Future Ahead - Online Bond Trading Platforms

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Background:
Bond markets complement traditional bank financing by facilitating long-tenor, fixed-rate, debt financing from non-bank credit channels. Development of bond markets have consistently ranked among the topmost priorities for regulatory authorities and policy makers. The goal of making India a USD 5 trillion economy calls for significant investment by the corporate sector, which calls for access to alternative debt financing channels in the form of domestic debt capital markets and reducing its dependency on traditional bank financing or foreign currency borrowings. Access to capital, along with lower cost of capital, is a critical prerequisite for achieving this objective.

One of the ways for bringing down the cost of debt capital is through pooling of resources or savings from investors having divergent risk profiles and investment horizons. Investors demand additional compensation for holding less liquid assets in lieu of assuming liquidity risks. Presence of diverse category of investors helps improve liquidity of debt securities, which, in turn, leads to lower market-based borrowing costs for the issuer, transparent price discovery and helps enhance investor participation.

Online Bond Platform Providers (OBPPs) fulfill a critical role in this regard, as they provide an avenue to particularly non-institutional investors for accessing the bond markets. Given the increasing adoption of technology for financial market product offerings, users are comfortable transacting through online bond platforms. Going digital is no longer a source of competitive advantage, but an essential and integral component of the product and sales strategy of any financial entity. As an alternative distribution channel for offering debt securities, OBPPs complement traditional channels for offering financial products.

Recent developments for regulation and promotion of online bond platforms:
Several initiatives over the last one year have created a predictable backdrop for OBPPs, thereby strengthening the foundation for the next stage of growth of such entities. Some of these initiatives deserve special mention in this regard.

Firstly, the regulatory framework for OBPPs, as laid down by SEBI in November 2022, provides clarity of regulatory intent regarding supervision of OBPPs, and is aimed at streamlining the operations of the OBPPs. As per extant regulatory framework, OBPPs are required to obtain registration as a stock broker in the debt segment of stock exchanges, prior to commencing its activities. The initiation of measures relating to mitigation of payment and settlement risk, implementation of comprehensive risk management framework and introduction of grievance redress mechanisms would increase the confidence of investors for participating in bond markets.

SEBI, vide its circular in June 2023, permitted OBPPs to offer listed debt securities, listed municipal debt securities and listed securitized debt instruments, including Government Securities, State Development Loans and Treasury Bills and Sovereign Gold Bonds. OBPPs should not have, on its online bond platform or any other platform or website, any link or tab to websites or platforms of its holding company, subsidiary or associate, undertaking any activity or offering products or securities or services (including offering of unlisted securities) that are not regulated by a domestic financial sector regulator. OBPPs are not allowed to offer unlisted debt securities on their platform.

Secondly, the recent amendments, under the 2023 Union Budget, to the taxation rules for various fixed income products reduce the tax arbitrage between different fixed income investment options. These amendments establish a tax-agnostic framework for various categories of fixed income investments and are expected to incrementally encourage direct investment in bond markets. Such changes are positive for online bond platforms, which facilitate direct investment in bond markets.

Thirdly, the reduction in denomination for debt securities issued on private placement basis, from Rupees ten lakhs earlier to Rupees one lakh now, effective January 1, 2023, have made corporate bonds accessible to a wider category of non-institutional investors. Since OBPPs facilitate access to markets particularly for non-institutional investors, lower denominations help such investors to diversify their holdings across small ticket size transactions in multiple debt instruments for the same cumulative investment amount.

Future ahead for online bond platforms:
With SEBI defining the regulatory contours for online bond platforms, coupled with the underlying demand drivers for debt securities from non-institutional investors, the outlook for OBPPs continue to remain robust. However, the future growth of OBPPs hinges upon their ability to navigate certain emerging challenges, amidst a highly competitive landscape for digital product offerings. The scalability and investor acceptance of online bond platforms would depend largely upon the strategy adopted by OBPPs to address these issues, which are critical for maintaining the integrity of the markets and the confidence of the participants therein.

Offering high yield bonds: Bonds are a critical component of an investor's asset allocation strategy due to their regular payouts, capital conservation nature and steady income generation. While lower rated bonds entice investors with higher yields, they come with attendant market, credit and liquidity risks. Such bonds need to be positioned only to savvy investors having relevant risk profile, who are able to understand and evaluate the associated risks. The offering of lower rated, high yield bonds on online bond platforms needs to be done in a transparent manner, accompanied with all the relevant bond information and issuer disclosures, including the offer document and latest credit ratings. SEBI has stipulated minimum disclosure requirements for each debt security offered for sale on online bond platforms, which needs to be adhered to, in letter and spirit.

