Liquid Corporate Bond Markets are needed for Infrastructure Financing

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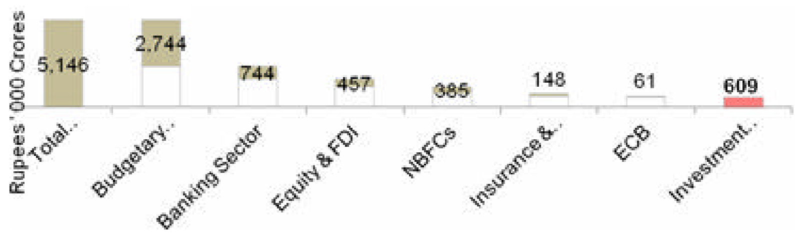
The Government estimates an investment need of over USD 1 trillion, i.e., Rs 60 trillion for the 12th Five Year Plan (FYP, 2013 – 2017).

Traditionally, the major sources of debt funding have been commercial bank loans, bonds of specialised non-banking financial companies (NBFCs) and external commercial borrowings (ECBs). Bank lending has been the largest contributor and accounts for 35-40% of the debt requirements, followed by NBFCs and ECBs, each accounting for a further 20-25%.



Source-RBI, Interim report of the High Level Committee (Planning commission)-Aug 2012

However, this financing pattern is unlikely to be sustainable given the quantum of investments envisaged. With an expected drop in the quantum of budgetary support, the share of the private sector in infrastructure investment is expected to further increase. Prudential caps on bank lending also limit bank lending to infrastructure, given the concentration of promoter groups in multiple sectors of infrastructure. This compels a rethink of the way infrastructure needs to be financed. A funding gap of Rs 7-9 trillion under different scenarios of financing is likely to emerge, according to estimates of the Sub-Group on Developing Capital Markets of the 2012 Committee on Infrastructure Financing. Although there have been concerns with the structure of some specific Public Private Partnership (PPP) contracts, such structures are expected to remain the dominant form of private sector participation in infrastructure project development.

There is a need therefore for (1) increased flow from existing sources, (2) supportive policy measures to develop nascent / low contribution segments such as insurance & pension funds and corporate bond markets and (3) channelling larger domestic household savings into the infrastructure segment.

1. Increasing funds flows to infrastructure sector from banks

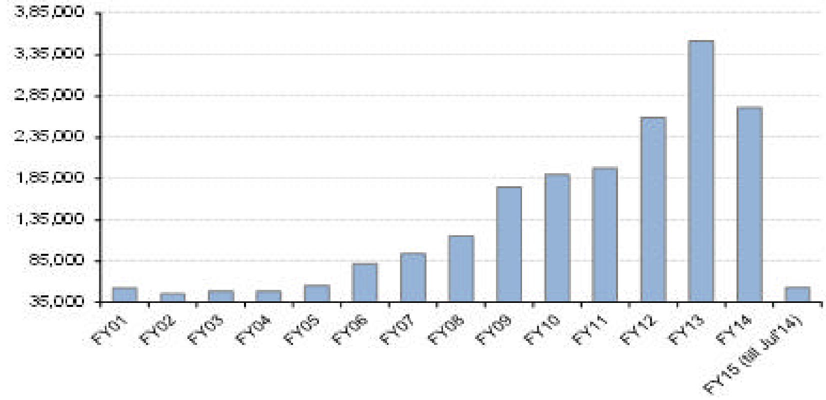
Banks would need to change their strategy by focusing on more short term loans to infrastructure where they provide "risk capital" during the construction period. Once the project is operational and there is visible cash flow of revenues linked to the project, the loan should be refinanced by an institutional investor with greater capacity to provide long tenure debt.

Institutions which are best suited to "take out" and refinance banks' project exposures are insurance and pension funds. However, investment guidelines for insurance and provident funds in India have remained quite restrictive, preventing them from taking exposures to infrastructure Special Purpose Vehicles (SPVs) which do not typically have the highest grade ratings. However, there has been a gradual easing in the investment norms of these institutions, which opens a window for them taking over some bank infrastructure exposures.

