Indian Corporate Bond Market- Taking Stock

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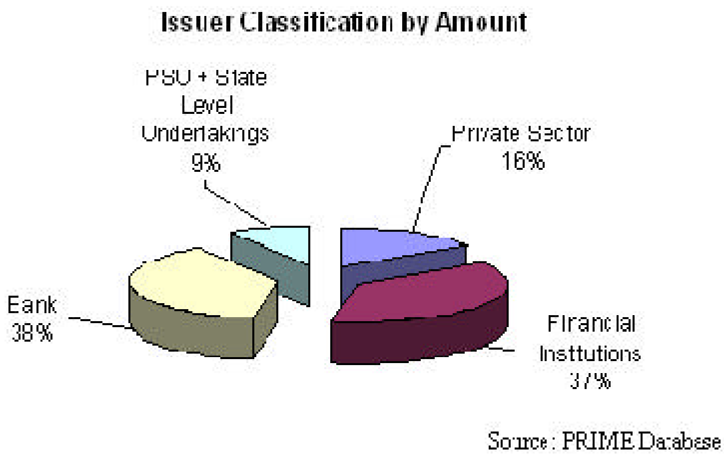
"...And then one day you find ten years have got behind you. No one told you when to run, you missed the starting gun..." (Time, Pink Floyd)

Another year has gone by and it is time for a new PRIME directory to be published. Last year we dwelt on the Indian Corporate Bond Market taking the road less traveled to help issuers mobilize financing in the most cost effective and efficient manner. Now, it is time to take stock on how far the market has traversed in this direction especially in light of the increased financing requirements of a rapidly growing economy...

"The financial services sector continues to dominate the market, raising Rs 82,982 crore or 90 per cent of the total amount."

"Corporate bond mop-up on a high" – June 12 2007, Business Standard



Perhaps what the caption does not capture and the picture attempts to is one of the biggest developments in the market last year: Banks raised over Rs 35,000 crores (almost double of previous year) through a combination of lower Tier II (LT2), Upper Tier II (UT2) and Hybrid Tier I (HT1) issues in FY 2007 to augment their capital adequacy ahead of Basel II.

However it is not the fact that over Rs 2000 crs were raised through 11 Perpetual (HT1) Rupee bond issuances or the fact that the spread between HT1 and LT2 was barely 50 basis points that warrants attention as much as the speed with which the HT1/ UT2 market mushroomed.

On Jan 25, 2006 RBI issued guidelines for banks to augment their capital adequacy through these hybrid capital issuances, even as there was no clarity on how these instruments would be rated or how exchanges would capture the maturity of a perpetual bond in their system! Guidelines for the key investor segments (Insurance Companies/ PFs) were yet to include these new instruments...

These myriad challenges in normal market speed would have meant that the first issuance was a good six months if not a year away. But lo behold the first UT2 issue and the first HT1 issues were executed by UCO Bank in March 2006 barely two months after the announcement. By May 2006, SBI closed the largest UT2 issuance that mobilized Rs 2,300 crs and the bank went on to mobilize close to Rs 10000 crs for the year to become one of the largest single issuers in the local market.

How did this market kick-start so fast?

"Necessity is the mother of all inventions"

In one word- "Need" or rather a compelling need that can be mutually met by the demand and supply side.

Banks had a compelling need to issue these securities by March 31, 2006 to shore up their capital adequacy. Long-term investors like Insurance companies and Provident Funds viewed these instruments as a means to earn higher returns for the same credits they were comfortable with and were permitted to invest in. When the issuers and investors were ready and more importantly the rules of the game permitted them to fulfill each other's needs, the rest had to fall in place quickly.

Then why has the corporate bond market not taken off so far???

Development of the domestic corporate debt market in India is constrained by a number of factors - low issuance leading to illiquidity in the secondary market, narrow investor base, inadequate credit assessment skills, high costs of issuance, lack of transparency in trades, non-standardised instruments, comprehensive regulatory framework and underdevelopment of securitisation products. The market suffers from deficiencies in products, participants and institutional framework. This is despite the fact that India is fairly well placed insofar as pre-requisites for the development of the corporate bond market are concerned (Mohan, 2004b). There is a reasonably well-developed government securities market, which generally precedes the development of the market for corporate

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Clearly the demand for debt capital to fund growth is undisputed as well as the need to earn higher returns on the savings is evident. If it has not materialized in the market taking off then it has to be the rules of the game that do not lead the issuers and investors alike to complement each other's needs.

It is important to recognize that while we highlight the high savings rate (32.4% of GDP currently) and investment rate (31% of GDP), we should also look at the break up in their composition and the trend.

