

Emerging Role of Retail Investors in Debt Capital Markets



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Overview

In today's highly institutionalized world of capital markets, placing financial instruments with the retail segment has been an elusive target for all policy makers. Combined investment vehicles like mutual funds, pension funds, insurance companies, investment trusts, endowments et al have been the primary torch bearers for the buy side of the markets for time

immemorial.

While most of the developed geographies have some or the other way for retail participation in the bond markets, India has lagged behind significantly in this aspect. This has partly to do with the fact that the bond markets in India are still in the emerging stage and penetration is still mild at best. That being said, recent policy actions by the central bank like permitting retail participation in G-Secs, emergence of Fixed Income ETFs, relaxation in public issues of NCDs and private players leveraging technology to develop portals specifically for retail are all a positive step towards enhancing retail interest in bonds. However, this is fairly in its infancy stage and needs dedicated nurturing to bear the fruits that it has been designed for.

Drivers of Retail Participation

Retail contribution in financial instruments is of paramount importance as the overall savings rate, which has been one of the strong points of our economy, has been on a decline for quite some-time now. Household financial savings rate fell to 8.1% of GDP in the quarter ended December, 2020 from a peak of 21% and 10.4% during the previous two quarters respectively, according to the estimates by the Reserve Bank of India. The decline was due to the liquidation of precautionary and forced savings seen during last year's peak pandemic months of April-June, 2020. The household financial savings have plateaued to 8.1% in Q3 FY21 from the high of 21% in Q1. Domestic savings rate is an important metric in the sense that it determines the quantum of funds available for the governments or the corporates to borrow from.

The good news is that FY21 and beyond may see an increase in annual household savings rate after all, led

by the recovery. The long term annual savings rate is expected to settle at ~12% which is significantly higher than the previous two-three fiscals. This opens up a massive opportunity to encourage retail contribution to the debt markets without which our markets will be exposed to external debt raising.

India needs capital for rapid growth, capital expenditures, mergers and acquisitions etc. from Pharma to Infrastructure sectors, all necessitate an enormous debt market presence. An extremely liquid debt market plays a very significant role by being an auxiliary to the banking system, to cater to the crucial requirements of the corporate sector for long term asset creation and capital investment. In absolute terms the US bond market is ~20 times the Indian bond market and China is ~5 times. In terms of amount outstanding to GDP, ~80% approximately is the debt market in India. When compared with some of the countries in Asia like Japan, this figure runs hot at 250%. The aspirations of India to become a developed nation will require that the market is supported by retail involvement without which it will be highly difficult for the country to fund its growth.

Holders of Indian Debt

The biggest pie of debt outstanding in India is the Government Securities which is about 55% of the GDP. The corporate bond market is about 20% of the GDP. As of now government securities are largely held by banks (39 per cent of outstanding) followed by insurance companies (25 per cent) and RBI (15 per cent). Provident funds own 5 per cent and mutual funds and FII's another 2 per cent each. In fact, the ownership of FII's has been steadily falling from more than 3 per cent in December 2019. On the other hand, mutual funds have increased their holding of government securities. The retail participation is nil. In the US, where retail investors do participate in the government bond market, retail owns about 5% of the government debt. Retail investors will ensure a stable demand for government securities, which, in periods of volatility, can pillow the impact of sales from institutional and foreign investors.

Symbiotic for all

Endorsing retail and mid-segment participation in G-sec / highly rated market is advantageous to both the issuer and the investor.

o Issuer Perspective

From the issuer's standpoint, a differentiated investor base for bonds is vital for ensuring stable demand in the market. An assorted investor base with different time horizons, risk inclinations, and trading purposes ensures active trading, creating liquidity and allows borrowings

at reasonable cost. In some cases, retail demand also helps issuers tie up demand in longer tenors well suited to their business requirement, otherwise available in limited quantum from institutional investors. Retail distribution of NCDs also help issuers develop a broad based & diversified set of investors open to investing rather than being limited to a limited set of institutional investors thereby reducing their dependence to short squeezes in the institutional space.

o Retail Perspective

From the investors' viewpoint, there is a need for investment options that provide decent returns and protect the capital. In spite of such features, there is low retail interest in the government & highly rated corporate bonds and this investor apathy needs to be tackled by the regulators and market bodies. In recent times, as we go through a low rate regime, traditional fixed income instruments like FDs returns have nose dived to alarming levels thereby causing havoc to retail investors return. In the current scenario, many of the investors don't have options like long tenor GOI Securities or AAA rates PSU/ Pvt Bonds as an investment option to lock in decent yields for a long tenor. Therefore, retail participation in bonds can really open up the investment scenario for investors with different options from risk reward and tenor perspective.

