Creating Fresh Paradigms in the Indian Corporate Debt Market: Perspectives and Challenges

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A global perspective of bond market

Size of the corporate bond market underscores the level of industrialisation that an economy has undergone. Not surprising then that despite the best of efforts, Indian corporate bond market remains a shallow spot in an otherwise well-developed financial market.

Between 2010 and 2015, the market penetration of the debt amount outstanding as percentage of GDP increased from 10.31% to 16.74%. But the sobering fact was that elsewhere the market had literally exploded.

The corporate bond market in the emerging economies tripled in 10 ten years to 6.9 US$ trillion from US$ 1.9 trillion in 2005. Not just that, the global debt in 2014 stood at US$ 199 trillion (as per Mckinsey).

In comparison the gross domestic debt market itself is rather small. At 17% of GDP, Indian domestic debt market is nascent when compared to US which has 123% of debt to GDP or even S Korea which is at 77% of debt to GDP. In fact, we fare poorly even when compared to relative peers such as Malaysia, Thailand and China.

The reason for this weak and nascent development of the bond market has to do with following issues. One is lack of investor appetite and trading for corporate bonds; another is the overwhelming size of the bank credit book that shadows the bond market and the third is the absence of enabling infrastructure that facilitates relatively easy participation and settlement of broad segment of trades – something that is lucrative enough to develop a bond trading community.

Institutionalised Investment in Corporate Bonds in FY15

Institutions	Corporate Bonds (Rs.Crs)	Total Investment (Rs.Cr)	% Investments in corporate bonds
EPFO	182,128	636,039	28.63%
Corporates	137,708	1,032,299	13.34%
Banks	267,765	2,983,576	8.97%
FPI	181,781	2,320,539	7.83%
MFs	250,054	1,194,744	20.93%
Insurers	420,349	2,344,228	17.93%
Total	**1,439,785**	**10,511,425**	**13.70%**

Source: CRISIL Year Book

Take the case of the bank credit book on standalone basis. Bank credit at around Rs 72 lakh crore overbears on around Rs 17 lakh crore of outstanding corporate bond book. The financial mobilisation and retail participation in the banking sector elbows out any commercial borrowing possibility at reasonable cost from exhausted retailers. To increase investor demand for corporate bond fund a level playing field and ease of investibility would have to be ensured.

And Prima facie it is not difficult.

India has a gross savings rate of 33% of GDP which is already one of the highest in the world. Around 40% of these savings are financial savings, of which 47%, or almost half account for fixed deposits. So it isn't that fixed income is not palatable to Indian investors. The lack of appeal of corporate bonds has to do with surface penetration and little awareness about the product viability. This scant penetration in itself is an outcome of poor development of mutual funds, insurers and pension funds in the country. It is the trio of these three segments that channelize and increase proxy participation for the retail investor in the corporate bonds. Thus, in absence of deep development of mutual fund and associated asset management market, the corporate bond market is deprived of one key market maker and market mobiliser. The importance of the trio can be highlighted from the fact that even in developed markets such as US, nearly 70% of the corporate bond issuances is consumed by MFs, insurers, and pension funds.

Ways and Means to Develop the Corporate Bond Market

The abysmal base of corporate bond fund volume is infact indicative that therein lies a huge potential to expand the market volume and the value outstanding.

To achieve this, the primary requirement shall be to instill investor awareness. Other than that, the market regulator and participants both would need to build a network and a medium through which benefits and risks associated with investment in debt through direct or indirect channels are communicated. To generate acceptability for corporate bond should not be an insurmountable challenge for its proponents. Indian investors show higher inclination for debt products. The debt products are also easier to explain that other asset classes. Other than cases such as mutual fund, the coupon on debt assets can be stated upfront to the investor. So acceptability potentially can be higher.

It is also important that simple and timely communication to investors be devised that advises on the suitability of the products, impact of the risks associated, return expectation etc. This would help the investor relate better with the products. It is equally important to develop new products that are likely to meet varied investor needs such as investor horizon and assured returns. Products that incorporate features of structured products while keeping the messaging simple for investors might have great appeal for investors.