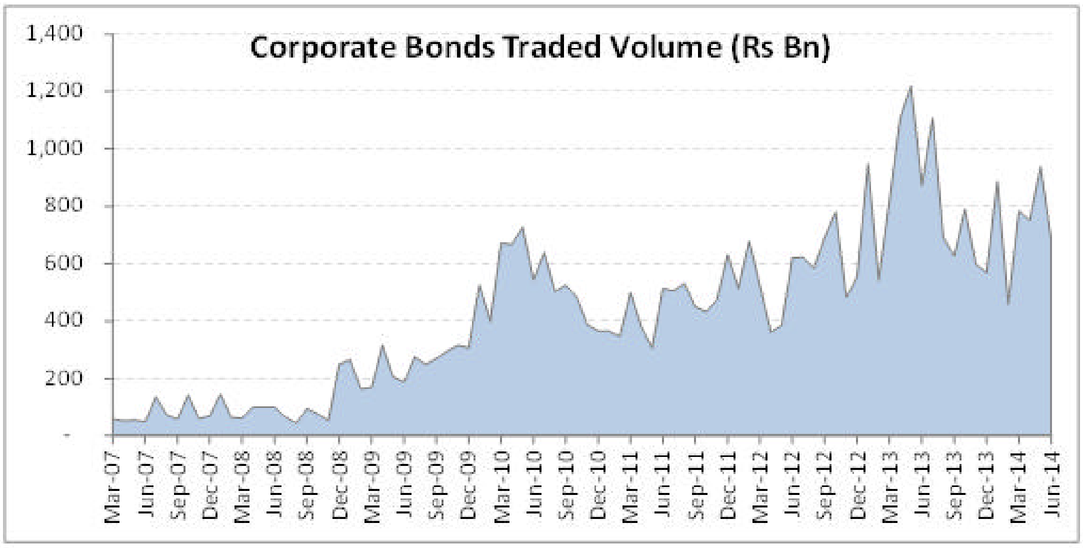
One solution to enabling these institutions to invest in long term project has been the use of credit enhancement mechanisms for lower rated debt issued by SPVs. RBI has been cautious in permitting banks to provide such enhancements, but is in the process of permitting partial credit and liquidity guarantees of bonds by banks. For provident, Gratuitiy, Pension Fund Trusts the investment guidelines may be modified and a separate category can be introduced to fund infrastructure debt & equity requirement. It should be modified from ownership based criteria (i.e., public or private sector) to end-use (e.g., infrastructure) or ratings-based criteria. This can be done through investment in units of Infrastructure Debt Fund or in equity/debt mutual fund schemes oriented towards Infrastructure sector.

2. Importance of developing bond markets

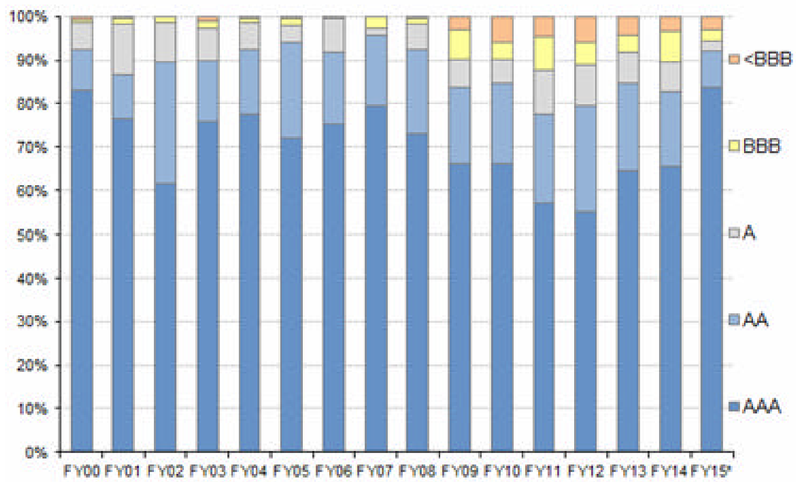
Bond markets have emerged as an important channel for both corporate and project finance. Internationally the corporate bond market is an important source of long term funding for corporates, including those engaged in infrastructure development. Corporate bond markets in India have become more active over the last decade. In particular, high grade securities segments have functioned reasonably well, and have been orderly. Primary issues have increased manifold and investors have absorbed.



