# Easing Banking Dis-intermediation is the Key to Indian Bond Market Development

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***No Dearth of Efforts***

To start-off on a lighter note, whenever the organisers of any discussion forum, run out of an exciting finance or market topic, they go back to the tried and tested topic guaranteed to generate interest and the topic is –Developing Indian Corporate Bond Markets(CBM). Needless to say the author while organising such forums has used the trick with some success! However, therein lies the conundrum. For last 15 odd years all market participants, various regulators and governments across political orientation have unanimously agreed about the need of developing bond market in India. To that extent, there has been never a dearth of efforts in terms of formulating roadmaps for developing the Bond market. Subsequently a lot of these measures were actually implemented.

Very few reports on developing Indian bond markets have been more discussed and debated than the report titled the High Level Expert Committee Report on Corporate Bonds and Securitization Chaired by Dr. R.H. Patil (Patil Committee report) published on December 2005. It had 47 recommendations with 17 heads focused on the development of the primary bond market alone.

Subsequent reports from various committee/working groups have made incremental recommendations over the very comprehensive Patel Committee report. The recommendations tend to address four broad areas namely i) Legal aspects ii) Regulatory issues iii) Tax issues and iv) Market Micro structure.

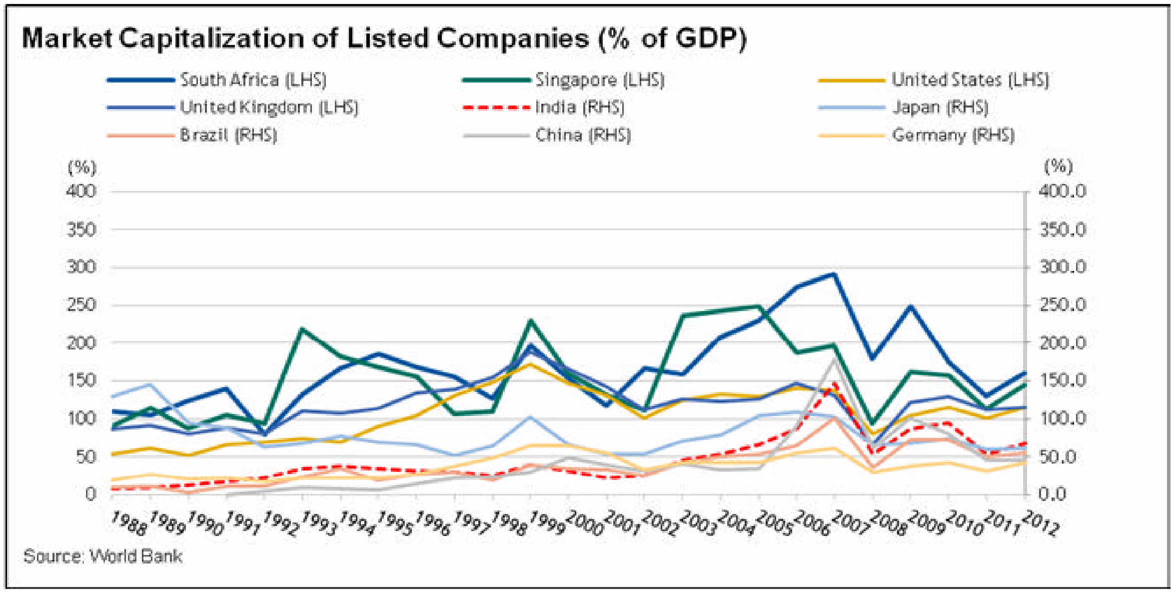
Among the key recommendations implemented some dealt with fundamental aspects which have eased the process of issuance and trading of corporate bonds. The concerned regulator increased the ease of issuing bonds by rationalising the requirements from the issuer, enhanced the investor base, continuously evolved the order matching trading system and gradually reduced withholding tax. The directional uptick in Indian bond market owes a lot to such enabling regulations.

Post these fundamental developments the focus seems to have shifted to 'exotic' efforts such as launch of corporate repo, interest rate future and credit default swap. As such these products improve the liquidity of bond markets and also facilitate price discovery, but India hardly has a sizeable bond market in the first place. The idea behind these offerings was the famed approach of BCD (Bond-Currency-Derivatives) Nexus. It is doubtful whether this approach can kick-start the bond market in a regime where more fundamental aspects has been limiting the growth. If the bond market has shown some sign of activity, in recent times, it has more to do with the dis-intermediation of the banking systems and per se not because of Interest Rate Swaps(IRS) or Credit Default Swaps (CDS)!

