Trading of Corporate Loans – the New Imperative

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Corporate loans are basically negotiated deals or debt obligations. From bilateral facilities corporate lending evolved to credit lines involving a small club of lenders and further progressed to syndication with a larger number of banking participants, in tune with the increasing scale of projects requiring ever larger funding. Secondary sales are few and far between (other than those downsold within the first two-three months of syndication), due to the fact that these loans are mutually negotiated, non-homogeneous in nature and tend to have some individual characteristics, which lends to asymmetry of information between a buyer and a seller. Any secondary trade that does take place is between banks and at par or near par pricing. In the case of highly stressed assets the sale is to the Asset Reconstruction Companies (ARCs), at substantially discounted prices. ARCs are expected to have specialised restructuring / recovery expertise and about a dozen ARCs are active in the country. But deals take a long time to fructify and a large number of deals fall through, primarily on account of differing perceptions on valuations between banks and the ARCs. Sales to ARCs have also been impeded by some structural issues and capital constraints. The secondary corporate loan market is currently at least two decades behind in sophistication (transparency, efficiency, price discovery platform etc.) to the stock market or even the public debt market and two to three decades behind what is prevalent in the developed world where trading of loans has witnessed a healthy growth.

In the western economies the trading of loans picked up in the last decade of the 20th century because certain institutional investors other than banks started perceiving them as assets with an attractive risk adjusted return profile. These loans began being perceived as more attractive than bonds because they were generally senior secured debt obligations and had a floating rate of interest. A wide range of market participants entered the scene (pension funds, special loanoriented retail mutual funds, hedge funds, private equity funds), who became active traders as against banks which tended to hold investments till maturity. Due to the diverse nature of the interest from these investors, on the basis of tenor, underlying asset, risk appetite, etc., syndication structures evolved to satisfy the varied demands. While retail loan mutual funds were interested in shorter tenor, pension and insurance funds looked at the longer tenor term loans. Trades in the highly leveraged loans (to companies in the non-investment grade rating or those with high levels of outstanding debt or loans to fund new projects), which carried a higher rate of interest, fuelled growth in the secondary market. As a vibrant secondary market was evolving a need was felt for standardisation of documents and of trading procedures and practices so as to make the market efficient, fair and transparent. This saw the birth of self-regulatory bodies like the Loan Syndication and Trading Association in USA (LSTA) in 1995, the Loan Market Association (LMA) in 1996 which covered Europe, Middle East and Africa and the Asia Pacific Loan Market Association (APLMA) in 1998.

The Indian corporate bond market is very shallow, with penetration being merely 16-17% of GDP. To put this in perspective, the market in USA is more than 100% of their GDP. The bond market is dominated by large financial and infrastructure companies and public sector undertakings, with manufacturing companies accounting for less than 1% . Almost 98% of the debt is placed privately. A substantial portion is of relatively short duration and more than half of the bonds issued enjoy the highest rating. There is little diversity. Significant secondary market trading takes place primarily in short duration corporate bonds where the mutual fund industry has played an important role. But as the country's requirements of long term infrastructure projects have been estimated at a high US$ 4.5 trillion, it is imperative that an ecosystem of a diversified set of investors is developed in the long tenor corporate debt market (both loans and bonds), as against the current bank dominated loaning environment. The development of a secondary market in loans with a diversified set of investors with different investment horizons and risk appetites would benefit the bond market also. It would enable the development of a continuous yield curve across various maturities and rating buckets, the absence of which is an impediment to expanding the bond market.

Bank borrowings are today practically the sole source of funding for long term projects in the absence of a meaningful corporate bond market. But banks have capital constraints and large volumes of non-performing assets (NPAs) which dampens their appetite. As per RBI's projections made in Sept. 2019, the gross non-performing assets of the banking system are expected to touch Rs 9.9 lac crores by Sept.2020. This figure is only expected to worsen due to the adverse impact on the economy as a result of widespread disruptions in the current pandemic. The high corporate loan book together with the relatively high share of NPAs in the banking system, in an era of trade tensions and slowing economy, could present a major source of financial vulnerability. The IL&FS implosion has exposed the weak underbelly of NBFCs- asset liability mismatches. Thus there is not only a huge potential for an institutionalised secondary market for corporate loans but it is imperative that it be developed expeditiously. It is heartening to see that the Reserve Bank of India has taken the first step when in December 2019 it announced the setting up of a self-regulatory body (SRB) for the secondary market.

To be effective the SRB needs to represent and converge the interests of both the buyers and the sellers. It would, therefore, be appropriate to extend its membership to all financial players (banks, non-bank financial institutions, asset management companies, insurance companies, etc.) as also to the service providers to the market (legal firms, rating agencies, financial publications and so on).

The issues that need to be addressed:

i) Standardisation of documentation for syndicated loans (including covenants, indemnities and terms & conditions).
ii) Standardisation of trading documents and standardisation of trading procedures and practices to bring in trust, efficiency and speed, as with trades in other asset classes.
iii) Setting up an Administrative Agent or a Central Registry for updating the register of lenders.
iv) Effective price discovery, transparency and efficient transaction execution through an online Loan Sales Platform.
v) Facilitate the desired regulatory amendments by working closely with the financial regulators- RBI, SEBI, IRDAI, PFRDA- and other Government agencies.
vi) Facilitate the development of arrangers, market makers and specialised brokers.
vii) Determining a suitable pricing benchmark.

It would be desirable to develop a mark-to-market pricing service operated by an independent third party to provide ongoing secondary market prices for use by the secondary loan market participants.

A vibrant secondary loan market based on the above infrastructure will help fuel innovation and the development of sustainable loan products (structured loans, Credit Default Swaps etc.). Increased liquidity will add momentum to the primary syndication market, the corporate bond market as also the securitisation market in the country.

There is some apprehension that an originate-to-market model (or trading in loans after syndication) would lead to moral hazard issues and incentivise inadequate due diligence. The experience of the western countries, however, suggests that for reputable arrangers this does not hold true.

Reputable arrangers remain cognizant of the fact that investors who are adversely affected would not come forward for future deals originated by them.

There are a number of ways banks can benefit from the development of a secondary loans market:

- It can be an essential tool for capital, risk, liquidity and balance sheet management.
- It facilitates portfolio management and also the implementation of any desired focus change in the lending book (eg. a decision to decrease/increase the exposure to a particular sector).
- Enables them to crystallise their losses speedily in respect of potentially stressed or nonperforming loans.
- Improves loan origination standards in the primary syndication market.

Borrowers, especially those who seek term funding, benefit due to:

- A wider and deeper investor base.
- Greater market liquidity.
- Availability of new products designed to meets the needs of a diverse investor base.

Investors benefit through:

- A diversification of portfolio with the addition of a new asset class.
- Dispersal of risk across various sectors.
- Higher returns.
- Increased liquidity of investments.
- Speedier closure of stressed asset deals.
- Reduction of information asymmetry and increased transparency.