Heterogeneity of debt securities: Equity instruments are fairly homogeneous, since all equity shares of the same issuer usually have similar product and risk characteristics. Unlike equities, bonds are not homogeneous, and different debt securities of the same issuer may have different characteristics including coupon rates, seniority, collateral structure, redemption profile, covenants or secondary market liquidity. Such heterogeneity impacts the liquidity of debt securities and makes price comparison difficult across instruments. The fragmented nature and heterogeneity of the corporate bond market, coupled with lack of standardization and information asymmetry, calls for detailed understanding of the underlying instrument characteristics. The OBPPs need to disseminate such information to potential investors for them to take an informed decision prior to investing.

Investor education: Online bond platforms are popular with non-institutional investors and help facilitate access to markets for new-to-credit investors. Given the heterogeneity of debt securities and the risks associated with lower rated bonds, investor education is a key pillar of the strategy for offering fixed income securities. Further, investors also need to understand the price-yield dynamics while investing in bond markets. OBPPs have already been taking proactive measures in terms of imparting investor education and they need to continue with their investor awareness initiatives going forward.

Further, SEBI has outlined the Advertisement Code for OBPPs in order to ensure that advertisements are true, fair, clear, complete and unambiguous. Advertisements shall not contain statements which are false, misleading, biased or deceptive, or any statements based on assumption or projections, and shall not contain any testimonials or any ranking, based on any criteria. The advertisements shall be communicated in simple language and shall avoid using technical or legal terminology or complex language or excessive details, which may confuse the investors. No celebrities are allowed to form part of such advertisements. OBPPs are advised to evaluate, through a set of questionnaires, with appropriate risk factors and disclaimers, the optimum level of investment risk an investor or seller is willing to take, taking into account multiple factors such as risk appetite, loss appetite, age, investment horizon, etc.

Sourcing of debt securities: While most OBPPs have focused their efforts and resources on providing seamless user experience to its registered users by improving the look-and-feel of the online platform, introduction of user-friendly features and on portfolio analytics, one needs to note that the success of an OBPP ultimately lies in its ability to source wide variety of inventory of debt securities from the end holders of securities in small or odd lots, at the best possible price, and to execute the end-to-end clearing and settlement process in a seamless manner. Diversity of debt securities, available on the online platform, allows users to customize their bond portfolios based on their portfolio size, risk appetite, yield objectives and investment horizons. An efficient sourcing framework can help reduce the acquisition price of the debt securities, and thereby improve the investment yield of the portfolio for investors.

Settlement of trades: As per the existing regulatory framework, all orders, with respect to listed debt securities, placed on the online bond platform needs to be mandatorily routed through the Request for Quote (RFQ) platform of the stock exchanges and settled through the respective Clearing Corporations. While the RFQ platform presently does not offer settlement guarantee, OBPPs need to avoid or minimize cancelled trades, if any, in order to ensure integrity of markets and to avoid reputation risk.

Data privacy: OBPPs handle significant amount of personal information and have access to sensitive financial data of its registered users. In view of the introduction of the Digital Personal Data Protection Bill, 2022, OBPPs need to put in place strong internal controls and adopt robust processes for processing of digital personal data in a manner that recognizes both the right of individuals to protect their personal data and the need to process personal data for lawful purposes. OBPPs need to maintain confidentiality and security of all data relating to its activities and strictly control access to such data.

Grievance redress mechanism: OBPPs need to have robust grievance redressal mechanism for investors with direct supervisory oversight of their senior management. OBPPs are required to take steps for redress of grievances of the investors within 30 days from the date of the receipt of the complaint, and disclose the number, nature and other particulars of the complaints received, if any, in such form as specified by the stock exchanges. Given the relative opaqueness surrounding pricing of less liquid securities in over-the-counter (OTC) markets, OBPPs need to provide clarity upfront, to investors regarding price, yield, accrued interest, settlement dates etc. Transparency relating to fees and charges, both initial and recurring, needs to be top priority for the OBPPs.

Conclusion:

In summary, online bond platforms serve as a critical alternative distribution channel for bond markets and are critical for ensuring access to fixed income markets for a wide category of non-institutional investors. Growth in investment activity through online bond platforms can be considered a healthy barometer for the development of fixed income markets and are expected to contribute meaningfully to enhancing the depth and breadth of the domestic bond markets. The initiation of SEBI's regulatory framework for OBPPs, coupled with the increasing trend of digitalization of financial services, bode well for the future growth of OBPPs and one needs to watch out for greater action in this space.

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