Emergence of Indian Bond Markets – Cornerstone of FII Inflows

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The main source of capital for supporting Indian corporates' expansion plans has traditionally been the strong domestic bank loan market. A vibrant debt capital market is important from a macro-economic perspective, since it alone can provide access to larger and more diversified sources of financing - as well as liquidity and risk minimization for lenders. It is universally agreed that there is an urgent need for development of bond markets in India for raising long term funds, especially for the infrastructure sector. Bonds can also be used to raise money for sectors where banks have reached their risk limits/sectoral caps. An active bond market can help the banks to securitize their loans and down-sell them, thus allowing churning of portfolio and increasing efficiency of the banking system. Also, with the advent of Basel III, there is an urgent need to reduce pressure on the banking system as the main source of credit, as banks start facing increasing capital constraints.

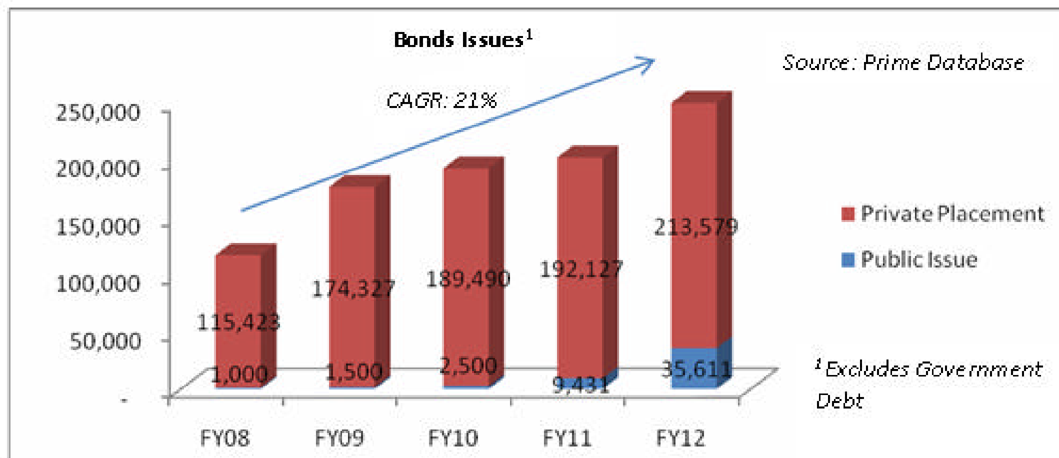
Over the last few years, equity capital markets have developed significantly in terms of liquidity, infrastructure and regulatory framework in India, whereas debt capital markets have lagged behind. Indian bond markets have traditionally been dominated by Government backed issues / issuers, with Government owned Insurance Companies and Banks acting as the major investors as well. While dominance of the traditional players in Indian bond markets is not expected to diminish anytime soon, there has been a consistent rise in issuances by private sector companies, while Foreign Institutional Investors have emerged as the new kids on the block.

Development of Indian Bond Markets

Bond markets in India have conventionally not been a major source of finance for Indian corporates. Save for a few triple AAA issuers (dominated by PSUs), Indian corporates have primarily used bank loans as the major source for debt financing. This is unlike markets in developed countries, where bonds are a major source of debt funding. As per data compiled by McKinsey Global Institute, in 2010 (calendar year end), the total bonds outstanding[1] globally stood at \$52 trillion, as against outstanding loans of \$64 trillion. The corresponding numbers for India stood at \$128bn of bonds outstanding, as against \$1,023bn of bank loans at the end of 2010, implying that bonds account for a mere ~10% of the total debt funding. In developed countries such as US and Western Europe, bonds accounted for 52%-55% of the total debt funding for the year 2010. Even in emerging markets like China, bonds accounted for 17% of aggregate debt funding in 2010.

However, the above numbers, while highlighting the opportunity for expansion of Indian bond markets, do not clearly bring out the growth experienced by Indian bond markets in the recent years. The total stock of outstanding bonds has grown from \$14bn in 2004 (calendar year end) to \$128bn in 2010, at a CAGR of 45% over the six-year period. In contrast, the global bond markets grew at a CAGR of 8% during the same period. It is thus evident that there has been a rapid and consistent increase in bond issuances[2] over the last few years.

