Role of Mutual Funds in Corporate Bonds Market

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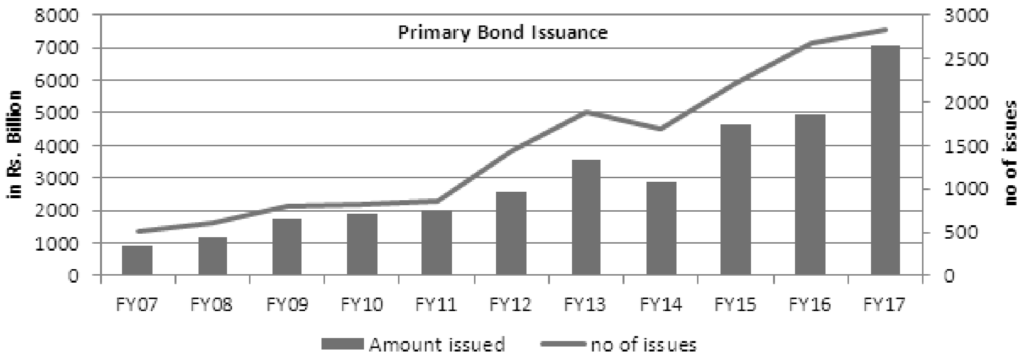
A well-developed corporate bond market is essential for the efficiency and stability of a country's financial system and the overall growth of its economy. An active corporate bond markets is pivotal in supporting the diverse financing requirements of the growing economy, especially for emerging businesses and infrastructure projects. Corporate bond borrowing leads to diversification of funding sources for issuers, provide true reflection of credit quality for market & can lead to more efficient capital allocation.

A strong corporate bond market also provides institutional investors such as insurance companies and pension funds with quality long term financial assets, helping them in matching their assets and liabilities.

The experience of advance economies who have much deeper bond markets suggests that local bond issuance does not share the strongly pro-cyclical behaviour of bank lending which typically shrinks during recessions (http://www.nber.org/papers/w17392.pdf). In fact, Alan Greenspan (1999) called for development of bond market as an effort to develop "***spare tires***" that borrowers can rely on when bank balance sheets are strained.

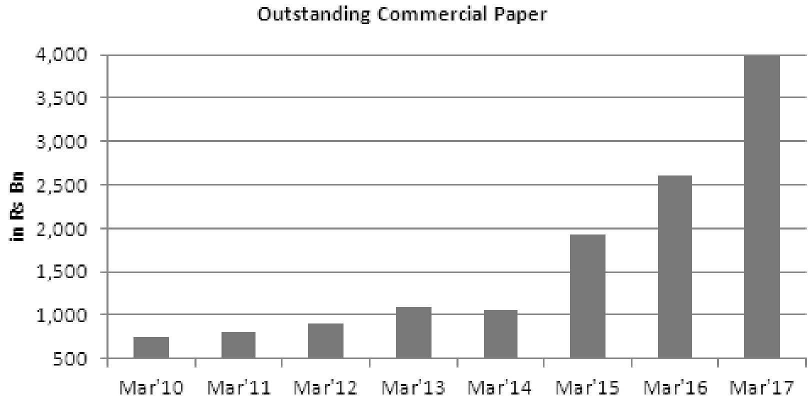
Indian Corporate Bond Market

The Indian corporate bond primary market has been a private placement market so far with most of the corporate bond issues being privately placed among the wholesale investors i.e. the Banks, insurance firms, pension funds, FPIs, NBFCs, Mutual Funds & Large Corporates. Around 94% of the total funds mobilized through corporate bonds in FY17 (till Jan'17) was through the private placement route (Source: SEBI). Secondary market trades are in the nature of a negotiated deal market where most of the deals take place through telephones and are reported to the Exchange for confirmation.



