Ring-fencing the Debt Market against Future Maelstroms

Market making, more transparency, removal of regulatory arbitrage among imperatives

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The Covid-19 pandemic has left the world shaken and stirred. Lives and businesses are largely upended, the global economy is perched precariously at the edge of a cliff, and worry beads are glistening everywhere despite the sharp rebound from March/April lows in most markets.

India is no less under duress. CRISIL sees the Indian economy contracting 5% this fiscal.

However, the domestic debt capital market, an important pillar of economic activity in the country, has endured the crisis well so far, thanks to timely measures mounted by the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI).

The regulators, in lockstep with the central government, have ensured adequate liquidity in the market to curb the expansion of spreads in high-rated debt instruments since March-end, when the pandemic-triggered lockdown started.

Are these measures enough? Does our economy have the ammo to combat such nonpareil events in future? These are some of the questions that arise in the milieu.

It is important that we take lessons from the current crisis and build in safeguards for future.

But first, a look at regulatory steps that have worked.

Regulatory response and impact

The banking system has had surplus liquidity since the beginning of 2020. That notwithstanding, the RBI announced the first set of crucial measures on cash reserve ratio (CRR) and targeted long-term repo operations (TLTRO) on March 27. More announcements were made in mid-April and May by the RBI and the central government, respectively (*see Annexure I for details*).

Debt market before the pandemic and after policy measures		
Pre-crisis - Surplus liquidity - Reduction in interest rates for sovereign and liquid corporate debt - Marginal rise in spreads for non-liquid and lower-rated corporate debt	**Policy measures** - Injection of large liquidity through TLTROs, CRR, LAF, etc. - Relaxation/exceptions in reporting for financials, credit rating and valuation process	**Impact of policy measures** - High risk aversion led to parking of liquidity in reverse repo. Investment/ parking through TREPS also up (Annexure II - Chart 1) - Yields eased sharply for risk free securities, high rated/liquid securities (Annexure II - Chart 2) -Spreads for lower rated and illiquid securities spiked, especially post winding up of debt schemes by a large AMC (Annexure II - Chart 3). Exposure to unlisted seurities, which limits transparency, is also a concern for such credit exposures. - TLTRO helped bring stability in issuances volume - Negligible sharp down grades/defaults reported and similarly fewer cases with valuation haircuts in the MF assets.

- **Issuances soar on TLTRO tailwind**

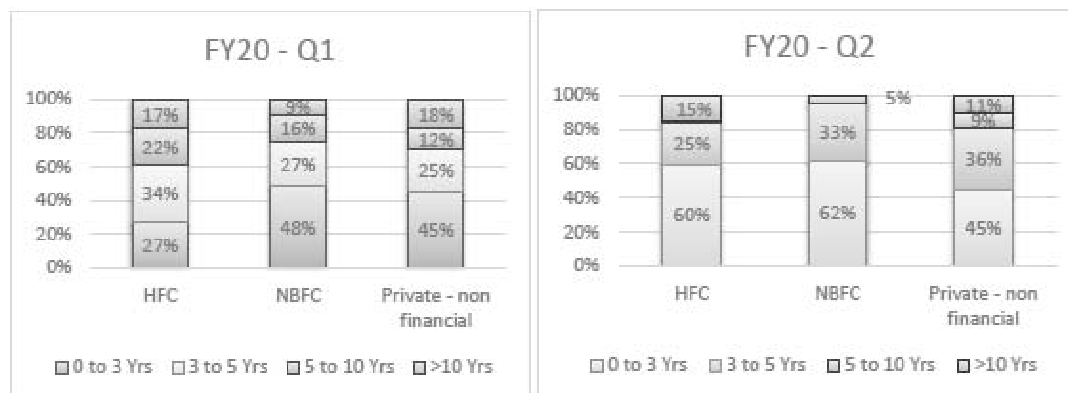
CRISIL estimates close to 40% issuances in the second quarter of 2020, driven by TLTRO

About Rs 2.27 lakh crore and Rs 2.07 lakh crore worth of securities were issued in the first and second quarter of 2020, respectively, as per Prime Database. Most issuances seem to have been driven by the RBI's TLRTO, which created a window of Rs 1.5 lakh crore (Rs 1.12 lakh crore utilised) for maturity of up to three years.

The second quarter reported issuances of close to Rs 80,000 crore for up to three-year maturity (~40% of total issuances in the quarter).

The following table suggests almost all sectors observed are tilted towards up to three-year maturity, which would also mean they benefitted directly or indirectly from TLTRO liquidity.

