10 things needed to propel India's Corporate Bonds market

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Over the past decade, there have been concerted efforts by the government, regulators and other stakeholders to create a vibrant corporate bond market in India. These seem to be bearing fruit if growth in issuances and traded volumes in the last few years are anything to go by. However, in terms of penetration, the corporate bond market barely touches 14% of India's gross domestic product (GDP), way below the levels in developed countries – such as 80% of GDP in the US.

Going ahead, both the infrastructure and banking sectors will need major capital infusion. CRISIL estimates show the infrastructure sector will require close to Rs 26 trillion in the next 5 years, of which about Rs 7 trillion will have to be funded by the bond market. And the banking sector will need to raise Rs.3.4 trillion debt to meet non-equity capital requirements under Basel III regulations.

The total Rs 10.4 trillion of corporate bond issuances necessary for these two sectors is tantamount to an average issuance of Rs 2.1 trillion in each of the next five years – or nearly 60 per cent more than the annual issuances by these sectors in the last three years to March 31, 2013.

India's corporate bond market needs innovative and out-of-the-box initiatives if it has to enable money-raising of such gigantic magnitude. CRISIL believes the following steps will be necessary to bring the bond-financing ecosystem up to speed:

- **Uniformity and rationalisation of stamp duty across states**
  This is a reform long awaited by market participants since stamp duty adds significant cost to issue of debentures. As pointed out by Dr R H Patil Committee, two key issues with stamp duty have been:
  - The duty rates in India has been higher than other competitive markets
  - Rates vary across states in India

  There is a need to address both these issues effectively.

- **Greater transparency**
  An integrated platform hosting all necessary information related to issuance, terms and conditions, corporate actions, credit rating changes and others can be very helpful for all types of investors. This can help lessen information asymmetry and facilitate efficient price discovery. We understand NSDL and CDSL, under the directions of SEBI and with the cooperation of other stakeholders such as issuers, debenture trustees and rating agencies, are already working towards this. If anything, there is a need to expedite this and ensure that it continues to remain updated and relevant.

- **Set up robust, real time credit event reporting system**
  Today, there is limited information available on credit events related to bonds and bank loans. Credit events such as bankruptcy, default and restructuring help investors take timely action – hence the need for real time information about these events. A central agency can be mandated with the task of collating and displaying such information from banks and issuers/debenture trustees. The formation of Central Repository of Information on Large Credits (CRILC) by RBI is a significant step in this direction; in the long run, the platform can be made more comprehensive in terms coverage of entities, security types (bonds), data collection, frequency etc.

- **Parity between bank loans and corporate bonds**
  Today, bank regulations prescribe differential treatment for loans compared with bonds. Loans can be carried on the books of banks perpetually at acquisition costs, with impairment recognised only on a realised loss basis – that too with a considerable lag. Bonds, on the other hand, are always to be carried at fair value and, therefore, respond much more quickly to changes in expectations of credit losses.

  This treatment has encouraged banks to favour loans over investment in bonds despite the similar nature of the two assets.

The following measures can help address this issue:

- Allow banks to classify (and reclassify) bond and loan assets into held-to-maturity (HTM) or available-for-sale (AFS) buckets based on their declared intent rather than automatically, based on legal documentation.
- Develop standardised debenture trust deed (DTD) templates, which can be used by banks for loans as well. This will improve the tradability of loans (and their fungibility with bonds). However, if discretion is permitted (as mentioned above) on HTM/ AFS classification, it would improve the liquidity and risk characteristics of overall bank balance sheets while removing the bias in favour of one form of documentation (loan) merely to avoid marking the asset to market. This would also allow banks to emerge as key market-makers in the bond market, ensuring the price arbitrage between loans and bonds is eliminated and liquidity is boosted.

- **Creating a wider institutional investor base**

  Increasing the scope of engagement of retirement funds and insurance companies can help widen the institutional investor base.

  - *Retirement funds:* There is a need to channel large long-term savings managed by retirement fund organisations such as the Employees' Provident Fund Organisation (EPFO) to corporate and infrastructure bond markets. Out of EPFO's total corpus of about Rs 4.73 trillion as on March 31, 2013, only 31.81% was invested in corporate bonds. *(Current EPFO guidelines permit 55% of incremental receipts each year to be invested in corporate bonds, of which only 10% is allocated for private corporate bonds.)* The rest was invested in lower-earning fixed-income assets such as government securities, state development loans and special deposit schemes. Higher allocation to corporate bonds could help boost yields on retirement funds of a large chunk of the employed workforce.
  - *Insurance firms:* Less than 40% of the total debt assets (about Rs 12.76 trillion as on March 31, 2013) of insurance firms was invested in bonds and the rest in low-yielding sovereign instruments. Recently, the Insurance Regulatory and Development Authority (IRDA) has permitted insurance companies to invest up to 5% and 8% of their corpus of life and general insurance, respectively, in debt securities rated 'A' and below. There is, however, a need to permit higher allocation to corporate bonds as an asset class, currently restricted to 50% of the total investment.