Source: Prime Database

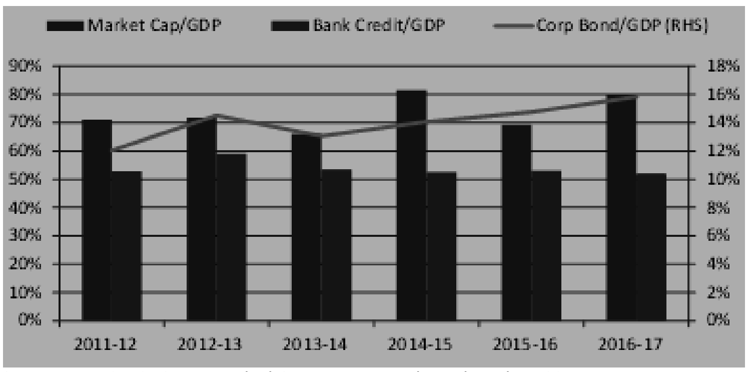
In the last 10 years, corporate bond issuance has seen a very healthy growth of 22% CAGR, much stronger than the 13% growth seen in bank credit (Source: RBI) with strong growth also seen in number of issues reflecting an important step in financial disintermediation bringing the borrower and the investor in touch with each other.



Source: CEIC

A significant part of the corporate bond market is the commercial paper market which meets the working capital & short term funding requirements from corporate. The commercial paper market has shown a healthy growth of 23% in the last 7 years to Rs. 3,979 billion as on Mar-17, a significant jump from its humble beginnings of Rs. 5.8 billion in 1993, due to its cost effectiveness & increasing demand from mutual funds.

While we have developed a world-class equities market from relatively unpromising beginnings with systems, disclosure standards & liquidity at par with global standards, a lot more needs to be done to further develop the bond markets. Since FY97 equity & bank credit markets have seen strong growth with Equity Market Cap/GDP reaching 80% at FY17 from just 32.7% & Bank Credit at 52% from 20%, corporate bond market has just reached 16% of GDP from single digits reflecting poor credit infrastructure & urgent regulatory need for creating enabling conditions for increased participation from market participants.



Source: RBI, CEIC, GDP: Nominal GDP at current prices, data since 2011 (at new base year), Market Cap: BSE Market Cap

	Corporate bonds as % of GDP	Equity as % of GDP
Germany	109.4%	59.6%
South Korea	74.4%	89.6%
Malaysia	43.4%	119.1%
Singapore	34.2%	157.0%
China	20.1%	58.4%
Brazil	17.5%	39.2%
India	16.0%	80.0%
Russia	13.5%	42.6%

Source: Bloomberg, ADB, GDP taken as on Dec'16 for other than India

A cross country comparison also reveals that while India compares favourably with global peers in equities, there is considerable scope to widen the corporate bond market.

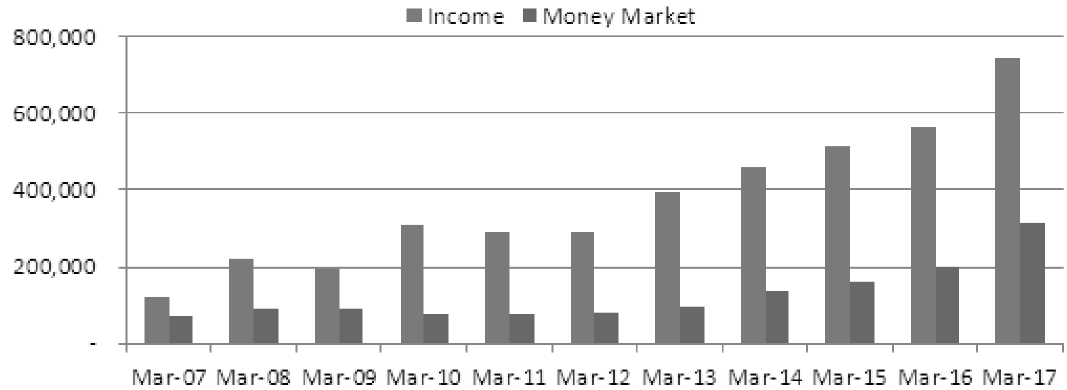
While both SEBI & RBI have initiated lot of steps over the recent period like capping bank exposure limits to large borrowers, opening up of Masala bond market, giving direct access to FPIs & increase of partial credit enhancement, more measures are needed to deepen the market. This can be achieved through better data transparency from bond issuers & rating agencies, guaranteed settlement mechanisms like DVP-3 (settlements are done on Delivery versus Payment after achieving multilateral netting), take-off in corporate bond repo through clearing system like CROMS & better CDS hedging regulations. Moreover, a market in distressed bonds backed by execution of strong bankruptcy laws will help create interest not only in top rated but weaker borrowers as well.