The lack of focus on the fundamental aspects is also reflected by the demand to regulators of pension funds and insurance companies for liberalising their respective rules on investment in bonds. While there is nothing wrong with such demands, someone should have analysed why mutual funds, who are allowed by SEBI to invest in bonds rated all the way down to "BBB" ratings, hardly has appetite for bonds rated at "A" category.

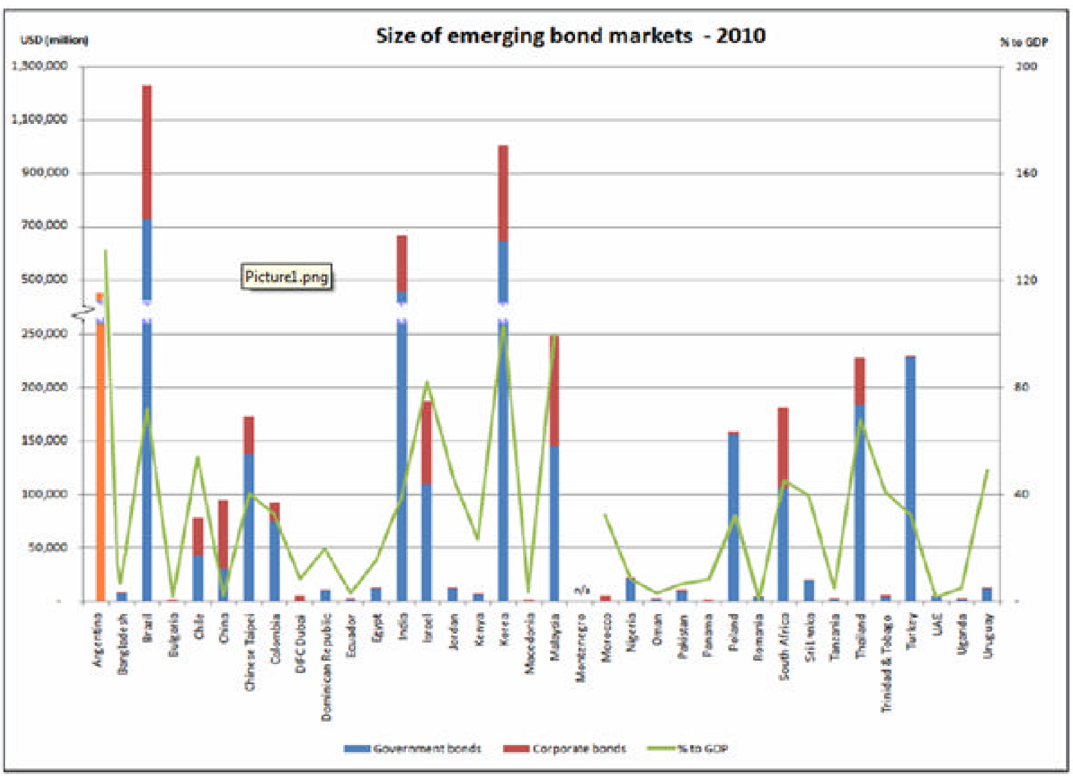
***Success in Developing Other Markets not replicated in Corporate Bonds:***

India started making dedicated efforts post 1990 to improve the functioning and depth of its financial markets. The most resounding success has possibly been the equity markets in India. The government's efforts such as favourable tax treatment of long-term capital gains on equity investments and facilitating tax savings by investments in schemes such as ELSS has been supportive of developing the equity market.




As shown if one takes a proxy measure such as Market Capitalisation by GDP, between 1990 and 2012, India has significantly reduced the gap between itself and major advanced economies.

Likewise, the efforts of developing the government securities market have also been largely successful. As per a recent IOSCO study, among the emerging market India remains a top player in terms of G-sec volumes, something that cannot be said about Indian bond markets. In fact the long-term game plan has been to first develop the G-sec market and then the corporate bond markets. So the question is if the government and regulators have been reasonably successful with Equity and G-Sec market what restricted their success in developing the bond market?




***Focus on "Exotic" But Low Hanging Fruit***

Arguably, the two most popular recommendations, namely the stamp duty rationalisation and improvement of bankruptcy regime, are yet to make any meaningful progress in last 10 years. These two measures may possibly have the largest positive impact in improving the bond market by directly impacting the economics of bond pricing.

