Improving Regulation for the Corporate Bond Market in India

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1. Overview of Corporate Bond market

The topic of development of India's corporate bond market has now turned a bit old but is of high relevance as it still has a long way to go. The corporate bond market is worth $287 billion, ~14% of India's GDP, way lower than the equity market of ~80% of GDP. The corporate bond market in India needs to be developed further to cater to the requirements of infrastructure and other key sectors of the economy.

Even today, Indian corporates are heavily reliant on bank loans to meet their funding requirements for capex. The traditional funding sources including retail monies, retiral funds and insurance companies can add significant value to the corporate requirements. Compared to our Govt. Securities Market, corporate bond market has still a distance to go. The economic growth of 8% (to be sustained at similar levels) cannot be achieved without a robust corporate capex cycle.

Dr R.H Patil's report on Corporate Bonds and Securitization in December 2005 was an important step in relation to the development of debt market in India. There have been a number of reports by expert Committees on development of corporate bond markets in India, including the latest one released by the working group headed by RBI ex deputy governor H. R Khan in August 2016. Some of the recommendations of various past committees have been implemented by the govt and other regulatory bodies, while the recommendations of the Khan committee are yet to be implemented.

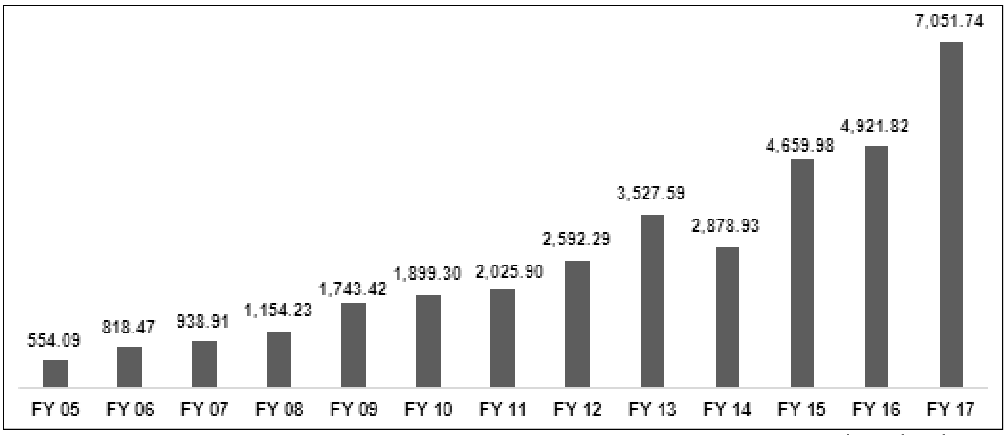
The corporate bond market has been growing steadily over the past few years, although major part of the volumes is still concentrated in quasi-sovereign and high rated papers. Issuance of unsecured and low rated instruments is the hallmark of a developed corporate bond market. The Indian corporate bond market is trapped in a vicious circle, where majority of the investors are chasing few good names (majority of them being AAA or AA+ rated entities). Some part of it may be attributed to the respective regulatory requirements. As a result, the real corporate bond (manufacturing/services sectors) issuances constitute only a small portion of the total issuances. While it is true that the Indian corporate debt market has transformed itself into a much more vibrant trading field for debt instruments from the elementary market that it was about a decade ago, several areas like liquidity in secondary market, bringing new names in both the issuer and investor category and creating a more hospitable market for papers rated AA or below are yet to be developed.

2. Market structure

The issuances in the corporate bond segment have grown many folds during the last decade. However, the issuances are dominated by high rated, financial institutions & Quasi-Sovereign instruments, maturity upto five years and on private placement basis.

Private placements constitute more than 90% of the total issuance, clearly indicating a low participation of retail investors.