As per Prime Database, the growth in issuances has been fuelled by the corporate sector (excluding FIs & Banks), whose fresh issuances increased from 19% in FY08 to an average of 29% of the total bonds issued over the last four years. The other major reason is the emergence of public bond market, which has exploded over the last five years, rising from less than 1% of the total bonds issued in FY08 to 14% in FY12. Tax free bond issuances - raising ~Rs. 28,000 Crs in FY12, acted as the major driver for public issue of bonds in FY12. With the Government targeting issuance of Rs. 60,000 Crs of tax free bonds in the current financial year, the importance of public bond market is expected to increase further in the coming years.

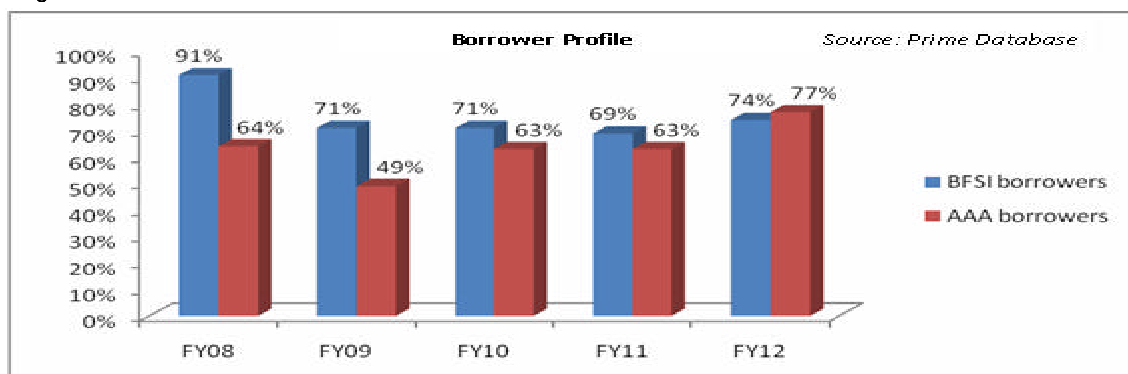


The recent introduction of Credit Default Swaps (CDS) by RBI augurs well for the development of Indian bond markets. CDS are instruments that provide buyers with protection against credit losses, just as insurance products do. CDS will lead to a gradual deepening of the corporate bond market, by enhancing the investors' appetite for lower rated issues, beyond the traditional favourites in the high-safety category. Increased use of CDS, over the medium term, has the potential to impart additional liquidity to Indian bond markets, which have generally been illiquid. The CDS mechanism will also help lower rated borrowers to diversify their funding sources by accessing bond market easily. CDS also holds the promise of providing the much-needed thrust to infrastructure financing, as RBI has allowed CDS for even unlisted bonds of infrastructure companies. A coordinated action by the other regulators can enable Insurance Companies, Pension Funds and Provident Funds to also participate in this space. However, the CDS market is yet to take off, with only a handful of CDS deals having taken place so far, primarily because of lack of participants and some inflexible regulations. For example, an investor using CDS can exit only by unwinding the contract with the original party. Also, if he sells the underlying bonds, he can transfer the CDS to the buyer of the bonds, only if the original protection seller agrees.

