Corporate Bond Markets-Transmission challenges & way ahead

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The corporate bond market has witnessed substantial growth along with significant changes in market structure, regulatory norms as well as depth of participation. With increasing reliance as well as regulatory push towards market-based borrowings, incrementally smoother transmission of policy rate changes into the real sector would depend on more efficient transmission through the bond markets. In this context, it is pertinent to revisit some of the factors that could have impeded adequate policy rate transmission in the recent past. While transient factors may get duly addressed, more structural issues need more attention and quicker resolution.

Liquidity Stance: Policy rate transmission is impeded when the rate stance and the liquidity stance aren't in sync or work at cross purposes. This has been adequately established over the very recent period. With the systemic liquidity remaining tight on account of various factors, until the last few months, the transmission of rate cuts have not been adequate or smoother except at the very short end of the money market curve. It is expected that the internal RBI liquidity framework review would address these issues in the near future. It is quite straightforward that in the absence of adequate liquidity, rate cuts don't get transmitted to the extent required. At the same time, prevalence of excess liquidity during a phase of monetary policy tightening/neutral stance would have the opposite effect of keeping market rates materially lower than what may be warranted. Our recent experience with respect to the period post demonetisation is fairly representative of the same. While periods of excessive liquidity could create issues of resource misallocation as the search for yield dominates, tighter liquidity during phases of monetary easing impedes adequate and optimal cost flow of resources to the real sector. Considering the lags in monetary policy actions with respect to its impact on the real sector, this issue acquires more importance and needs to addressed at the earliest. In an Inflation targeting framework, where the MPC decides policy rates as its sole mandate, the operating liquidity framework should be well laid out that acts in line with the policy stance. Maybe, at some point a wider debate is also necessary with respect to the framework itself and its effectiveness in a developing nation with a full-service central bank handling multiple responsibilities. Issues such as the central bank being potentially blind sided with respect to emerging financial stability & or growth concerns arising out of various other factors apart from interest rates needs to be explored?

Crowding out: While the central government budgets have maintained adherence optically to the headline deficit numbers, revenue side assumptions haven't been met in the last few years. This along with a stickier expenditure commitment has meant that adherence to headline deficit targets has been helped by larger recourse to off budget borrowings. Over the last 2 financial years, government has through Public sector entities borrowed over Rs 850 Bn through GoI Serviced bonds. These issuances have kept the PSU Spreads elevated, especially at the longer end. At the same time, these have been resorted to alongside the regular borrowings by these entities which are serviced out of their own cash flows. Apart from bringing about a permanent upward shift in the borrowing cost of some of these PSU entities, as the market faces a challenge of absorbing both their regular and GoI serviced bonds, these issuances also haven't led to any tangible benefits for the fiscal. It must be reiterated that the government pays a cost which has varied between 80-90 bps over the sovereign curve for borrowings which could possibly have been met out of the regular budget, with possibly a marginal increase in sovereign borrowing levels. At the same time, given that most private sector credits are priced over the comparable maturity/ ratings of PSU/ PFI, it is fair to assume that borrowing costs for other entities also stay elevated apart from crowding out effects.

Credit markets dislocation: credit markets in India have remained fairly turbulent since the default of ILFS and currently markets remain wary of funding certain issuers/sectors. Given that the crisis of confidence has sustained for a while, one cannot be oblivious to the potential of further systemic impacts. While there have been proposals to strengthen the NBFC/HFC sectors over a longer term with tighter supervision apart from more stringent liquidity and leverage norms, it is equally necessary to address the short-term challenges arising from additional defaults and more of liquidity withdrawal from these sectors on account of presumed fear. In this context, the Union budget announcement of providing a

first loss guarantee and the RBI liquidity provision is encouraging. Operational aspects of the same needs to be framed with the objective of providing a viable backstop facility. A well targeted liquidity facility with strict conditionalities attached such as submitting to an Asset quality review, shedding non-core assets within strict timelines, raising equity apart from management / promoter changes wherever necessary could obviate any potential moral hazard issues the Government /RBI may face with respect to providing such a facility.

Challenges ahead

The private placement debt market has grown from around Rs 2.18 trillion in FY11 to Rs 6.0 Tr in FY18. The issuances in H1FY19 amounted to Rs 3.73 Trillion. The increasing reliance on bond markets have also been led by regulatory push apart from the relative cost benefits in a phase of declining interest rates. SEBI regulations with respect to fund raising through debt securities by large entities take effect from FY20. The regulation has adopted a light touch approach with focus on disclosure and a monetary penalty in the absence of adherence to incremental borrowings of at least 25% through the bond markets. Over time, this measure would result in more issuances of bonds by entities rated AA and above through the markets. It is crucial that absorption capacity of the markets grows in accordance with the anticipated additional supply of non-AAA papers. Providing policy flexibility and building up robust credit evaluation capabilities within the long-term investors such as PF and pension funds is crucial in this context. Also, it is crucial to incentivise more patient pool of debt capital such as AIF etc which can absorb the additional illiquidity and credit risks. The headroom available for FPI investment in rupee debt can also be potentially increased, which is a more prudent measure than opening up more room for foreign currency borrowings, especially for entities without a natural currency hedge.

The other near-term challenges arise from the market liquidity perspective as downward ratings migration may be expected in the context of credit markets dislocation. While overall traded volumes of bonds reported on exchanges have increased to more than Rs 17 trillion cumulatively in FY18, liquidity beyond AAA bonds is still challenging in the best of times. Further changes in the EBP mechanism are also quite necessary, recognising that non flow trades aren't amenable to price discovery on a platform, given the extensive due diligence and covenant negotiations required. Also, for most borrowers, it's a routine practice to gauge market demand and price before launching an issue on the platform. This is a standard practice in any OTC dominated market. Presently participants face a challenge in credit trades as a negotiated trade (with extensive credit work and covenant negotiations) becomes vulnerable to "fastest fingers first" as traders/other investors with faster connectivity are able to put bids first on the platform. Any positive market news flow between the final IM finalisation/upload and bidding date makes any trade vulnerable to this, which is extremely unfair. Standard term sheets, typically issued by regular issuers, especially PFI/PSU and other regular borrowers are still amenable to price discovery through the platform. Even here, the ability to place orders first is the only determining factor for allotment. A more equitable solution that still incorporates the philosophy of full transparency on trades is essential.