Chart 1: Year-wise market volume of corporate bonds (Rs crores)



Source: Prime database

In regard to equity funding, corporate entities invariably prefer the public issue route and have been servicing retail investors even when their numbers are very large. But when it comes to debt finance, the same corporates have shied away from the hassles of servicing large number of investors as they find it highly convenient to meet their requirements of debt finance by relying on a limited number of lenders that provide both short term as well long term funds. A few reasons would be as under:

- Faster turnaround time due to fewer disclosures and regulatory requirements,
- Lower costs. Additional costs are involved in public issue in the form of marketing & printing expenses, distribution cost, etc. As a ball park figure, public issuance entails about 1-2% additional cost.
- Few of the corporate actions require approval from the majority debenture holders (say 51%). The process is cumbersome and time-consuming in case of publicly placed bonds.
- Lesser operational hassle in private placements, namely: record keeping, servicing of dues, etc.

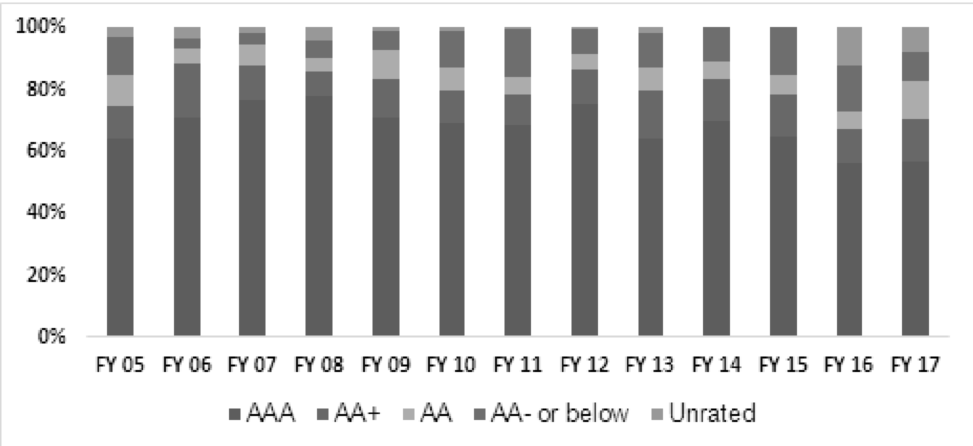
Rating distribution:

More than 80% of the issuances are concentrated around AAA and AA+ entities. The regulators have mandated a minimum rating criteria for investments, especially for retiral funds and insurance companies.

Investors in the corporate bond instruments are highly credit-safety conscious. Practically the demand for issuers rated A+ or below is hardly witnessed.

Regulatory restrictions: Retiral Funds and Insurance companies are amongst the largest investors in these bonds. However they are constrained by their respective regulators. PF & Retiral funds can invest only in AA or above debt instruments (unless backed by CDS). Firstly, insurance companies, as per IRDA norms, need to invest 75% of the corpus in AAA rated bonds. Secondly, the insurance companies cannot invest in corporate bonds below AA (unless approved by the Board).

Chart 2: Rating-wise issuances of corporate bonds (share in %)

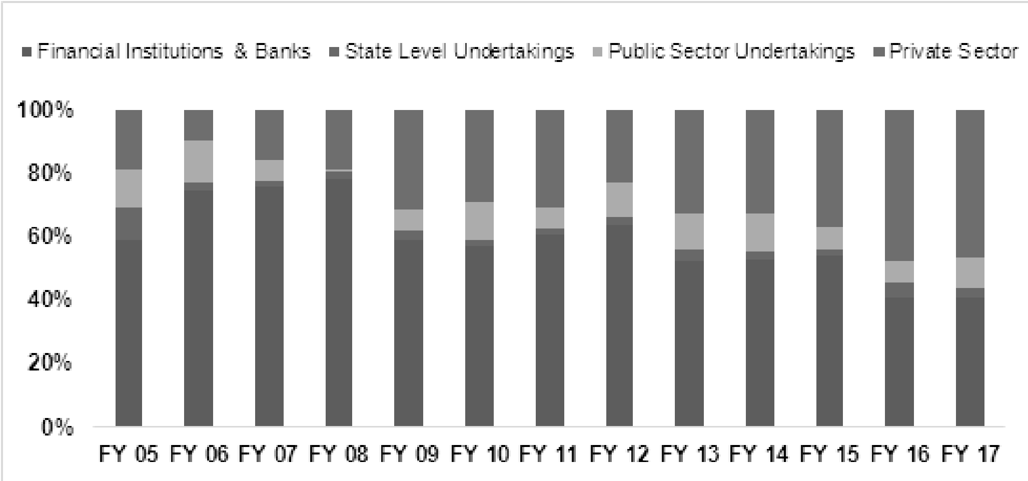


Source: Prime database

Issuer type & tenor:

