Corporate Bond Markets in India: A Framework for Further Action[1]

Speaking at this event - in this panel - leaves me with a sense of *déjà vu*. The fact that I spoke about the same issue at the same forum three years back in 2012 – and many other fora earlier – reflects the deep-rooted, inertial nature of underlying factors. At least for more than 10 years now development of corporate bond markets in India has been the focus of all stakeholders but the arduous pursuit of the 'holy grail' has not delivered desired results. In the process this has unfortunately become a convenient stick to flag the policy and regulatory intent. Every set of stakeholders has its own views on what needs to be done but much of the prognosis ends up giving a limited perspective.

2. Maybe it is time to dispassionately understand the big picture and acknowledge ten fundamental facts about the financial ecosystem as it exists today:

(i). Bond markets globally are institutional in nature – that too buy and hold kind of investors;
(ii). A sound bankruptcy regime is a pre-requisite for deep bond markets;
(iii). Development of bond markets needs sustained participation of long-term institutional investors across the credit curve;
(iv). Tax regime for financial instruments remains one of the key drivers of investor interest;
(v). Development of the market mechanisms and infrastructure can at best be an enabling factor – not the driving factor;
(vi). Fiscal consolidation leading to lower sovereign borrowings can enhance the demand for corporate bonds;
(vii). High indebtedness of major corporates both from domestic and external sources is not conducive for issuance of corporate bonds;
(viii). The centrality of banks in the financial system is a given at our stage of economic development. The corporate debt market, therefore, cannot play a predominant role in financing in the near future;
(ix). Predominant reliance on the banking system to support development of corporate bond market, directly or indirectly, militates against the very idea of the bond market de-risking the banking sector; and
(x). The corporate debt market cannot be looked as totally detached from the sovereign bond market. Corporate bond market may get a fillip as the interest rates come down and the fiscal deficit targets are achieved. The play on spreads across the credit curve will become more attractive.

[1] Remarks by Shri Harun R. Khan, Deputy Governor, Reserve Bank of India at FICCI CAPAM -2015 at Mumbai on October 27, 2015. The speaker acknowledges the contributions of Shri Vaibhav Chaturvedi and Shri Vivek Singh of the Reserve Bank of India

3. Alongwith recognizing the hard facts comes the realization that there are not many low hanging fruits remaining to be plucked – work forward is contingent on multifarious factors and some hard policy choices.

4. There have been a number of reports on the corporate bond markets, *viz.,* R. H. Patil Committee report (December 2005), Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre in 2007 (Percy Mistry Committee) and A Hundred Small Steps [Report of the Committee on Financial Sector Reforms (CFSR)] in 2009 (Raghuram Rajan Committee), Reports of the City of London, which have examined in detail various aspects related to the development of corporate bond market and have made useful recommendations. It has been recently decided by the Financial Stability and Development Council (FSDC) and its Sub-Committee that the issue needs to be looked into its entirety. An inter-regulatory group has already started work in this direction. The focus of this group will be to distill key actionable recommendations made by all earlier committees and suggest a time bound plan for implementation of the same.

Measures taken to develop the corporate debt market

5. Taking into account the recommendations made by various expert committees, several measures have been taken by the Government of India, the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI) for the development of corporate debt market in India. The success of these measures in achieving the intended outcomes has, however, been varied. Impact of some of the measures taken is captured below:

Intended outcomes mostly achieved	Intended outcomes partially achieved/ too early to say	Intended outcomes not achieved
• Setting up of reporting platform for post-trade transparency • Introduction of DvP in settlement of OTC trades in corporate bonds to eliminate settlement risk • Issue of long-term bonds by banks allowed with a minimum maturity of seven years to raise resources for lending to (a) long term projects	• Banks and PDs allowed to become members of stock exchanges to trade in corporate bonds • Investment norms for banks and PDs relaxed to facilitate investment in corporate bonds • Final guidelines issued for partial credit enhancements by banks to corporate bonds	• Introduction of Repo in corporate bonds to meet the funding needs • Introduction of Credit Default Swaps to facilitate hedging of credit risk by the holders of corporate bonds Reissuance of bonds permitted by SEBI

Intended outcomes mostly achieved	Intended outcomes partially achieved/ too early to say	Intended outcomes not achieved
in infrastructure sub-sectors, and (b) affordable housing. These bonds have been exempted from computation of net demand and time liabilities (NDTL) and are therefore not been subjected to CRR/SLR requirements • The investment limit for Foreign Portfolio Investors (FPI) has been increased to USD 51 billion during the last few years. Limit allocation methodology have been rationalized and withholding tax rate has been reduced from 20% to 5% • FPIs have been permitted to invest only in corporate debts of at least 3 years of residual maturity • International financial institutions like IFC were permitted to float a rupee linked bond overseas to deepen the off-shore rupee bond market so that IFC and other investors can raise rupees to invest in India. This has facilitated development of benchmark yield for long term corporate bonds • SEBI has allowed setting up of dedicated debt segment on the exchanges	• Measures taken to encourage investor interest/participation in the corporate bond market in terms of liberalizing the listing requirements; simplification in procedures and processes, simplified disclosure norms and standardisation of market conventions • Rationalisation of FPI regulations has been put in place for easier registration process and operating framework for overseas entities seeking to invest in Indian capital markets	

6. The measures taken by the Reserve Bank of India, SEBI and the Government have resulted in considerable increase in issuance as well as secondary market trading of corporate bonds. Total corporate bond issuance has increased by around 155% from

₹ 2709.46 billion in 2010-11 to ₹ 4,789.62 billion in 2014-15. Similarly, the number of issuances increased by almost 77% from 4,280 in 2010-11 to 10,941 in 2014-15 (Table 1).