However, these are the two measures whose implementation will be time consuming and involve a high level of complexity given the involvement of central and in some cases the state government as well. The roadblock involved in improving the fundamental aspects of the market, possibly persuaded all concerned to focus on relatively low hanging fruits.

The focus and the effort that has been dedicated in last 10 odd years in enabling the bespoke 'Bond Currency Derivatives' (BCD) nexus , could arguably have yielded better results if a portion of that effort was also dedicated in developing this fundamental demand –supply aspects of Indian bond market.

Let us try to understand in somewhat simplistic terms what BCD Nexus is all about.

BCD nexus rightly assumes that financial markets such as government bond, corporate bond, interest rate and foreign currency have strong inter-relations. So the argument it forwards is that each of these markets cannot be developed as standalone markets. All these markets with their core offering as well as the derivatives on these underlying assets would cause these markets to grow together. Under this scheme of things, to develop bond markets in India, India also needs interest rate derivatives market, credit derivative markets and the like. These derivative products are expected to ease the ownership of a corporate bond. Indeed, there is some rationale in it.

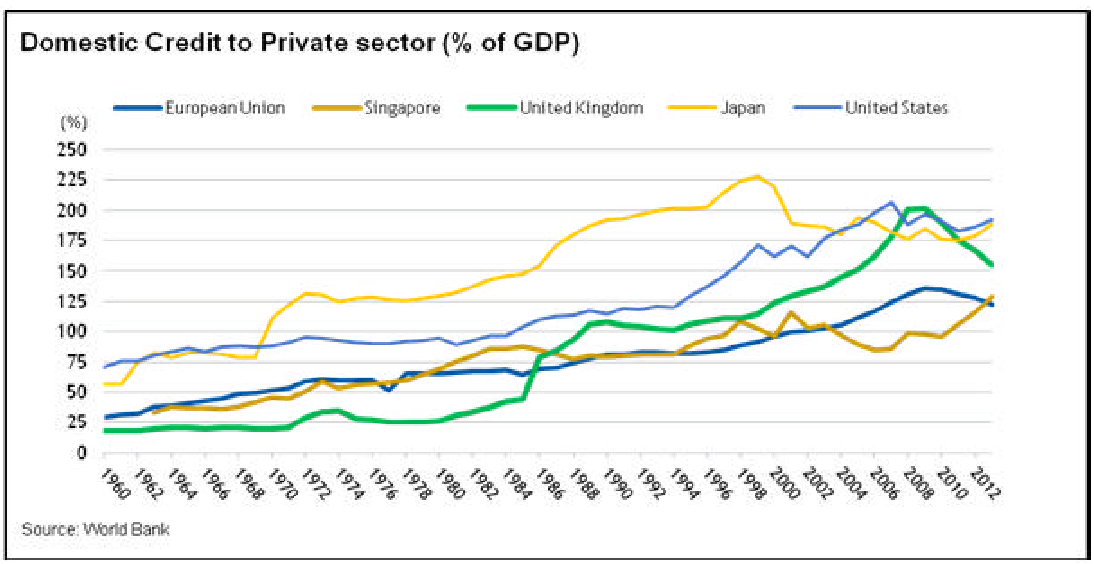
A corporate bond has three prominent, though not the only, risks. Namely, interest rate risk, credit risk and liquidity risk. As per BCD nexus enthusiasts, the ability to hedge various types of risks inherent in a bond arguably will make the bond market more attractive to a whole lot of investors. The investor will only keep those risks for which they have an understanding and risk tolerance. Thus if a corporate bond investor if uncomfortable with interest rate risk the she would use interest rate derivatives to hedge the same and hold onto the pure credit risk. Some investor may be uncomfortable with degree of credit risk may like to reduce the credit risk exposure by purchasing CDS.

While nothing grossly wrong with this elegant but may be somewhat over-simplistic line of thinking, however it overlooks certain fundamental aspects of bond issuances. It almost pre-supposes that the bond otherwise is appropriately priced based on risk based pricing and the corporate bond market has some critical mass.

Given the fact that corporate repo or CDS have failed to take off and usage of interest rate future to hedge interest rate risk in corporate bond holding is very limited it may be difficult to claim that the BCD nexus approach has yielded any benefit to Indian CBM as of today.