- **Tapping retail investors**

  As per the Reserve Bank of India's (RBI's) Annual Report for 2011-12, household savings in financial assets (retail investments) during the year were about Rs 7 trillion. Most of these were in debt-oriented assets, with 53% invested in bank deposits (which offer lower returns). Considering the large size of household financial savings, retail investment needs to be directed to corporate bond markets for achieving higher yields. The following steps can help:

  - *Tax incentives:* Based on the experience in 2011-12, where public issuances of corporate bonds surged to Rs 350 billion, providing tax sops is one of the most effective tools to attract retail investment. And in the year 2013-14 the public issuances touched Rs 423 billion, most of these issuances were of tax-free securities. *Parity in tax treatment*: Today, there is a disparity in the tax rates on debt and equity mutual fund products, which is unfavourable to debt schemes (Table 1). According to CRISIL, debt products should get the same tax treatment as equity products currently do.

Table 1 -Tax rates for mutual funds — capital gains and dividend distribution

Product	Short-term capital gains tax@	Long-term capital gains tax@	Dividend distribution tax*
Equity-oriented funds**	15.450% (15% +3% cess)	Nil	Nil
Debt-oriented funds	As per income tax bracket of the investor	10.30% without indexation; 20.60% with indexation	28.325% (25%+10% Surcharge+3% Cess)
Money market & liquid schemes	As per the income tax bracket of the investor	10.30% without indexation; 20.60% with indexation	28.325% (25%+10% Surcharge+3% Cess)

- *Tax rates applicable for financial year 2013-14*
- *@ Surcharge of 10% is levied in the case of individual/ HUF unit holders whose income exceeds Rs 1 crore*
- **Deducted at source – payable by the scheme*
- *** Securities transaction tax (STT) is deducted on equity funds at the time of redemption or switch to other schemes*

- *Financial planning*: New products such as target maturity funds and life cycle funds are effective tools for financial planning. Corporate bonds can deliver higher yields and ultimately help meet investor requirements. Such products should be encouraged by creating an awareness and regulatory framework (covering product construction, disclosures and distribution) for such products.

- Retail investor savings can also be mobilised through innovative products:
- *Products linked to corporate bond indices:* These indices can be housed in either mutual funds or special purpose vehicles or alternative investment funds that have a tax pass-through status. The indices, for instance, can comprise the top 30 most liquid investment grade corporate bonds in the sector. Rating band-based corporate bond indices can also be launched. Such debt investment products will give investors an opportunity to take exposure to the overall liquid corporate debt market. In the medium term, this will also contribute to the creation of a credit spread curve for the Indian debt capital market.
- Ultra-long maturity fixed maturity bonds/instruments: Products such as the 25-year deep-discount-bonds which had proved popular in the past can be introduced again. Target maturity products/funds and life cycle funds can be built by focussing on financial planning needs of retail investors. For such products, corporate bond is a favourable investment option. To avoid misspelling, such products must be created through a necessary regulatory framework (covering product construction, disclosures and distribution). Mutual funds and pension/retirement funds can play a key role in the success of such products.
- An effective investor education programme can play a key role in creating awareness and interest in corporate bonds among retail investors. Such qualitative initiatives can pay off over a longer time frame.

- **Encourage higher FII participation**
  In order to ensure the recent momentum in FII investments in the debt market continues, the government could consider the following measures:
  - Extending innovative means, such as FCNR swap deal offered by RBI in 2013, to FIIs to hedge foreign exchange risk
  - Enhancing investment limits
  - Ensuring Indian debt securities form a part of global investment indices

- **Encouragement for the securitisation market**
  Introduction of dividend distribution tax on PTCs in the budget of 2013 has made it costlier for banks to invest in securitisation through the PTC route. This amendment has had an unintentional and significantly negative implication, because of which taxable investors and financial intermediaries such as banks have been effectively barred from participating in securitisations. Removal of tax burden on such transactions will help to revive this important market, and create both liquidity as well as risk management capability for originators.

- **Vibrant secondary market through market making mechanism**
  Illiquidity of corporate bonds poses a concern for issuers as well as investors from competitive pricing and exit points of view, respectively. At present, liquidity is driven by factors such as ownership (largely public sector units), frequency of issuance (most frequent issuers), and rating (largely 'AAA' rated). Out of a total of about 13,000 bonds outstanding as on March 31, 2014, only around 100 bonds were traded on a frequent basis. To overcome this, there is a need for a market-making mechanism as it provides both a psychological support and exit options to investors. Investment banks, primary dealers and similar players could play the role of market-makers, and stock exchanges can facilitate infrastructure for such a mechanism.

- **Independent security level valuations**
  In an illiquid market, valuation of bonds is often carried out by asset managers themselves, which leads to a conflict of interest. Standard and independent valuation practices can bring greater confidence among investors by avoiding such situations.