Liquidity in the secondary market is mostly concentrated around AAA and AA+, that too of the regular issuers. Hence, the incentive to hold a longer tenor comparatively illiquid paper is limited to major investor segments like MF, FII, Banks, etc. Investors don't find exit for high duration papers. Hence they prefer to invest in shorter tenor and roll it over if the interest rate scenarios are favorable. Majority of the issuances are concentrated in the shorter maturity, say 2-5 years tenor.

Chart: Issuer type-wise bond issuances (share in %)



Source: Prime database

3. Initiatives by the Regulators

The market regulators have been taking steps to aid the development of the corporate bond market. Some of the recent steps are mentioned below:

(i) A portion of borrowings through debt market

RBI has laid down that a corporate having bank borrowings above Rs 25,000 as on 31st March 2017 (This limit will progressively reduce to Rs.15,000 crore starting FY19 and Rs.10,000 crore from the start of FY20), can raise 50% of its incremental borrowing from banks and the remaining has to be raised through the debt market.

(ii) Introduction of electronic bidding platform

According to SEBI circular dated April 21, 2016, “Electronic book mechanism for issuance of debt securities on private placement basis “, an electronic book mechanism would be mandatory for any issue of debt securities on private placement basis of Rs 500 Cr (inclusive of the green shoe option) or above in a financial year. The electronic book mechanism shall be provided by recognized stock exchanges (Electronic Book Provider (EBP)).

In case, the issuer comes with multiple issues in a financial year which are individually less than Rs. 500 crore but the aggregate issue size in the same year crosses Rs.500 crore, the issuer shall use EBP mechanism for any incremental private placement which takes aggregate issue size in the year equal to Rs.500 crore or above. The requirement of using electronic book mechanism shall also be applicable for those tranche issue(s) which individually may be less than Rs 500 crore, however is/ are part of a shelf offer, which including green shoe option, is more than Rs 500 crore in a financial year.

The use of electronic book mechanism has been made optional for: (a) issues of debt securities which are below Rs.500 crore in a financial year (b) issues which have a single investor and where the coupon rates are fixed. Arrangers acting as underwriters shall not be considered as single investors in these cases.

For all issues below Rs.500 crore, issuer shall disclose the coupon, yield, amount raised, number of investors and category of investors to the Electronic Book Provider and/ or to the information repository for corporate debt market as notified by SEBI, in the format as specified. Also, the EBP shall upload the allotment data on its website to be made available to the public.

The participants in this mechanism, along with the issuer, can be: (a) Arranger, if any appointed by the issuer (b) sub arranger, appointed by the arranger (c) Institutional investors. Only the institutional investors are allowed to enter the bids directly, all other investors through arrangers or sub-arrangers.

According to SEBI, this would streamline procedures for issuance of debt securities on private placement basis and enhance transparency in price discovery.

(iii) Re-issuance

According to SEBI circular dated June 30, 2017, “Specifications related to International Securities Identification Number (ISINs) for debt securities issued under the SEBI (Issue and Listing of Debt Securities) Regulations, 2008”, a maximum number of 17 International Securities Identification Numbers (ISINs) maturing in any financial year shall be allowed. The objective is to increase the float in the corporate debt market, thus enhancing its liquidity.

As per the circular, out of 17 ISINs maturing in a financial year, the bifurcation of ISINs shall be as (a) A maximum of 12 ISINs maturing per financial year shall be allowed only for plain vanilla debt securities. Further, within these 12 ISINs, the issuer can issue both secured and unsecured debt securities (b) maximum of 5 ISINs (i.e. for structured debt securities such as debt securities with call and/or put option, etc.) maturing per financial year shall be allowed only for structured products/market linked debt securities.