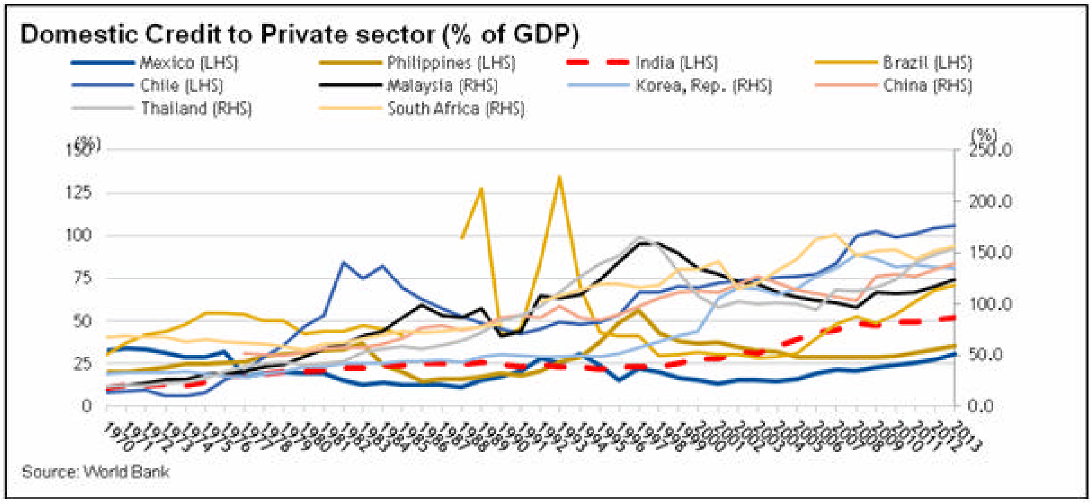
***Limited Empirical Evidence That BCD Nexus 'Kick-started' Bond market Anywhere***

It is possible to envisage a scenario where the basic corporate bond market is reasonably developed and has a certain critical mass. Subsequently if such a bond market is allowed to interconnect with currency and derivatives market then the volume of bond trading may go up in the secondary market improving liquidity and facilitating market price discovery.




( #Domestic credit to private sector refers to financial resources provided to the private sector by financial corporations, such as through loans, purchases of nonequity securities, and trade credits and other accounts receivable, that establish a claim for repayment.)

Globally, the period post 70s observed the coming of age of the options/derivatives market. Around the same time, the foreign currency markets were also becoming more market driven as opposed to government/regulator driven.



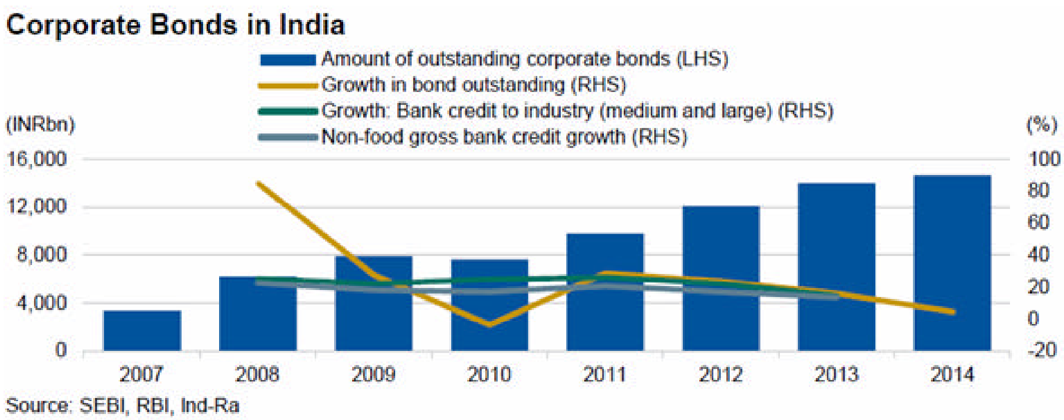

Most of these markets had robust derivatives and currency markets in 1980s and subscribers to the BCD nexus hypothesis can reasonably attribute the robust growth of the respective bond markets to the interplay between currency and derivatives market.

However, it may be worthwhile to note that the period from 1980 to 2008 also evidenced a global secular bull run in most asset classes supported by low interest rate and abundant global liquidity. So there may be more than one possible explanation for the surge in bond market of these nations other than just BCD Nexus.

