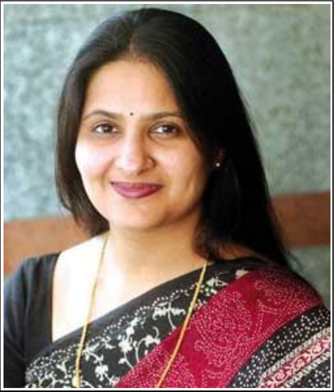
Time for swift structural solutions

Policy makers and participants will have to facilitate a viable corporate bond market in double-quick time because India badly needs the wherewithal to finance the next leg of its economic growth



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If the last two decades in India's financial markets was about how corporates tapped surging equity markets and bank credit to grow, the coming decades will require the services of another key pillar — a deep and well-functioning corporate bond market.

CRISIL estimates show that just to build out infrastructure India needs Rs 30 lakh crore till 2019, while banks require another Rs 5 lakh crore to meet capital norms under Basel III regulations. Clearly, both the equity market and banks do not have the ability to come up with such gargantuan amounts of money.

The corporate bond market will have to stand up and be counted. But today, the market is structurally illiquid causing concern for both participants and policy makers. Not surprisingly, investors have shied away. We believe innovations and efforts to improve secondary market volumes are a *sine qua non* if India has to have a deep and vibrant bond market.

Here's another pertinent perspective: in both absolute and relative terms, India's corporate bond market is small with bonds outstanding totting up to $280 billion *(Table 1)*. That number is seven times bigger in China at $1.91 trillion, and a whopping 75 times more in the US at $20.88 trillion. Japan's is about two-and-a half-times bigger at $675 billion. As a percentage of GDP, though, India fares well compared with China, but not so versus the US, Japan and Singapore. So the refrain on the street is that this existing stock of outstanding corporate bonds is just not enough to create a deep and liquid secondary market.

On its part, the Securities and Exchange Board of India (SEBI) has moved proactively to change and contemporise the rules of the game, spawning transparency that affords greater access to corporate bond market transaction data, among others, than ever before.

To be sure, there are many problems keeping the market away from the much-needed structural deepening, but then I believe there are solutions available with us, too, if we care to look:

Fragmentation of issuances: This is the primary cause of illiquidity, and happens because issuers float several bonds that mature in the same year. Issue sizes are based on fund requirement at the point of flotation, while coupons are based on market conditions. The upshot is that there are several small issuances with varying coupon rates. Consequently, investors are unable to buy large quantities of the same bond. This problem can be addressed by marking reissuances of the same security (same ISIN) for a particular year. The exercise can be based on price instead of coupon or yield, which is the process followed when reissuing government securities. Issuers can also, after legal compliance, buy back bonds, bunch and reissue a single security maturing in the same year as the original issuances. However, the flipside to this is the clustering of coupon and principal payments on one date. In January 2015, the SEBI board had approved a provision to enable consolidation and reissue of such bonds, but the response from issuers has been lukewarm. I believe the time has come to sort out this challenge. Apart from policy makers, investors also need to persuade issuers to reduce fragmentation and improve liquidity.

Lower participation of banks: Banks are one of the largest and most active participants in the government securities market, but they play a limited role in corporate bonds. This must change and one effective way to draw more banks in is by removing the loan to bond arbitrage. At present, banking regulations allow loans to be carried on the books of banks at acquisition cost and losses on a realised-loss basis and that, too, with a considerable lag. Bonds, on the other hand, need to be marked to market so respond faster to changes in expectations of credit losses or interest rates. This encourages banks to rather offer loans than invest in bonds of the borrower.

Lack of market making: A robust market-making mechanism can help buyers and sellers of corporate bonds find liquidity by providing two-way quotes. I believe specialised agencies can play a seminal role in facilitating this.

Lower FII participation: Participation by foreign investors can be increased by creating a mechanism to help them manage their currency risk at minimal cost, encouraging greater access to the domestic derivatives market, and facilitating the use of bonds as collateral. The inclusion of Indian bonds in global bond indices can also increase foreign investments in Indian debt.