However, an issuer issuing only structured/market linked debt securities, may utilize the entire bucket of 12 ISINs in a financial year only for structured/market linked debt securities. The additional 5 ISINs shall not be available to an issuer for utilization, either for structured debt securities or for plain vanilla debt securities.

The exemptions from applicability of ISINs are:

- Tier II bonds issued by Housing Finance Companies and standalone Primary dealers with minimum maturity of five years,
- Subordinated debt issued by insurance companies, which is either perpetual or the maturity period of which is not less than ten years for life, general and reinsurance companies and seven years for health insurance companies
- Additional Tier 1 bonds, Tier II bonds, and Bonds issued by banks to raise resources for lending to long term infrastructure sub-sectors and affordable housing
- Perpetual debt instrument issued by Systemically Important Non-Deposit taking NBFC
- Tier II bonds issued by Non-Systemically Important Non-Deposit taking NBFC

(iv) Partial Credit Enhancement

In order to boost infrastructure / project financing needs, RBI has allowed banks to offer partial credit enhancement (PCE) to project companies (rated BBB or above) in the form of a non-funded irrevocable contingent line of credit upto 50% (20% cap on an individual bank) of the bond issue size. The PCE would help upgrade the rating of the issuer by multiple notches, which would not only enable lower interest rates but also widen the investor base.

(v) FPI investments

FPIs are now allowed to invest in (1) Unlisted bonds of infra companies (2) Pass Through Certificates (PTCs).

(vi) Investments by Insurance Companies in Basel III compliant Perpetual Bonds

Based on certain criteria fulfilled by Banks, the Insurance Regulatory and Development Authority of India (IRDAI) has allowed insurance companies to invest in Additional Tier 1 (Basel III compliant) perpetual bonds. The investment criteria includes (1) the rating of the AT1 bonds should not be less than 'AA' (2) the aggregate value of the AT1 bonds held in any particular bank by an Insurance company cannot exceed 10 per cent of the total outstanding AT1 bonds at any time (3) banks should have declared dividends for preceding two years.

(vii) Masala bonds

Regulators have allowed companies and banks to issue offshore INR denominated bonds, opening a new avenue for fund raising. This doesn't entail any form of currency risk to the Issuer. Recent Key Changes in the Masala Bond Regulations include:

- **Form of borrowing:** Any proposal of borrowing by eligible Indian entities for issuance of these bonds will be examined at Foreign Exchange Department, Central Office, Mumbai and such request should be forwarded through AD bank only. Issuance of Rupee denominated bonds overseas will be within the aggregate limit of INR 2443.23 billion for foreign investment in corporate debt.
- **Minimum Maturity:** Minimum original maturity period for Rupee denominated bonds raised up to USD 50 million equivalent in INR per financial year should be 3 years and for bonds raised above USD 50 million equivalent in INR per financial year should be 5 years.
- **All-in-Cost:** The all-in-cost ceiling for such bonds will be 300 basis points over the prevailing yield of the Government of India securities of corresponding maturity.
- **Investors:** Related party within the meaning as given in Ind-AS 24 cannot subscribe or invest in or purchase such bonds. Indian banks, subject to applicable prudential norms, can act as arranger and underwriter. In case of an Indian bank underwriting an issue, its holding cannot be more than 5 per cent of the issue size after 6 months of issue. However, underwriting by overseas branches/subsidiaries of Indian banks for issuances by Indian banks will not be allowed.

4. Recommendations

Although the corporate bond market has developed multifold in the last decade based on numerous steps taken by the regulators and market participants, the market is still at a nascent stage. The Khan Committee report released in August 2016 listed a few recommendations to further strengthen and develop the corporate bond market covering the supply side and demand side issues as well as the secondary market features like instruments, market infrastructure, liquidity etc. The following areas need to be focused to speed up the market activities.