Hindrances for Retail Involvement

Infiltration of bonds to individuals could not be attained mainly on account of the competition from other instruments, many of them having tax benefits, such as, small savings schemes from the Government like Savings bonds and National Savings Certificates. These tools are targeted at the retail investors and the effective return on these securities work out to be higher than that on marketable securities (like bonds) which have no tax concessions. We do have retail participation via mutual funds but again these are limited to liquid funds or short duration funds which do not cater to the long-term requirements of the markets. Additionally, the retail participation is still majorly dependent on intermediaries who distribute these for a high fee, thereby adding to the cost of issuance. Bond platforms still in infancy in India are tackling this issue but has a long way to go from here. Another roadblock is the relative illiquidity in Indian bond markets which create lock in for retail investors with very few exit options.

Way Forward

The need to convert retail savers into investors is paramount. As mentioned before, bulky participation of retail investors in securities market will win dividends by increasing penetration of securities market, reducing dependence on foreign investors and domestic savers reaping benefits of economic growth. All stakeholders including Government, Reserve Bank and financial institutions must treat promoting retail participation in

bond market as a priority. Few pointers that might aid to this are as below:

- Encourage awareness among retail investor class to promote bonds as an alternate investment instrument. In pursuit of this objective, stakeholders must make concerted efforts for investor education with regard to this market. Given their reach, media, both print and electronic, have also very crucial role to play here. Banks, PDs, financial institutions and stock exchanges should take lead in this endeavour by creating awareness about the products
- The existing infrastructure for trading viz. depository, intermediaries, trading infrastructure is concentrated in Tier I cities. This has led to the concentration of treasury activities. Banks, by having an existing network of branches spread across the country and on a CBS platform, and Post Offices with a wide geographical presence are well placed to offer investment services to retail investors in the G-sec / bond markets. This potential must be tapped and leveraged as a distribution channel to cater to retail investors. Banks/PDs can create designated desks to focus on retail trades.
- Secondary market liquidity in G-sec is limited to a few securities and thus it is difficult to find a market quotes for a large number of G-sec. Due to the lack of secondary market liquidity, investors, especially retail/individual investors end up paying large illiquidity premium when they try selling the illiquid (off-the-run) securities. Lack of liquidity is a critical factor that needs to be addressed for ensuring participation by retail investors. Appointing designated market makers is a novel way of creating liquidity for investors, which in recent times have been well elucidated by the success of Bharat Bond ETFs wherein investors can easily liquidate or buy ETFs on exchanges from market makers thereby adding to the attractiveness of the product.
- Transaction costs for trading and maintaining gilt accounts are high for retail investors. Charges, such as, account-opening fee, which are high and not standardised, need an immediate review. A rule of reasonable and uniform charges is customer friendly and can lead to tangible benefits in promoting retail investments since such a move would bring in much needed transparency and induce competition
- Policy makers should consider offering tax concession on income from debt oriented mutual funds can be a measure aimed towards bringing in new classes of investors as well as encourage further investments in bonds by existing investors. Such concession would incentivise mutual funds and investors to increase participation. Tax concessions upto a certain threshold for direct participation can be a good way to encourage direct retail participation in bonds.

Conclusion

Notwithstanding the institutional nature of the debt market, it is in the interest of both the issuer and the investor to promote a retail culture in the market. In recent times, we have seen consistent retail participation in public issuance of debt mobilising 200-500Cr in each issue more so in AAA rated issuances. Additionally, the independent financial distributors and wealth segment have become a significant volume generator in debt capital markets signifying the increasing interest in direct bond investments. The central bank has already identified this and taken some welcome steps to revive this class of investor demand. It should also take steps to enhance the liquidity of the market and make it more

diversified in terms of the number of securities traded in the secondary markets, deepen the derivative market which can be used for hedging purposes. It is also essential that all other patrons like banks, primary dealers as also the media work in solemn to promote retail participation by actively engaging with the investors and focusing on providing high standard of customer service and hassle-free transaction experience. This is highly imperative for our economy given the declining share of household financial savings and the active contribution of retail will go a long way in providing a massive boost to our dream of becoming a developed nation.
