances targeted at FIIs. While one can argue that the primary driver was ‘interest rate’ arbitrage, it infused liquidity and crashed down spreads for borrowers and the FII took the currency risk. Hence, we need to actively encourage FII investments in long dated paper at least.



Source: Reuters



Source: ADB 2006 Bond Update

In fact, after the Asian crisis, most of the ASEAN countries realized the importance of a vibrant local currency corporate bond market and took steps to deepen their market allowing foreign investors to participate in the local markets thereby transferring currency linked risks.

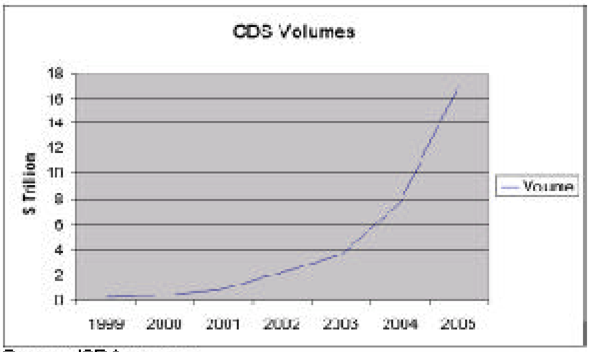
Hedging Mechanisms

The other big stumbling block for investors is the inability to hedge underlying ‘interest rate’ and ‘credit spread’ risks. The investors are left with their hands tied in a scenario that sees interest rates and credit spreads widen. Their inability to participate in an increasing rate environment exacerbates the situation further. Hence, it is extremely important to provide for ‘hedging mechanisms’

While there is lot of discussion on allowing “interest rate” hedging through ability to short G Secs in the cash market and through interest rate futures, they are yet to see the light of day. It is heartening to note that there is a growing realization on their necessity.

The other saving grace is that the existence of INBMK linked and OIS rupee interest rate swap markets has facilitated investors to hedge their underlying interest risk. After all paying a ‘fixed rate’ in the swap market is akin to ‘shorting’ a bond while receiving a ‘fixed rate’ in the swap market is akin to ‘going long’.

However, the one risk that investors are left naked to deal with is the ‘credit spread’ risk. Credit Derivatives have been the world’s answer recently to enable investors to hedge themselves against credit spread risk. The credit derivative volumes have grown exponentially. The recent event of credit markets recovering after a GM downgrade is attributed to these instruments helping investors transfer these risks and making the markets resilient.



Source: ISDA survey

Credit Default Swaps (CDS) help investors offset credit risk by buying and selling ‘protection’. We have had a committee set up to introduce these instruments in the Indian market way back in 2002 but their recommendations are yet to be implemented. Once again lifting a page from the Indian equity markets, the introduction of derivatives has witnessed volumes grow ten fold and the market has been able to absorb shocks as demonstrated during the recent sharp falls. Hence, it is important to introduce credit derivatives at the earliest.

Co existence of Public and Private markets

99% of the primary corporate bond issuances currently happen through the private placement route. Sophisticated institutional investors are the subscribers to these bonds. Earlier this used to be a completely OTC (Private) market until September 2003 when SEBI mandated that these issuances had to be listed, rated and information disclosed in line with SEBI Disclosure and Investor Protection (DIP) guidelines.

These guidelines have raised the specter of underwriters/investors bearing market risk as they have commitments outstanding to issuers at a price, but they can sell down only on listing that could take anywhere between 1 to 2 weeks. This leads to reduced ability to take positions as well as causes issuance to be bunched together due to attempts at timing benign interest rate periods.

While the spirit of SEBI’s diktat is appreciated in terms of bringing better transparency and accountability to the process, the detailed measures stifled the ‘privately placed’ nature of these issuances bringing them on par with public issuances. Though listing provides for transparency in trades, the same can be achieved through mandatory reporting of trades rather than going through the entire listing process. The rating rationale is always detailed and Institutional Investors like Banks, Insurance companies, MFs and PFs have the wherewithal to complete their own due diligence. Hence, instead of a detailed disclosure in line with equity issuances, there is a case for abridged disclosure or private contracts between the institutional investors and issuers.

Even in the most developed markets, public and private markets co-exist. There are regulations to ensure that sales of the privately placed and traded bonds are restricted to QIBs. This will further local corporate bond volumes by reducing issuance timelines making it possible to churn more issuances.

Had Shakespeare been around as a business columnist today, he would have said *“There is a tide in the affair of Indian corporate bond market, which taken at the flood, leads on to fortune. Omitted, all the voyage of its life is bound in shallows and in miseries. On such a full sea are we now afloat. And we must take the current when it serves, or lose our ventures.”*