Improve participation of retail investors:
Majority of retail investors park their money in fixed deposits of banks. Generally retail investors are risk averse and perceive banks to be safe entities. Retail investors may be given tax benefits on their investments. The capital gains tax on bonds may be aligned in line with equity, i.e. short term can be taxed (equity is taxed at 15%), while long term can be exempted.

Participation of FIIs in longer tenors may be improved:
Currently they prefer to invest in AAA rated securities mostly in 3-5 year segment. To develop the long term financing needs of the corporates, especially those which are low rated, FIIs need to be enticed. Tax rates on long term investments (>=5 years) by FIIs (especially by SWF and retiral Funds) may be relaxed; kept at 3% for AA+ & above and fully waivered for AA and below rated securities.

Relaxation in Regulations:
Insurance: IRDA allows insurance companies to invest in debt only upto 10% of net worth plus outstanding debentures of the investee company. Outstanding loans may be allowed to be added along with net worth and debentures. IRDA currently requires insurance companies to invest in central and state government securities: 50% of total investments for life insurers and 30% for general insurers that may be reduced to 40% and 25% respectively.

Retiral Funds: Below AA rated bonds may be allowed without CDS (For sectors like infrastructure)

Market Making:
Due to illiquidity in the corporate bond market, only buy and hold type investors (i.e. insurance and retiral Funds) invest in long term tenor, others like MF and bank treasuries mostly invest in tenor up to 5 years. So a liquidity-provider is needed in the market who can give two-way quotes. The merchant bankers may be made market makers (like Primary Dealers) and capital relaxation may be given for the market making portion. E.g. currently AAA attracts a 20% risk weight, which may be waived/reduced.

Prepare a centralized database:
A centralized database for corporate bonds (including but not limited to issue information, financial information, promoter information, etc) – for both primary and secondary transactions should be created. It would act as guidance for the issuers and investors and improve transparency in the market, which eventually can lead to deepening of the market.

Indices and Yield Curves:
Unlike G-sec, there is no corporate bond yield curve and hence it is difficult to price papers rated AA or below. Although FIMMDA publishes the credit spread for each rating class and issuer class, there is no study to test these spreads in the market. There are many different types of corporates/institutions in the same rating grade.

Single or multiple indices can be created and bonds of similar maturity or rating can be grouped together to allow investors to gauge the performance of bonds.

FBIL (Financial Benchmark India Pvt Ltd) may publish:

- Yield curves for corporate bonds in each rating grade for uniform valuation
- Bond indices which can be used as benchmark (e.g. SENSEX for equity)

Development of corporate bond repo market:
Repo in corporate bonds will resolve the short term funding issues for the investors. Currently market repo in Gsec takes place on the CROMS platform. Absence of electronic platform is a major issue. NSE is working on building an electronic platform for repo trades with corporate bonds. We have seen only a few corporate bond repo deals till date. The regulator (RBI itself) is contemplating allowing market participants to do corporate bond repo transactions with RBI. However, to implement this a suitable amendment in the RBI Act is required.

5. Looking ahead

The development of India's corporate bond market is still lagging behind other developed as well as emerging economies. Numerous discussions, committees, forums and initiatives from the government and regulators have helped the market to come to stage where it is today. Even today, the domestic corporate debt market suffers from deficiencies in products, participants and institutional framework.

The biggest issue of crowding of debt markets by government securities cannot be addressed by market participants and regulators alone. Fiscal prudence in terms of management of public debt and cash could result in a reduction in the debt requirements of the government, which in turn would provide more market space and improve demand for corporate debt securities.

Future development of corporate bonds is likely to be a gradual process as experienced in other countries. It is important to understand whether the regulators have sufficient willingness to shift away from a loan-driven bank-dependent economy and also whether the corporates themselves have strong incentives to help develop a deep bond market. Banks will play a major role in shaping up the debt market as they provide over 50% of the funding needs of corporates today mainly through loans. Only a conjunction of the market players, regulators and corporates can pave the path for the systematic development of a well-functioning corporate debt market in India.