Issuances skewed towards up to 3 year segment



Yield variations indicate pricing policy arbitrage between market participants

In normal market conditions, yields in primary and secondary markets do not vary significantly, especially for higher-rated and regular borrowers. Differences, if any, are generally on account of illiquidity for large-quantity trades.

For issuances made during the pandemic period, however, the deviation in yields has been much higher in many cases.

CRISIL analysed trades in the secondary market three days prior and post such primaries on the electronic bidding platform issuance dates. It was noticed that in case of many large issuances, primary yields were lower than for secondary – in a few cases the difference was as much as 200 basis points (bps) with the average being over 25 bps.

The issuances pertained to several sectors, including non-banking financial companies (NBFCs), housing finance companies and corporates, and also a few non-AAA and non-benchmark entities.

Besides surplus funds – and at lower cost – the valuation benchmark may have played an important role for such divergence. To be sure, banks and non-bank entities (mutual funds, insurance companies, pension funds, and corporates) follow different valuation rules and different benchmarks for pricing of debt security, which acts as a threshold for investors' purchase decisions.

Earlier crises were different, as were the policy responses to those

During earlier crises – the Global Financial Crisis (GFC) of 2008 and Taper Tantrum of 2013 – the root cause of the crisis were varied and also it has impacted Indian debt markets in a very different manner. The policy response then was to address each of such impacted areas.

GFC 2008 – Liquidity was one of the most critical concerns. Sell-off by global investors led to short-term rates spiking up quickly and the yield curve getting inverted. Concerns on credit led to widening of spreads. The equity and foreign exchange markets were impacted adversely. Mutual Funds were also impacted due to redemption by corporates. The policy response included reduction of the cash reserve ratio (CRR) from 9% to 5% and reduction in reverse repo, creating liquidity close to Rs 4.9 lakh crore, as well as reduction in statutory liquidity ratio, refinance to EXIM Bank and SIDBI to support the agenda.

Taper tantrum 2013 – Resulted from tapering by the US of quantitative easing (QE) initiated post GFC. This led to a rise in yields in the US and global markets. Outflows to developed markets from emerging markets (EMs) such as India impacted foreign exchange rates. Indian policy makers deployed a multi-pronged regulatory response, including currency intervention, monetary policy, trade policy and capital flow management measures. Liquidity in short term was tightened by way of a 200 bps hike in the marginal standing facility (MSF) and a hike in CRR, and eased for the long term by TWIST (buying long-term and selling short-term G-secs), thus inducing an inverted yield curve.

In the context, imperatives for future

Four key takeaways emerge from developments during the current pandemic:

First, the need for market making to support outright buy/sell and not lending. TLTRO 1 helped as it allowed investment in higher-rated instruments. However, TLTRO 2 did not get adequate response since banks did not have the appetite for lower-rated instruments. Also, the special lending window for mutual funds got lukewarm response.

Clearly, banks can play the important role of a conduit for higher-rated and blue chip securities, but not so for lower-rated and illiquid instruments. In times of trouble, asset management companies lean on outright sale of securities and not lending for quick liquidity.

Hence, market makers are critical for corporate debt. Also, in exceptional circumstances, the RBI can develop a framework for buying corporate debt securities directly.

Second, the need to remove regulatory arbitrage in pricing. Difference in yields in the primary market indicates regulatory arbitrage among entities regulated by different regulators. Risk-based pricing for debt securities, which involves pricing for risk-free plus spreads for credit, illiquidity and other technical factors, should not vary much.

Additionally, primary and secondary market levels cannot differ a whole lot for market-specific factors. These distortions impact market behaviour of firms in terms of entry and exit decisions.

A uniform approach using fair/ mark-to-market (MTM) valuation can address these concerns. Some have argued that it is not fair to use MTM pricing for held-to-maturity (HTM) portfolios. However, for risk management, MTM is the best indicator of the realisable price of a security and we would urge policy makers to incorporate MTM pricing as part of risk assessment.

Third, more transparency in listing. Transparency is the very essence of a robust market infrastructure. Besides making investment in listed instruments mandatory, it is critical to increasing frequency and extent of disclosures by listed entities.

Hence, additional amendments need to be made to SEBI (Listing Obligations and Disclosure Requirements, or LODR) (Amendment) Regulations 2018. The amendment dated May 9, 2018, amended Clause 33 (3), which requires quarterly disclosure of standalone and consolidated financial results by all listed entities with effect from April 1, 2019.

Additionally, CRISIL recommends disclosure of a summary balance sheet statement for standalone and consolidated results (with either equity or debt instruments listed), and that listed entities should disclose quarter-wise debt separately (including commercial paper, short-term and long term maturing over the subsequent four quarters).