Policy measures designed to facilitate issuance and trading have helped: market infrastructure for trading corporate bonds is largely in place, although secondary markets are currently dominated by the OTC segment. Reporting requirements for trades have also been increasingly improved. Although trading volumes are relatively small, they have increased (although some of this might be due to mandated reporting).



The increasing holdings of papers rated BBB and lower in the chart below (as well as anecdotal accounts) suggest that the high yield segments also have an increasing subscription, primarily from HNIs and entities seeking high yields. The challenge now lies in developing the intermediate segments.



This deepening has been due to initiatives taken by the Government and concerned regulators to develop the market. These include broadening of SARFAESI purview, reduction and rationalisation of withholding tax, progressive reduction in differential treatment of loans and bonds by banks, etc. RBI and SEBI have progressively introduced instruments for hedging market, liquidity and credit risk: Interest Rate Futures, repos in corporate bonds, Credit Default Swaps, etc. Secondary markets have also been deepened through reduction of trading lot size, cutting withholding tax for foreign investors from as high as 30% to 5%. However, market characteristics have inhibited the growth in use of these instruments. Permission for a wider set of investors and institutions – both domestic and foreign – might enable progressive use of these products.

For development of Municipal Bond Market, incentivise urban local bodies (ULBs) to access capital and financial markets for investment in municipal infrastructure through facilities like Pooled Finance Development Fund (PFDF). This will improve levy and collection of appropriate user charges, supporting tax regime, and the framework for security creation and enforcement.

Additional measures are needed to increase the pool of investors, primarily to incentivise trading and liquidity. For instance, insurance companies should be given some incentive to trade. Banks may be provided increased flexibility in using HTM portfolio (depending on end use of bonds, ie., if an investor proposes to hold an infra bond till maturity), in addition to current permission for infra bonds with maturity greater than 7 year. This has helped banks to manage P&L volatility in the corporate bond portfolio. However, if such bond investment is also made eligible for exemption from CRR, SLR & Priority Sector requirement this will provide more flexibility to holders of such bonds to promote structures like take out financing after COD & avoid problems of refinancing of loans by bonds in cost efficient & faster manner. Mutual Funds can be allowed to create products that can benefit from rising interest rates, unlike the current regulations where they can only benefit from falling rates, their valuation norms for such investments may be modified suitably.

3. Making Debt Markets More Liquid

There is a need to broaden investor participation, particularly retail and foreign investors. Overseas non-registered hedge funds can be allowed to invest in Indian corporate paper, without restrictions on the yields offered on such papers. Hedging longer tenor investments is another challenge as the longer tenor market instruments are not liquid. A committed line for infrastructure investments may be offered for hedging investments, even if not at concessional rate. A concessional window, similar to the FCNR swap, might also be considered, even if for a limited period.

Participation of retail investors in the corporate bond market is usually through mutual funds. However, during the past few years, some firms in the developed markets have begun issuing corporate bonds specifically for retail investors, in smaller lot sizes. One reason for this retail interest in corporate bonds is the search for yields, given the low interest rates prevailing in the post financial crisis, QE world. However, sustaining retail interest in corporate bonds will typically have three requirements, which is especially true for emerging markets: (i) post tax returns have to be higher than inflation (ii) secondary markets for trading these bonds have to be liquid and (iii) markets should be transparent.