Mutual Fund Industry Overview

The first non-UTI, public sector mutual funds were set up by public sector banks with establishment of SBI & Can Bank Mutual Fund in 1987. However, 1993 started the onset of a true growth period for mutual fund industry in which the first Mutual Fund Regulations came into being, under which all mutual funds, except UTI were to be registered and governed. The emergence of an industry with uniform structure, operations and regulations made it easier for investors and distributors to deal with fund houses & helped garner wide number of investors and assets under management.

Mutual funds today have emerged as a tool that allows all types of investors, irrespective of size and return horizon to participate in markets & earn reasonable tax efficient returns on their savings. This has helped the industry past the Rs 19 trillion mark, marking an impressive 18% compound annual growth since 2000 (Source: CRISIL). However, despite the growth in assets, India accounts for less than 1% of the global mutual fund industry. Also, mutual fund penetration, as measured by AUM to GDP ratio, is at a modest 10% compared to the global average of 54% (Source: CRISIL).

The Indian mutual fund industry remains tilted towards debt-oriented mutual funds (including liquid funds), accounting for over 61% of the total assets as of March 2017 (Source: CRISIL) due to heavy institutional investor bias although retail category is also growing on increasing investor awareness that fixed income funds can offer a stable alternate to equity & better performance than the traditional fixed instruments such as Fixed deposits.



Source: MFI Explorer, Income includes all debt fund categories other than money market & gilt

As can be seen, both Income & money market mutual funds have seen a healthy growth rate of 20.1% & 15.9%, to Rs. 7.4 trillion & Rs. 3.14 trillion respectively in the last 10 years.

Despite their smaller size compared to banks or insurance companies, mutual funds have played a seminal role in development of corporate bond market in terms of innovation, price discovery, providing liquidity & transparent bond valuations by virtue of being active manager of funds compared to other participants who have tended to be "buy" & "hold" investors.

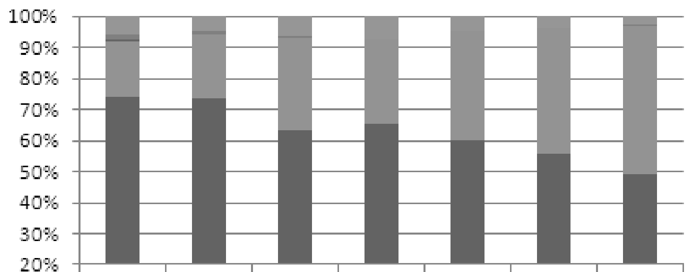
Trends in Asset Allocation

1) Increase in asset allocation towards corporate bonds & resultant improvement in market liquidity

The Indian mutual fund fixed income industry has come a long way on improving investor awareness, better product choice & consistent long-term returns. Within the income category, assets of short-term debt funds have seen the fastest growth growing by 3.85 times in the past three years and 81% in FY17 itself to their new high of Rs 2.72 trillion at the end of March 2017 (Source: CRISIL) as short term funds have provided superior post tax returns over fixed deposits with reasonably low volatility.