What should be noted is that globally the most advanced bond markets exhibited a level of development even prior to 1980s which India is unable to achieve even today3. Clearly, one may need to look at other factors existent in those markets in the decade of 70s and 80s, which even now the Indian markets may be lacking.

**Bank Disintermediation Behind Uptick of Indian Bond Market**

Post 2010 there has been some improvement in the Indian bond market. But it was driven by the most common reason, across jurisdictions and time periods, of why bonds are issued : which is dis-intermediation of banks. The Reserve Bank of India (RBI) introduced base-rate in July 2010.




AAA rated issuers (often quasi-Sovereigns) and AA rated issuers who typically have negligible default rate tapped capital markets because they were able to get funding below the base rate of banks and banks could no longer lend them below their base rate.

This trend of disintermediation has continued till recently. Even now while the market driven interest rate has fallen in response to RBI rate cut , the base rate of most banks has not been commensurately adjusted downward. Thus one continues to see a flurry of bond issuances from high investment grade issuers. However, the depth of the bond market may not have improved since one does not come across many bond issuances in A or BBB rating category.

***Three Proposals to Improve Bond Markets in India***

While most of the recommendations by various committees and fora have been quite comprehensive, the author feels a lot more focus could have been given on strengthening and developing the building blocks of the bond market. These three proposals would go a long way in facilitating bank disintermediation. Besides, the level of complexity in implementing them is much lower as compared to formulating bankruptcy code or rationalising stamp duty across states. Thus they may be implemented immediately while one waits for bankruptcy code and stamp duty rationalisation.

**1) Non-Bank Investors Must Have Access to All Recovery Tools:** Surprisingly, the recommendation to allow all institutional investors uniform access to all recovery tools currently available is only heard in last three-four years. SARFAESI Act (Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest) arguably the best recovery tool available to Indian lenders is available only to Banks, Housing Finance Companies (HFC) and only recently to NBFC (with assets above INR500 crore).

Access to SARFAESI tends to reduce the loss-given –default of the lender. Institutional investors such as Mutual Funds, Pensions Funds, Insurance companies who do not have access to SARFAESI would experience higher loss given default. While pricing a bond these non-bank entities may tend to price the bond higher than what a bank will price the loan for the same borrower.

This makes MF and other non-bank entities unattractive to corporate issuers whose credit rating is at "A" category or below. Thus MF tend to restrict themselves to high investment grade companies where the historical default rate is all but zero thus far in India.

Additionally, it may be unfair to expect regulators of pension funds and insurance funds to allow these entities to invest in debt securities lower than AA without giving them the access to recovery tools which are at par with the banks. Thus all institutional invest must be allowed to use SARFAESI Act.

**2)Information Asymmetry Benefit to Bank Borrowers:** For both bank loans and private placements, performance-related information is typically not made public. As of today, the debt servicing status of a listed borrower comes to the knowledge of investors rather irregularly, only from annual reports or irregularly from media reports.
In the event, the borrower is a listed entity, information about its default is likely to affect its stock price. Thus there is a strong motivation for the borrower to enter into debt transactions with lender counterparties which do not disclose this information. For weaker corporates, this may be an added motivation to continue with bank lending or private placements.

Steps taken to enhance information dissemination and thereby reduce information asymmetry with respect to such transactions may have positive implications for bond market development. They are:

- If a listed debt issuer knows the performance information would be shared actively with the market whether it borrows from bank or privately places a bond, then the borrower would focus on the most cost-effective source of raising debt.
- The prospect of prompt dissemination of negative performance information to market could improve payment discipline as well as make corporates rethink on debt-fuelled aggressive growth strategies in some cases.

**3)Disclosure of Aggregate Loan Pricing Information from RBI:** Lack of depth of CBM has created a chicken and egg problem with respect to the price discovery Corporate bonds. As such rating and maturity spectrum are not regularly available. This circular reference where lack of pricing information leads to lack of issuance of new bonds at lower rating level which in turn feeds into the problem of no bond being available for trading to generate the credit spread and the yield curve. This may partially be addressed by creating a **proxy credit spread benchmark.**

In terms of asset size, a huge portion of bank loans are already rated by CRAs. RBI, along with monthly statistics, should endeavour to publish loan pricing data by rating level and maturity. This would provide a more relevant pricing benchmark for the pricing of corporate bonds. Understandably, this will come at a lag but compared with almost no meaningful pricing benchmark available, this will be a significant progress. This will go a long way in addressing weakness in the secondary market.

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