Domestic Savings and Capital Formation Trends (as a % of GDP)

Year	Private Sector (incl Household)			Public Sector		
	Savings	Investments	Net	Savings	Investments	Net
FY2000	25.6	17.9	7.7	-0.8	7.4	-8.2
FY2001	25.3	16.5	8.8	-1.9	6.9	-8.8
FY2002	25.5	16.3	9.2	-2	6.9	-8.9
FY2003	26.9	18.4	8.5	-0.6	6.1	-6.7
FY2004	28.5	19.4	9.1	1.2	6.3	-5.1
FY2005	28.7	21.3	7.4	2.4	7.1	-4.7
FY2006	30.4	23.6	6.8	2	7.4	-5.4

Source: Economic Survey

Private sector capital formation has swung 5.7% of GDP between FY2000 and now, offsetting the growth in savings of household + Private sector. While public sector capital formation has remained flat even as savings increased by 2.8% of GDP.

It becomes evident that over the years there has been a major swing with the public sector generating relatively higher surpluses (saving more than investing) while the private sector has been investing more than saving. In short public sector does not need capital where as the investment guidelines for the resource rich insurance companies and PFs are skewed towards government investments (90%) even as the paradigm has changed.

Empirical data indicates that resource mobilization by PSUs has declined by 43% while issuances by State Government owned entities have declined by 15% between FY06 and FY07 (Source: PRIME Database).

Hence there is an increasing compelling need from the private sector that is massively investing in capital expenditure and infrastructure to borrow but the investors constrained by limits have no wherewithal to bridge this need.

Earlier, it made sense to stipulate investment guidelines biased towards government exposure since PSUs commandeered the economy and contributed significantly to capital formation. However, these investment guidelines in the current context have led to a polarizing of issuances with a few highly rated issuers accounting for a significant portion of the market at the margin pushing up yields for private sector issuers.

It also did not matter so much to the private sector so far, since banks were major sources of local credit at rates finer than bond markets or issuers found it cheaper to borrow overseas. However, with banks cost of funds sharply rising and overseas interest rates inching up, the local bond market will be even more needed. Similarly with government/ public sector issuances declining investors would clamour for more flexibility.

Hence it is imperative that investment guidelines are recast to align them along lines of credit risk rather than based on class of owners, the basic premise of capital market pricing. It is also important that as guidelines for PFs are relaxed, they fold into a professional money management platform.

The other aspect of last year's market was a sharp rise in premiums (spreads) with tightening domestic liquidity. Corporate spreads as we understand are a summation of liquidity and credit risk premium. Thanks to the surfeit of overseas issuances and a liquid cross currency swap market, one can normalize to extract the "liquidity" premium as demonstrated in the table.

1 year AAA borrowing rate comparisons					
Date	AAA	MIFOR	Eq $ Cost	CDS lvls	Premium
31-May-07	10.00%	8.15%	L+185bps	50bps	130 bps
31-Mar-07	11.00%	9.00%	L+200bps	50bps	150bps
31-May-06	7.70%	6.16%	L+154bps	60bps	94bps
31-May-05	5.90%	5.06%	L+84bps	70bps	14bps

As domestic liquidity tightened and the uncertainty over liquidity cycles increased due to flows/ Central bank actions, the liquidity risk premium has shot up sharply. It is also a reflection of the relative liquidity between the domestic and overseas markets.

An interesting feature of last year was single loan repacks. As bank loan rates shot up, corporate accessed mutual liquidity through the "Loan PTC route". This involves an intermediary bank/NBFC lending to the borrower and assigning the receivables to a trust which funds itself through PTCs issued to the mutual fund investors. Needless to state that since this is a structured paper, there is a premium pricing compared to a straight bond.

The mute question to ask in this case is why did issuers not tap the market directly at cheaper levels through the bond form given that they had a credit rating?

A possible explanation is that speed to market given the IM, listing processes was long and the "Loan to PTC" route cut short that timeline as well as the requirement to list. As several committees have recommended there is a clear need to relook at the listing process. Of course, now that PTCs are recognized as "security" and would need to be listed, it probably is time for the rulemakers to frame it with the right perspective.

Summing up our stock taking for the year, the efficacy of a capital market should usually be measured along three dimensions:

1. Cost of issuance- lowest expenses for issuance (low friction cost) as well as cheapest pricing for a given risk
2. Time to issue-ability to hit the market in the quickest time
3. Transparency- widest information dissemination especially on trades/ their pricing

Last year, the setting up of corporate bond trade reporting platforms has helped on the transparency front and hopefully the single name CDS market set to be introduced will help hedge/price credit risk reducing the 'uncertainty' premiums. But there is work needed to address the cost and time elements.

"…and everything under the sun is in tune
but the sun is eclipsed by the moon." (Eclipse, Pink Floyd)

To top it all there is an imperative need to unshackle the investors. Else it is like imagining the best football stadium and a great football final between Brazil and France but a match being played at 10:00 a.m. in the morning on a working day (Monday) with a restriction that nobody can bunk work to watch the game at the stadium. No fun with out the spectators and the conclusion cannot be that it was a bad game!

The frequent statements from the Government and the Central Bank indicate that they are seized of the importance of funding infrastructure/ capital expenditure to spur growth. So the ingredients are falling in place and may be the Sun is stepping out of the moon's shadows…..

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