It is the short term category which is the biggest investor in corporate bonds given increased & has brought about great innovations in terms of new credit structures & introduction of more issuers in capital markets. As can be seen from the table below, the inflows in short term funds have brought about greater participation of corporate bonds in mutual fund asset allocation with share of corporate bonds moving to 48.1% in FY17 from just 18% in FY11.

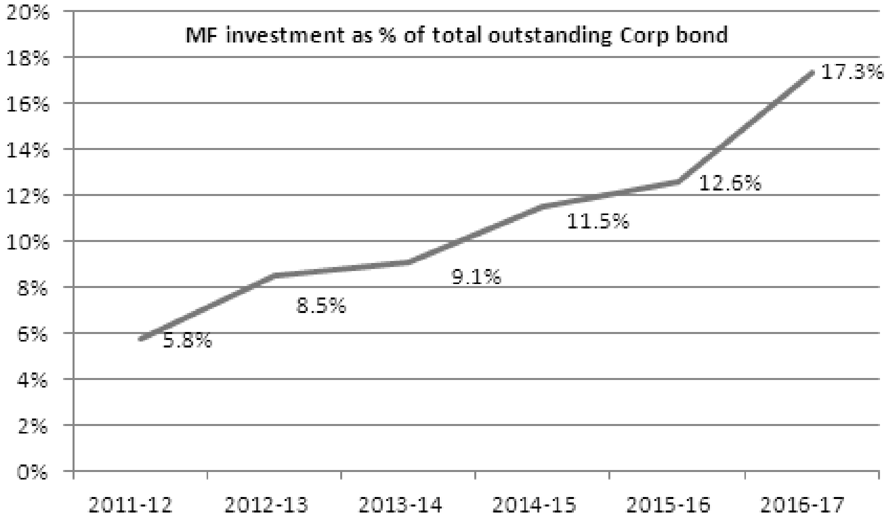
% of MF Debt AuM



	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Bank FD	5.6%	4.8%	6.5%	7.2%	4.8%	3.7%	2.6%
Securitised debt	2.1%	1.1%	0.2%	0.0%	0.0%	0.0%	0.3%
Equity linked debentures	0.1%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%
Corporate Bond	18.0%	20.3%	29.8%	27.2%	35.1%	40.8%	48.1%
Money Market	73.2%	72.5%	56.4%	59.2%	47.1%	41.6%	38.5%
G-Sec	1.0%	1.3%	7.1%	6.2%	13.0%	13.9%	10.5%

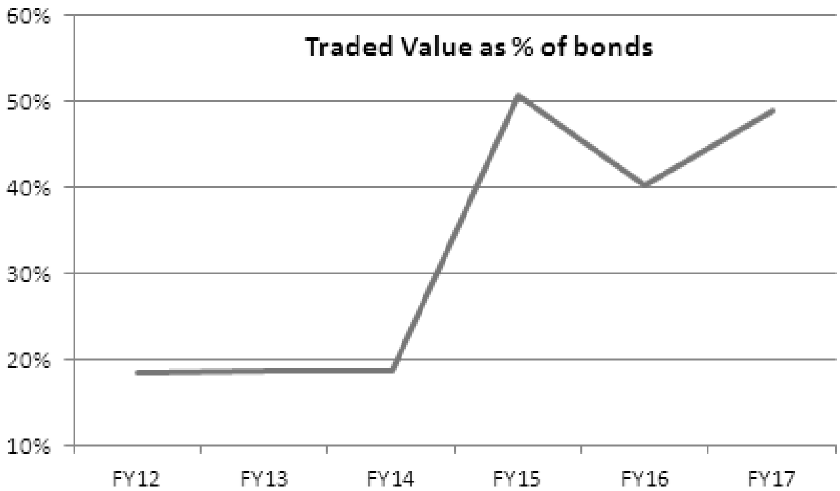
G-Sec · Money Market · Corporate Bond · Equity linked debentures · Securitised debt · Bank FD