For example, fixed income ETFs can bring in convenience, liquidity, low cost for the retail investor. In fact,Fixed income ETFs are very popular globally. The US has seen a CAGR of around 20% in last 10 years in Fixed income ETFs.

Taxation is another element that acts as an influencer for investment decision. Compared with equity, debt mutual funds are less tax efficient currently. Tax incentivisation could act as a medium to develop the bond market. In fact, a 401K kind of sop may enable growth of pension industry within the mutual fund ambit - and as well as increase the overall outstanding and trading volume of the corporate bond market.

It is also vital that organised job market must expand. Their expansion will lead to growth and mobilisation of corpus under EPFO and NPS. Additionally, mandatory contributions by way of pension could be considered. This too would go a long way in enabling a more robust bond market. But the task is not easy.

Lesson From History of the Indian Sovereign Market

In our opinion, the initiative and the process that the regulator went through to create a robust gilt market has all the precursor and learning that needs to be applied for creating a functional corporate bond market.

The history of corporate bond market in India relatively short We will have to assess the brief history of Debt markets and trading as market used to exist. In order to get a better understanding of the market we will have to analyse the history. In late 1990 and early 2000 when the Government Fiscal deficit started expanding, the RBI and the central government realised the need for deepening the Gilt market and hence formulated concept of Primary Dealer(PD) whose job was to subscribe to Government bonds and T Bills and make market and create liquidity. This initiative energised the market and stimulated trading in the gilt segment. But the absence of trading alone were challenges facing the regulators. The main issue was settlement as it was in physical form and main source of risk. There were some issues too, however it was not very meaningful and were contained in time and RBI decided to get Government securities De-Materialised (demat). The move was timely since the overall size was not big and activity was also not that high.

Post the Demat era, the activity in Gilt caught up significantly and the settlement challenges were removed. The RBI moved ahead with the decision of creating Clearing Corporation of India Ltd (CCIL) in 2001 and Negotiated Dealing System – Order Matching (NDS OM)by 2005. The CCIL was incorporated to guarantee the settlement and the NDS OM was created to act as an electronic platform similar to what is observed in the BSE and the NSE for equities. This transformed the telephone based opaque market to a more transparent market and created a more effective platform for trading . The market took off in the year 2000-2001. At that time, the total Government gross borrowing was around Rs 1,30,000 crore and the daily average market volumes used to be around Rs 5,000-10,000 crore in FY 2002-2003.

Thus, it can be inferred that the first step towards developing corporate bond market is to have an efficient gilt market, gitls tend to act as a benchmark for corporate bond pricing. We now have a gilt market which has all qualities of a developed market.

So the question to ask is where we are in terms of the corporate bond market? Analysing the same in detail, we realise that trading volumes in corporate bond is negligible. There are primarily following reasons in our understanding

- Firstly, Gilts have a transparent trading platform and settlement guarantee and DVP 3 (delivery Vs Payment on net basis) while the corporate bond market has none.
- Secondly, there is absence of standard conventions for Interest payment. That is, how may one compute the broken period interest if the bond is to be traded in secondary market. (some use Actual by actual some use Actual by 365 and some say its actual by 360 while the same Government bonds is 30/360).
- Third, Gilts have 1 day shut period for Interest payment and redemption, whereas corporate bond market has it ranging from 7-30 days and it’s quite difficult to ascertain the same.

- Lastly, all Gilt are semi-annual interest payment, whereas corporate bonds have various structures such as monthly, quarterly, annual or zero coupon. So a standardised payment structure could be useful.

In summation, there have been remarkable developments in terms of initiatives being taken towards developing the bond market. But currently, the initiative is limited largely towards giving regulatory approvals. Further deepening of Credit Default Swaps (CDS) market also would

Conclusion

Indian corporate bond market has a long way to go before it becomes meaningfully comparable to gilt as also in the global landscape. The market in itself is nascent and barely comparable to equivalent industry in other geographies.It requires innovative products, standardisation, regulatory assistance and trade facilitation. More importantly, an intermediary distribution channel would also need to be established that acts as the market marker and market mover for the corporate bond market to be more successful.