The first requirement has been evident in retail investor response in India, over the past couple of years. There has been a sharp increase in issuance of tax free bonds in FY13 and FY14. Total tax free bond issues were Rs around Rs 57,000 crores in 2013 and 2014. Most of these issues had retail quotas of around 40% of the issue. In addition, High Networth Individuals (HNIs) had quotas of at least 10 -15% of the issue. Post tax rates for these issuances had been quite attractive, leading to oversubscriptions in the retail quotas for many of these issues. The recent initiative of the Govt and RBI to permit banks to issue long maturity bonds for infrastructure and affordable housing is one measure that has the potential to attract retail investment. However banks may be permitted to trade with retail investors in order to provide liquidity and develop the bonds market along with eligibility for exemption from CRR, SLR & Priority Sector requirement.

Second, markets have to be liquid for enabling exit with reasonable transaction costs. A diversity of views is a pre-requisite for market deepening and liquidity, which needs a wider class of investors, for which the presence of market makers is crucial. Broker dealers for instance, facilitate selling down of institutional issues to retail investors. Despite several initiatives in India over the past decade, market making has been difficult to implement. First, there is a lack of competitive and capitalised intermediaries as market makers. Banks and Financial Institutions dominate the markets as arrangers. However, since their main business is lending, their appetite for market risk is limited, compared to credit risk. To minimise underwriting risk, moreover, arrangers prefer highly rated corporate bonds, and markets for lower rated papers (eg., SMEs) have not developed.

In addition, process improvements also induce more liquidity by reducing transactions costs. Improved market infrastructure – for instance, seamless settlement procedures for clearing entities, integrated trading and settlement systems – results in better price discovery. Large numbers of outstanding papers / ISIN codes fragments trading. Larger size issues of single bonds and reissues will mitigate this going forward. Establishing principles similar to "reverse enquiry" issuance often followed in bank MTN issues might also infuse more liquidity.

Third, market making is key for infusing liquidity. Currently, banks are allowed to issue senior bonds in phased manner based on their underlying loan portfolio of infrastructure and affordable housing exposures. These senior bonds enjoy exemptions from CRR / SLR and their deployment from Priority Sector Lending (PSL) requirements. In order to incentivise the issuance of such bonds, the underlyings may be expanded from the loan book to also bonds issued by infrastructure companies or Infrastructure Finance Companies (IFCs) which are held in banks' books & add senior infrastructure bond issued by banks. To encourage retail investors to invest in these bonds, these issues may be brought under the purview of Sec 80C benefits within the overall exemption limits (along with the currently permitted instruments like insurance premia, provident funds, etc). This will also allow banks and IFCs to issue these bonds at competitive prices.

Banks might be incentivised to buy these bonds towards meeting their High Quality Liquid Assets (HQLA) for Basel 3 Liquidity Cover Ratios (LCR) requirements, of course with appropriate haircuts. Govt or RBI may allow banks to buy other banks' infrastructure bonds to create liquidity.

Fourth, measures for improving disclosure are expected to increase transparency and hence investor trust. Globally, regulators are trying to move secondary markets from OTC and bilateral to exchange traded transactions. In India, too, turnover on the Wholesale Debt Market (WDM) segment on exchanges has increased. However, the bulk of transactions remain bilateral.

4. Conclusions

This article discusses different options for deepening corporate debt markets in India, which will help channel larger funds into infrastructure. These include broadening the issuer base, diversification of investor classes, introduction of new channels, bringing in new structures through tax incentives, etc. While measures to develop debt markets have to continue, it is equally important to ensure that policy and regulatory environment are conducive for risk capital and equity to flow into the infrastructure sector. Over the past few years, hurdles in fuel linkages and environment clearances, *inter alia* have led to many projects getting stalled, delays in commissioning, loss of revenues and cash flows and consequent stress on loan repayment ability. The Govt has already taken many measures to improve the investment climate for lending to infrastructure and mitigate sector risks: Establishment of a Project Monitoring Group (PMG), facilitation of environment clearances, efforts to increase coal supply, price rationalisation, etc. Uncertainty on taxes is being sought to be gradually mitigated.These measures will expedite the flows of funds – both debt and equity – into infrastructure projects.