Source: Sebi



Source: Sebi

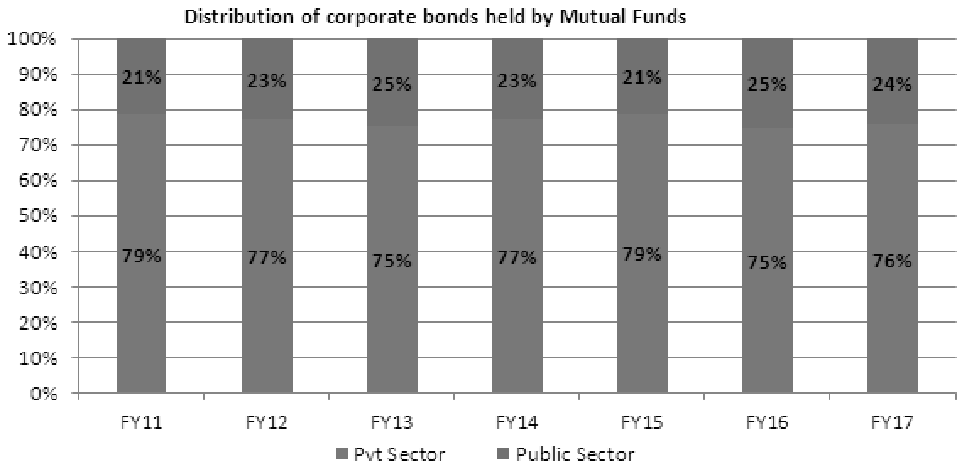
As a result, despite being less than 10% of banking system (income mutual funds), mutual funds today form a critical part of corporate bond eco-system with mutual funds owning 17.3% of outstanding corporate bonds.



Source: SEBI, CEIC

This also reflects in increasing trading volume at NSE as mutual funds tend to be much more active in market due to active market calls due to more performance oriented focus. This is partly also due to the institutional nature of fixed income investors who typically have quarter end or financial year end fund requirements which accentuate the need for more nimble portfolios.

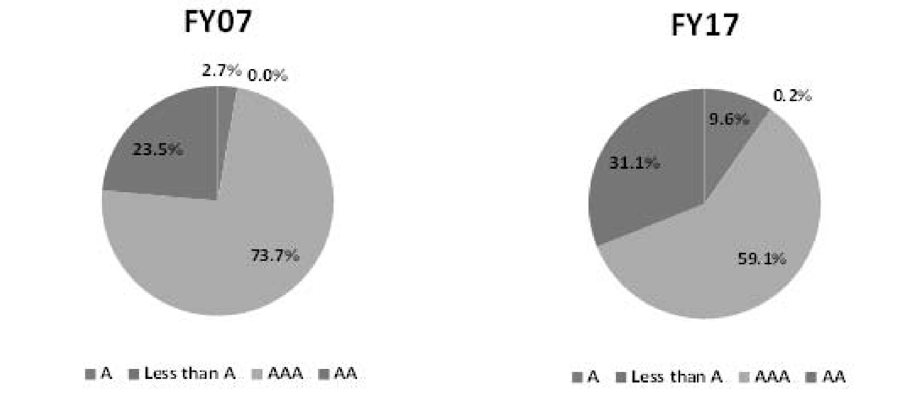
2) Greater participation of private sector



Source: SEBI

While equity mutual funds are often credited & rightly so of providing much needed capital to our private sector, one has oft overlooked the contribution of fixed income mutual fund in providing the same to private sector debt which is increasingly getting taken out by mutual funds due to much more attractive pricing, flexibility in structures & faster turnaround time.

