How to add some mojo into the Indian Corporate Bond Market

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At a time when Indian Public Sector Banks (PSBs) are struggling, the corporate bond market should be picking up some of the slack. Despite various initiatives over the last two decades, the Indian corporate bond market remains small, with minimal impact in financing.

Development of the corporate bond market is an important policy goal to meet the financing requirement of a multi-trillion dollar economy. India's public debt to GDP is about 70%. In contrast, corporate debt to GDP is only about 17%, which is small particularly when compared to other emerging markets like Brazil (99%), South Korea (77%) and Malaysia (44%). The supply of corporate bonds was about 29 Lakh Crores at the end of FY 2018-19. It is expected to double in the next 4-5 years, but it could do more than that if demand were deeper. More than 50% of the issuance is by financial companies and a significant portion of bonds are held to maturity.

The demand base for corporate bonds remains mostly institutional with retail investors accounting for a mere 3% of issuance. Institutions buying corporate bonds are mostly insurance companies and mutual funds. Both by regulation and by prudence, insurance companies restrict themselves to the top of the credit curve in terms of corporate bonds. Insurance companies prefer the explicit or implicit sovereign guarantee in their portfolios. They typically buy corporate bonds that are AA rated or better. Mutual funds tend to buy short-term paper and/or privately placed paper. In the wake of the IL&FS crisis from October 2018, mutual funds have been shell-shocked into becoming more conservative in their approach. All this means that the already tight demand market got a bit tighter for corporate bonds. Longer duration paper, particularly that rated A or lower has extremely limited demand. In the absence of domestic pools, Foreign Portfolio Investors (FPIs) have been incentivized to buy corporate paper and they have done so. However, Emerging Market Debt is not yet a widely accepted asset class for global investors. The high-yield global trade in emerging market paper waxes and wanes in intensity thereby causing significant variations in demand.

On the supply side, costs are high even as liquidity is low. In a low dollar interest rate environment, large corporates can and do raise money from abroad. Even adjusted for hedging, the costs to these sophisticated borrowers is often lower than the rupee cost of borrowing. The external borrowing market also offers greater flexibility in tenure and terms of financing.

If there are issues with supply and demand, there have historically also been issues with the plumbing of matching supply with demand. Technical concerns with ISIN numbers (identifiers), settlement systems and non-uniform stamp duties have plagued the market. There are two major "matching" problems that need to be tackled. One is the lack of a market-making mechanism for corporate bonds. While this has been allowed under SEBI regulation, exchanges have not operationalized market-making thus perpetuating a low-level equilibrium in corporate bond liquidity. In addition, the market for credit default swaps (CDS) has been dead-on-arrival and has been lacking a catalyst for the last decade.

So, what should be done?

The real nub of the issue is that corporate bonds are not "owned" by any single regulator. SEBI, RBI and the exchanges are all responsible for pieces of the puzzle, but no single organization is in charge. The most important action therefore is that one of the regulators should be made in charge of corporate bonds and be held accountable for its development. The lackadaisical approach that the Ministry of Finance has hitherto taken to pushing corporate bond development must give way to urgency – "mission mode" to use a popular phrase with the incumbent government. Only when an accountable corporate bond "tzar" is appointed will things begin to move.

Another important idea is to accelerate the setting up of pension systems in India. Until India develops its own long-term pools of capital (insurance companies are currently the only real long-term investors in debt), the local demand side for long-term corporate debt will be remain limited. Pension reform undertaken at the same time as a prudent expansion to the credit basket of the EPFO and insurance companies can add a meaningful demand element to the corporate bond market. As demand increases, supply will increase to meet that demand.

Many of the technical ideas to "fix" the corporate bond market are already in public domain. These ideas have come from the market and have generally been incorporated in the many committees that have delved into the issue – the latest being the H.R. Khan committee in 2016. None of these committees take on the single regulator or the pension pool ideas I mention above. They have generally preferred to focus on the mechanics of the market. I summarize below the most important technical initiatives that need to undertaken:

Market Making for Corporate Bonds: Even though SEBI regulations permit market-making for corporate bonds, exchanges have not moved to operationalize this. Market making will enhance both comfort and liquidity for market participants.

PSB Interest in Corporate Bonds: Currently PSBs do not hold corporate bonds in their treasury portfolios because of a lop-sided incentive, a loss or default on a bond held could invite investigation from authorities. So, they prefer to hold loans in the HTM portfolios where the default process is very gradual. Unless these incentives change, the largest pool of current capital will not invest in corporate bonds.

Credit Default Swaps (CDS): The CDS market has been put on ice after the 2008 financial crisis. With appropriate safeguards and regulations, CDS markets must be reintroduced and liquefied in India.

Tri-Party Repos: Finance Minister Nirmala Seetharaman's 2019 budget refers to the desire to deepen the tri-partite repo market for corporate debt securities. The NSE and BSE already operate electronic platforms for repos. If the repo securities can be extended as suggested to AA or even single A securities, this will add fillip to market liquidity.

Credit Enhancement Guarantee: The government announced a CEG scheme in 2016. Some initial steps were taken, and it finds mention again in the latest budget. Once again, urgency and completion are needed.

Reforming Stamp Duty: The Stamp Duty Act dates back to 1899 and is hopelessly outdated in dealing with modern instruments. The Government has proposed a uniform stamp duty act that will rationalize and standardize the rate across states. Hitherto states have been reluctant to give up their power with respect to Stamp Duty. While it appears difficult that this reform will take place in the context of a disappointing GST intake, the Government and States must at least modernize the act for financial instruments.

Tax Incentives: For a specified period of time, the Government should consider reducing taxes on interest from listed corporate bonds to develop HNI and retail interest in corporate bonds.

The bond markets are usually large, lumbering, technical beasts that take a while to get going, but once they do are difficult to stop. Despite the best of intentions, India's corporate bond market has remained small and ineffective. If concerted action is taken at the same time, there is no reason why it cannot catch momentum. A properly functioning corporate bond market is required for India's large infrastructure needs and for it to diversify from a banking system that remains dominated by PSBs.