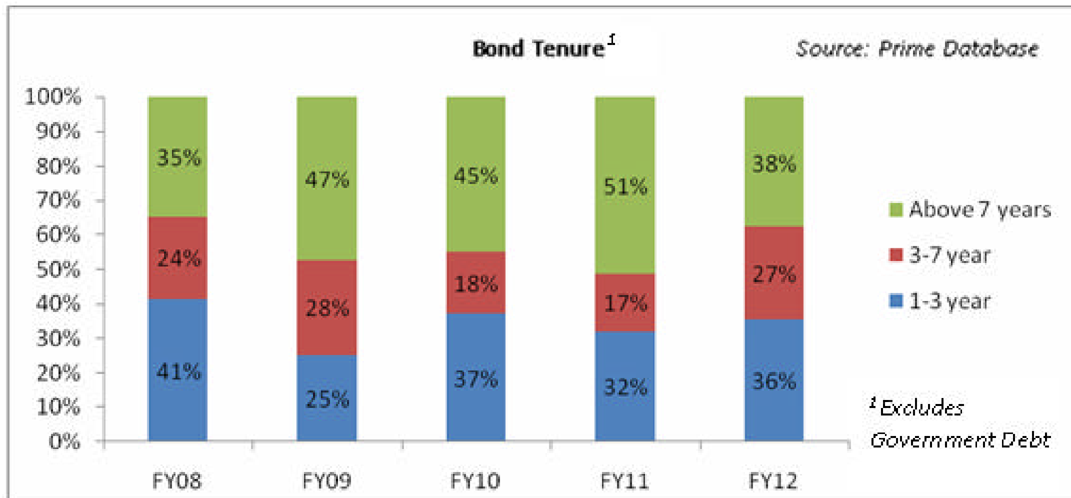
Bond markets still lack depth

Despite the impressive growth numbers, Indian bond markets still lack depth. This is primarily because of the limited investor base and tight regulations. In spite of the efforts made by RBI to develop the domestic bond markets, the investor base in rupee debt markets is still quite narrow - with banks and mutual funds dabbling only occasionally, depending on the liquidity conditions. Insurance Companies and Provident Funds / Pension Funds make up for the bulk of the investor base.

Also, Indian bond markets continue to be dominated by issuances by Banks and Financial Institutions[3], which account for more than 75% of the total bonds issued in the last five years, while AAA rated entities account for more than 63% of the total bonds issued in the last five years. There is still only limited acceptability of issuers with lower credit rating, which compels most of the corporate borrowers to rely on bank funding for their debt requirements. Another noteworthy feature is that borrowers with credit rating of less than AA can borrow funds at much cheaper rates from banks, as compared to the bond market. This can be attributed to the fact that many investors cannot invest in bonds below a particular rating, due to their internal guidelines or regulatory compulsions. For borrowers with rating of greater than AA, the converse is true, and they are able to access bond market easily - with a finer pricing.



Another aspect of the corporate bond market in India is the marked preference for shorter tenures. In FY12, a majority (62%) of bond issuances were for short and medium term (less than 7 years). In other words, Indian bond markets currently do not substitute the long term funding requirements (typically 10 years and more) of issuers. Further, a significant proportion (80% for FY12) of the long term issuances (greater than 7 years) is accounted for by AAA rated issuers. Thus, although long term bond issuances are also on the rise, most of the issuances continue to be for short and medium term.[4]