A scalable exchange-based trade platform: Exchange-based bond trading has not picked up in India for various reasons, such as:

- There is no system in place to address counterparty risk in transactions.
- Current trading screens can't display a large number of outstanding bonds in a user-friendly manner. This is partly a technical problem and partly a legacy issue of fragmentation discussed earlier. It's imperative that we raise the game on user-friendliness.
- There is scope for enhancing transparency on the exchanges through time stamping of trades, reporting of accurate yields, user-friendly dissemination of terms and conditions, and transaction-wise trade data. This can facilitate easy retrieval of data for analysis by users.

Limited primary market: Limited penetration of the primary market shackles the secondary market, too. The primary market is driven by demand from major investors and suffers from drawbacks such as few issuers, concentration of top rating categories, varied conventions (day count, payment for holidays, etc) and fragmentation. All of them impact liquidity directly or indirectly.

Few takers for related instruments: There have been few takers for bond repos, interest rate futures, and credit default swaps that were introduced in the recent past. The reason for this is the limited growth of the underlying market itself. And because of steep haircuts (7.5% for AAA rated securities) bond repos are less appealing so participants continue to choose the collateralised borrowing and lending obligation – or CBLO – facility for short-term borrowings.

Low retail participation: Despite India's high savings rate as a proportion of GDP, retails investors prefer fixed deposits over bonds because of lower awareness about the latter security. Their indirect exposure to bonds through mutual funds and other pooled investment products is also far lower compared with equity. This can be addressed by:

Creating products that invest in bonds with defined maturity and returns so as to meet the financial planning needs of the retail investor.

- Spreading awareness about bond and bond funds/products to help investors understand its utility and risks.

Absence of a liquid yield curve: Even though bonds are available across tenures and rating categories, major trading is limited to top rated securities of 3-, 5- and 10-year tenures.

To sum up, India's corporate bond market remains in the vice-grip of low demand and supply and therefore quite under-developed compared with global peers. Non-conducive regulatory provisions that encourage borrowings through banks than bonds, poor price discovery mechanisms and tepid demand discourage the issuers, too. And fewer outstanding bonds lead to illiquidity and poor price discovery, futher discouraging investors who are not of the held-to-maturity kind. This leaves them unsure whether price discovery will be fair, or if they will be able to liquidate when needed.

But all is not dark and gloomy. One of the recent positive events has been the notification by the Ministry of Labour and Employment permitting the Employees' Provident Fund Organisation and exempted trusts to trade and hedge their investment below AA rating by using credit default swaps. This could have a positive impact including on liquidity.

I believe policy makers and participants have to be in a continuous huddle, as it were, to identify issues affecting efficiency in the secondary market, and address these.

To ensure a better future, to fulfil the government's social contract, unprecedented acts of nation-building, essentially involving infrastructure and ecosystems, are imperatives in the medium to long term. That, in turn, will require exceptional wherewithal. I believe given the limitations of the banking sector and the equity market, the criticality of a well-developed and deep corporate bond market to India's tomorrow cannot be overstated.

HOW GLOBAL DEBT MARKETS STACK UP

	Outstanding ($ billion)		Daily trading volume ($ billion)		Trading ratio*		GDP penetration**	
	G-Secs	Corp bonds	G-Secs	Corp bonds	G-Secs	Corp bonds	G-Secs	Corp bonds
US	12630.2	20884.5	524.5	226.2	4.15%	1.08%	72.51%	119.90%
China	3370.2	1909.2	16.43	5.09	0.49%	0.27%	32.43%	18.37%
Japan	8330.8	675.28	184.60	0.94	2.22%	0.14%	204.28%	16.56%
Hong Kong	110.6	88.7	1.82	0.17	1.64%	0.20%	37.40%	30.02%
Singapore	139.9	93.1	0.61	N.A.	0.44%	NA	48.95%	32.55%
Malaysia	165.26	124.6	1.29	0.13	0.78%	0.11%	54.76%	41.27%
India	665.1	279.6	5.81	0.7	0.87%	0.25%	32.45%	13.64%

** Average daily trading volume in the 12 months ended March 31, 2015 /Outstanding as on March 31, 2015 **Outstanding as on March 31, 2015/GDP Source: Asian Development Bank (Website : http://asianbondsonline.adb.org/ SEBI (Website: www.sebi.gov.in), International Monetary Fund (Website: www.imf.org)*