Such an amendment will ensure better and faster dissemination of information on performance of listed entities, enabling timely rating action. Frequent and comprehensive disclosure on the balance sheet (besides the profit and loss statement) will also improve access to information and quality of analysis for all market participants, including investors and credit rating agencies.

Fourth, regularising the recent listing relaxations. SEBI has relaxed many rules, including providing more time for issuers to meet regulatory/ filing requirements owing to the pandemic and the ensuing lockdown. Such relaxations, while welcome, must not be perpetuated and should be regularised as soon as practicable.

The SEBI circular dated May 12, which allowed non-disclosure of consolidated financial statements for listed entities from certain segments, needs to be regularised as it risks limiting the information available to investors. This circular allows listed entities that are banking and/or insurance companies, or those with subsidiaries that are banking and/or insurance companies, to provide consolidated financial results on a voluntary basis for the quarter ended June 30, while continuing to submit the standalone financial results.

Further, in May, the finance minister announced as part of the pandemic fiscal package that debt listed companies will be treated akin to unlisted companies for disclosure requirement purposes. This is another proposal that goes against the grain of increased transparency that SEBI has espoused, investors have come to expect, and CRISIL has always championed.

We believe this proposal has implications for investor confidence and interest in debt capital market in the long term, irrespective of its merits in the short term. We recommend this proposal be reconsidered or at least be regularised at the earliest.

Annexure 1 – Key policy measures

<table>
<tr><th>Date</th><th>Announcement</th></tr>
<tr><td>RBI –March 27</td><td>TLTROs: Up to three-year tenure of appropriate size for a total amount of up to Rs 100,000 crore at a floating rate linked to the policy repo rate. Liquidity availed under the scheme by banks has to be deployed in investment-grade corporate bonds, commercial papers (CPs) and non-convertible debentures (NCDs) over and above the outstanding level of their investments in these bonds as on March 27, 2020.

Other measures to infuse liquidity of around Rs 2.74 lakh crore
• Policy repo rate under the liquidity adjustment facility (LAF) cut by 75 bps to 4.40% from 5.15% with immediate effect
• MSF rate and bank rate reduced to 4.65% from 5.40%
• LAF corridor widened as detailed in the accompanying Statement on Developmental and Regulatory Policies; reverse repo rate under the LAF cut by 90 bps to 4.0%</td></tr>
<tr><td>RBI – April 17</td><td>TLTRO 2.0 This window is available at the policy repo rate for tenors up to three years for a total amount of up to Rs 50,000 crore. Funds availed under TLTRO 2.0 shall be deployed in investment grade bonds, CPs and NCDs of NBFCs.

At least 50% of the total funds availed shall be apportioned as given below:
• 10% in securities/instruments issued by micro finance institutions (MFIs)
• 15% in securities/instruments issued by NBFCs with asset size of Rs 500 crore and below
• 25% in securities/instruments issued by NBFCs with assets size between Rs 500 crore and Rs 5,000 crore</td></tr>
<tr><td>RBI – April 27</td><td>Decided to open a special liquidity facility of Rs 50,000 crore for mutual funds.

Under the SLF-MF, the RBI shall conduct repo operations of 90-day tenor at the fixed repo rate. The SLF-MF is on-tap and open-ended, and banks can submit their bids to avail funding on any day from Monday to Friday (excluding holidays).

The scheme was available till May 11 or up to utilisation of the allocated amount, whichever is earlier.

Funds availed under the SLF-MF were to be used by banks exclusively for meeting the liquidity requirements of mutual funds by (1) extending loans, and (2) undertaking outright purchase of and/ or repos against the collateral of investment grade corporate bonds, CPs, debentures and certificates of deposit (CDs) held by mutual funds.</td></tr>
<tr><td>Central government – May 14</td><td>Under the Atmanirbhar Bharat Package, the government has announced measures for NBFCs, HFCs and MFIs. One such measure is to provide liquidity of Rs 30,000 crore to these institutions by investing in investment-grade debt papers of companies. This measure is expected to provide liquidity to mutual fund holdings in these companies. The RBI recently announced details of the package.