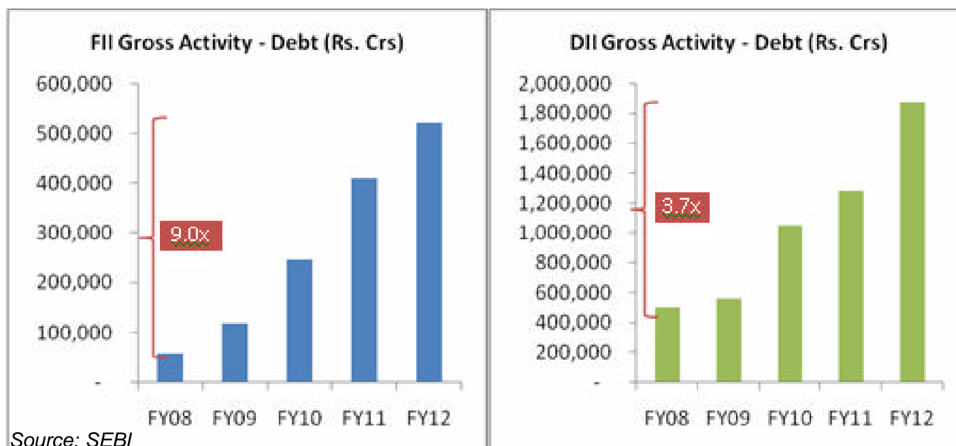


This is primarily because of regulatory factors and the norms for investments followed by major investors. IRDA does not allow Insurance Companies to invest in corporate bonds, which are rated below AA. Pension and Provident Funds have traditionally been investing in Government Securities on account of their preference for safety as well as a perceptible bias against private sector debt. Guidelines issued by the Central Board of Trustees to these funds for their investments are skewed in favour of Government Securities, Government guaranteed investments and PSU Bonds. Further, because of ALM issues, banks also generally look to invest in short to medium term paper. Moreover, RBI does not allow corporate bonds to be categorized in HTM category, because of which, banks have to mark to market their portfolio, whereas there is no such MTM requirement in case of loans, which encourages banks to opt for exposures through loan route. Co-operative Banks are permitted to invest upto 10% of their deposits in PSU Bonds and only Scheduled Co-Operative Banks are allowed to invest in Private Sector Bonds. Tackling the regulatory issues and changing the investor mind-set could help deepen the bond market significantly.

Rise of Institutional Activity

In the last few years, Indian bond markets have seen a consistent rise in institutional activity, with increasing participation from both Foreign Institutional Investors (FIIs) and Mutual Funds. The rising interest from institutional investors is driven by a plethora of factors - such as favourable Government regulations, availability of good quality paper and lack of opportunities in equity markets. Further, the rising volumes have created a positive feedback loop, which has attracted a greater number of institutional investors to the market, thus driving the volumes further.

The bond market activity (sales and purchases) of FIIs has increased multi-fold in the last five years, as tabulated hereunder:



Source: SEBI

The government has been increasing the corporate bond limits for FIIs over the past few years, while greatly liberalizing the guidelines for investments by FIIs in infrastructure bonds. In September 2011, the Government reduced the lock-in requirements and also relaxed the maturity norms for investment in long term infrastructure bonds by FIIs. It allowed FIIs to invest upto $5bn in such bonds, with freedom to sell these to domestic investors after a period of one year. This increased the attractiveness of such bonds, since under the previous rules, FIIs could invest in long-term infrastructure bonds subject to minimum residual maturity of five years and lock-in of three years. Further, with rising participation from FIIs, they will have greater flexibility to off-load their purchases amongst themselves even during the one-year internal lock-in period, thus improving the liquidity of their portfolio. The following table summarises the present FII limits and utilization in respect of investments in bonds:

<table>
<tr><th>No.</th><th>Type of Instrument</th><th>Upper Cap (in USD bn)</th><th>Utilization (%) - As on May 31, 2012</th></tr>
<tr><td>1</td><td>Government Debt - Old</td><td>10.0</td><td>90.4%</td></tr>
<tr><td>2</td><td>Government Debt - Long Term*</td><td>5.0</td><td>71.7%</td></tr>
<tr><td>3(a)</td><td>Corporate Debt - Old</td><td rowspan="2">20.0</td><td rowspan="2">85.9%</td></tr>
<tr><td>3(b)</td><td>Debt Oriented Mutual Funds</td></tr>
<tr><td>4(a)</td><td>QFI Investment in Debt (including Investment in IDF)</td><td>3.0</td><td>0.0%</td></tr>
<tr><td>4(b)</td><td>Corporate Debt Long Term Infra - One-year lock-in with one-year residual maturity by FIIs</td><td>5.0</td><td>63.0%</td></tr>
<tr><td>4(c)</td><td>Corporate Debt Long Term Infra - Three-year lock-in with three-year residual maturity by FIIs (including Investment in IDF)**</td><td>17.0</td><td>1.5%</td></tr>
<tr><td>5</td><td>Upper Tier II</td><td>1.0</td><td>0.0%</td></tr>
</table>