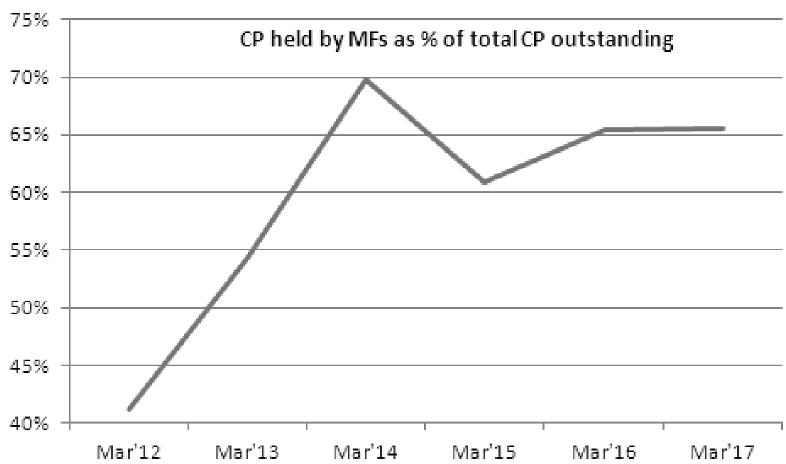
3) Financial inclusion & diversification



Source: MFI, All open-ended Income Schemes

One of the main objectives of developing a bond market has been financial inclusion i.e. to enable emerging businesses to raise money at a cheaper cost. The participation of mutual fund investments in not just private sector credit but higher diversification in "AA" & "A" rated issuers without comprising overall portfolio credit quality shows the critical resource gap fixed income mutual funds are filling today. Investors benefit from the fund's portfolio diversification into different instruments, sectors and debt issuers.

4) Financing working capital requirements of the economy



Source: CEIC

As in the case globally, the Indian money market industry also has provided short term credit intermediation to the economy with more than 65% of outstanding CP being held by mutual funds. While this may appear to be outsized compared to mutual fund overall participation in the financial system, thanks to regulator's intervention & mutual fund industry's own risk management practices, there are stringent issuer, sector & maturity limits set at fund level to avoid undue volatility.

5) Participation in structured credits

Being a pass through vehicle, fund industry has been one of the first mover in many new structures brought about in Indian debt market which has helped in price discovery & helped strengthen market infrastructure. Some of the debt instruments where the mutual fund industry has been first to invest:

a) Basel III Additional Tier 1 Bonds
b) Lease Rental Discounting
c) Securitisation for transmission business
d) InviTs

The current macro-economic environment of improving current & fiscal position, stable inflation & currency, addressing of structural constraints such as linking of small savings to market rates couldn't provide a better backdrop for fixed income mutual fund industry to grow which will further help provide credit intermediation.

There's a very interesting & a fortuitous anecdote the current Deputy Governor of RBI provided in 2013 during a panel discussion on corporate bond market which could be relevant for Indian markets(https://www.nseindia.com/research/content/res_panel_3.pdf), he gave the example of European corporate bond market which was also marginal compared to the banking system but took off because of the banking crisis as banks were under-capitalised to fund the real sector & hence they had to directly reach out to the bond markets. ***"Is it possible that the reason we have not had such a big take-off in the corporate bond market yet in India (and in many other parts of the world) is that maybe we actually need banks to occasionally go through some upheaval? And when they do, it is time for the savings to go directly to the corporations". "When banks are impaired or they are not able to provide the required intermediation, maybe it would be best to send money directly to the corporation even though it might not be as efficient as the overall banking solution"***

Given the current capital constraints of Indian banking industry with low deposit rates for savers & lack of capital for industry, mutual funds are best placed to fill the gap.

However, AUM growth of mutual funds wont alone help develop corporate bond market beyond a point as we still need to see strong bankruptcy resolution mechanisms which further enhances the confidence of bond investors across sectors. Moreover, any discussion on investment products has to be followed by new risk management products, an area, where lot more needs to be done such as credit default swaps which can act as a natural complement to the bond market. In case of secured bonds, we also dissemination of better information about the underlying collateral no matter how strong is the structure.

Given that majority of the fixed income investors look at fixed income funds as an alternate to fixed deposits & looks for capital conservation primarily, mutual funds also need to set some self-imposed strict risk parameters which will help sustain this asset growth in the long term.

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