Further, the government has announced a Rs 45,000-crore Partial Credit Guarantee Scheme for lower-rated companies. In case there is a loss, the first 20% of the loss will be borne by the Government of India. Companies with credit ratings of AA and below, even the unrated papers, will be eligible.</td></tr>
<tr><td>SEBI – through different circulars</td><td>• Relaxation from compliance with certain provisions of the circulars issued under SEBI (Credit Rating Agencies) Regulations, 1999, due to the pandemic and moratorium permitted by the RBI. It stated, based on its assessment, if the CRA is of the view that the delay in payment of interest/ principle has arisen solely due to the lockdown, creating temporary operational challenges in servicing debt, including due to procedural delays in approval of moratorium on loans by the lending institutions, CRAs may not consider the same as a default event and/or recognise default. Appropriate disclosures in this regard shall be made in the press release.
• Review of the post default curing period for CRAs – After a default is cured and the payments regularised, a CRA shall generally upgrade the rating from default to non-investment grade after 90 days based on the satisfactory performance by the company during this period. CRAs may deviate from the said period on a case-to-case basis, subject to the CRAs framing a detailed policy in this regard. The policy shall also be placed on the CRA's website. Cases of deviations from stipulated 90 days, if any, shall be placed before the ratings sub-committee of the board of the CRA, on a half-yearly basis, along with the rationale for such deviation.
• Relaxation from publishing quarterly consolidated financial results under LODR – This May allowed listed entities that are banking and/or insurance companies or those with subsidiaries that are banking and/or insurance companies to provide consolidated financial results on a voluntarily basis for the quarter ended June 30, 2020, while continuing to submit the standalone financial results.
• Valuations of debt securities held by mutual funds – The circular requires Association of Mutual Funds in India-appointed valuation agencies to assess whether delays in payment of principal or interest or extensions in maturity of a security by an issuer have arisen solely on account of the aforementioned reasons at the time of providing debt and money market valuations to mutual funds. In such cases, the circular states that the valuation agencies may not consider the same as default.</td></tr>
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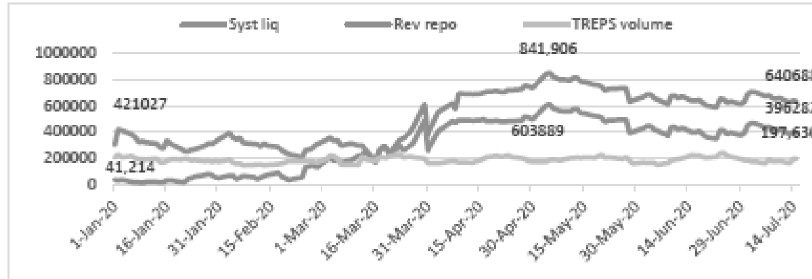
Annexure II

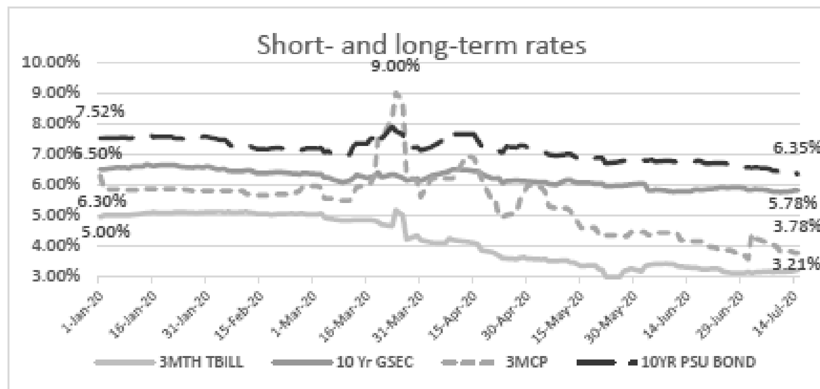
Chart 1 - Liquidity trending up



Source: RBI, CCIL

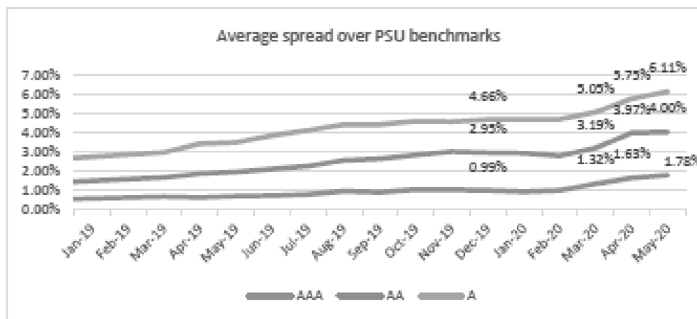
Note: While the RBI reports absorption as a negative number, this chart captures it as positive for better readability.

Chart 2 - Interest rates on the slide for risk free and liquid corporate debt



Source: CRISIL Research

Chart 3 - Spreads widen in lower-rated and non-benchmark securities



Source: CRISIL Research