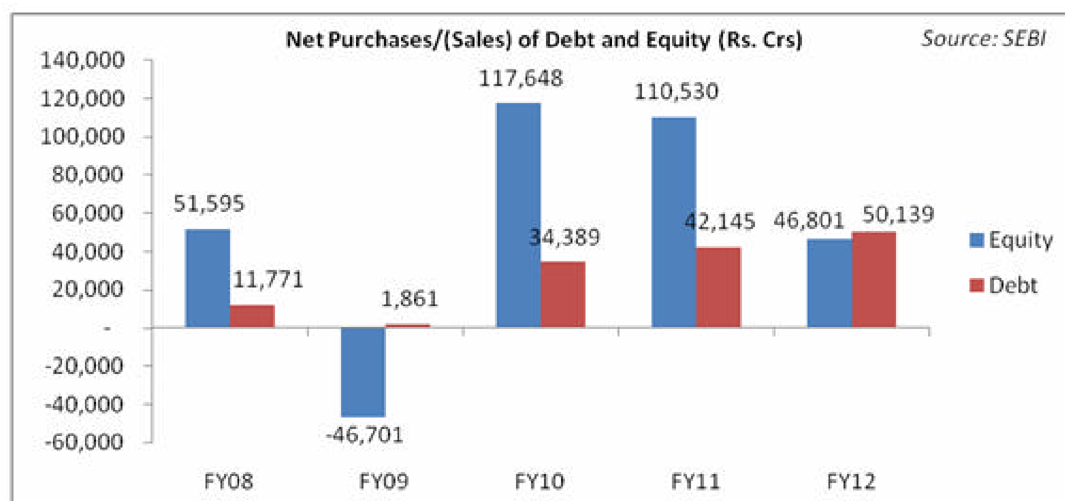
Source: SEBI, RBI

*Limit has been increased recently to USD10bn

**Lock-in has also since been reduced to 1 year

Cornerstone of FII Inflows

FIIs have been net investors in both debt and equity markets in India in the year 2011-12. However, the equity markets were boosted by flows of ~$9bn from foreign investors in the last quarter of FY12. In comparison, FIIs have been net purchasers of debt on a consistent basis throughout 2011-12. So much so, that for the first time in last five years, net FII inflows in debt exceeded the net inflows in equity during 2011-12. This trend has continued in the months of April and May 2012 as well. Net FII inflows in debt have gone up from less than 10% of the total FDI + Foreign Portfolio Investments (debt and equity) in FY08 to over 22% in FY12, thus underlining the importance of bond market in attracting FII money.



Indian bond markets will continue to be of great importance in attracting foreign capital, given the attractive returns and the continuing evolution of markets. Recognising this, along with the recent liberalization of limits and regulations for FII investments in bonds, the Government has also allowed Qualified Foreign Investors (QFI) to invest in corporate bonds. More capital flows in this market will increase the depth and drive the trading volumes and liquidity, thus attracting different categories of investors, which will, in turn, boost demand for instruments of varied tenures and credit ratings, thereby expanding the market's breadth as well as depth.

Some of the key issues that need to be addressed in order to ensure further development of Indian Bond Markets are as under. Addressing these issues, in part or full, will increase the appeal of corporate bonds for both foreign and domestic investors.

- Distribution Reforms: The current distribution system for public issues/private placements of bonds needs to be reformed in-order to ensure broader ownership and increased efficiencies. The current system, which promotes pass-backs from intermediaries to investors, leads to inefficient pricing in the bond market. While SEBI has curbed such practices in public issues of bonds, additional steps - such as introducing such curbs in the private placement market also, registration of all brokers, etc. need to be brought in.
- Regulatory Reforms: The private placements market, while under the aegis of the Ministry of Company Affairs, is currently loosely regulated. There needs to be a market regulator in place to ensure transparency in both primary and secondary market transactions in private placements, besides framing rules for intermediaries, which would benefit the bond market and boost investor interest.
- Trading Reforms: Private placement transactions are currently carried out in the OTC category, which is opaque in terms of pricing and information on buyers/sellers. Also, the counter-party risks have to be borne by the buyer/seller. Reliance on the OTC market needs to be reduced by listing and trading of all privately placed bonds on stock exchanges, which will ensure higher transparency, increased efficiency in price discovery and enhanced investor interest in the bond market.

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[1] Includes bonds issued by Corporates and Financial Institutions; excluding Government Debt

[2] Excludes securities issued for tenure of less than 365 days; Fall in issuances of papers of tenure of less than one year is because of tight liquidity conditions in the recent past, and the inverted yield curve, because of which short term money has not been attractive

[3] Excludes securities issued for tenure of less than 365 days

[4] Excludes securities issued for a tenure of less than 365 days and public issues of debt