Table 1: Issues and Total outstanding Corporate Debt

(amount in Rupee billion)

Financial Year	Issuance details		% change in issuance	Net outstanding (As at end-March)	No. of outstanding instruments	% change in outstanding amount
	No. of issues	Amount				
2010-11	4,280	2,709.46		8,895.09	12,155	
2011-12	5,565	3,100.69	14.44	10,516.38	13,721	18.23
2012-13	5,578	3,880.25	25.14	12,901.46	15,874	22.68
2013-14	4,911	3,881.51	0.03	14,673.96	13,104	13.74
2014-15	10,941	4,789.62	23.40	17,503.20	19,439	19.28
2015-16 (up to Sept 2015)	4,358	1,442.48	69.88	18,660.59	21035	6.61

Source: Securities and Exchange Board of India

7. In comparison to other economies, the size of the bond market in India, however, remains moderate as a percentage of GDP (Table 2)

Table 2: Size of the local currency corporate bond market in other Asian economies

(as a % of GDP)

	Q2 2014	Q2 2015
China	17.8	18.8
Hong Kong	29.3	29
Indonesia	2.2	2.2
South Korea	74	76.4
Malaysia	41.3	41.5
Philippines	5.6	5.8
Singapore	30.6	32.4
Thailand	16.7	17.4
Japan	16.9	16.2

{Source: Asia Bond Monitor, Sept 2015}

8. It, however, needs to be noted that the development of a corporate bond market in India has lagged behind in comparison with other financial market segments due to certain structural issues. Some of these issues include:

- The corporate bond issuance is dominated by private placements as these account for more than 95% of the total issuance of corporate debt (2014-15);
- Issuances are concentrated in the AA or above rating, largely by public sector entities and financial institutions
- A majority of the issuances are concentrated in the 2-5 year tenor;

- Limited/narrow investor base. Investment mandates of institutional investors such as insurance companies, pension funds and provident funds do not permit large investment in corporate bonds;
- Reissuance of bonds has not picked up;
- Lack of functional trading platform with CCP facility like NDS-OM (as available in Government securities market) impedes the growth of secondary market;
- Market for credit risk protection instruments like CDS has not yet developed;
- Non-standardized stamp duties on corporate bonds across various states affects issuances.

Way forward

9. Activating the corporate bond market will require a number of regulatory measures to address both the macro issues as well as the market micro-structure issues. While creating an efficient market infrastructure will create conditions for issuers and investors, the structural issues can be addressed over the longer term as the market evolves and the financial system gets more integrated with international markets. It would be convenient to look at the set of issues in a comprehensive manner. I would like to classify some of the possible measures in the '*7I*' framework which I had talked about in one of my earlier speeches.

Issuer

Reissuance of bonds

10. Corporates may be encouraged to re-issue existing bonds under the same ISIN code. This will augment market liquidity and potentially reduce the cost of borrowings. Though SEBI has recently allowed reissuances by the corporates, there has not been any reissue of bonds by any corporate. In order to encourage reissuances, there may be a need for some incentives in the form reduced documentation formalities, less issuance fees, etc.

Issuance of municipal bonds

11. An active corporate bond market would enable market for municipal bonds issued by the Urban Local Bodies (ULBs). The potential for issuing municipal bonds assumes importance in the context of the proposal to set up 100 smart cities. However, the size of the municipal bond market in India is rather limited and is distributed over a few strong municipalities of Ahmadabad, Nasik, Nagpur, etc. The possible reasons could be overlapping jurisdiction on municipal bodies leading to plethora of rules; perceived lack of specialized project management support in ULBs; non-transparent budgeting and

accounting systems in many of the ULBs and limited exit route for investors due to lack of secondary market trading.

12. To address these issues some of the measures which could be considered, are strengthening the governance structure of the municipal issuers by ring fencing the municipal bond funds; providing partial or full guarantee by the Central/ State government; mandating Escrow account for debt servicing of bond proceeds, etc. SEBI has since issued the Regulations for Issue and Listing of Securities by Municipalities.

Investor

Liberalising the investment guidelines for long term players

13. In order to encourage demand, investment norms for regulated entities may be reviewed to facilitate their active participation in corporate debt market. The current investment guidelines for pension and other retirement benefit funds may be reviewed from ownership criteria (public sector / private sector) to ratings based criteria. They may also be permitted to use interest rate swaps, repos and credit default swaps.

Encouraging Retail Participation

14. Participation of retail investors in corporate bonds continues to be limited. In order to increase retail investors' participation in corporate bonds, we need to encourage issuance of zero coupon bonds, provide clarity on taxation issues, include provision of special quota for retail investors in debt issues and provide reduced transactions costs for retail investors.

Intermediaries

Introduction of a market making scheme

15. A market making scheme in corporate bond could potentially improve market liquidity. But market making in an illiquid market is challenging and not many intermediaries will be ready to take on the risks of making two-way quotes. A viable market making scheme may have to be formulated with suitable incentives to encourage market participants to provide two way quotes. Stock exchanges may have to come out with market making scheme in consultation with the regulators. Perhaps the role of debenture trustees in this regard may also need to be explored.

Infrastructure

Efficient trading platforms for corporate bonds

16. NSE has developed a dedicated trading platform for privately placed corporate bonds. There is, however, negligible activity on the trading platform. Although the system provides for DVP-III guaranteed settlement, it is learnt that the system has some issues, viz. high margin, high penalty for default, non-availability of all the issued bonds on the platform, etc. According to some market participants, there is a need for combined settlement for corporate bond repo and outright market under DVP-III mechanism at par with the G-Sec market in order to increase the traders' participation.

17. Stock exchanges could discuss with the market participants and make suitable changes in the existing platform to encourage trading. If required, they may adopt a calibrated approach in the matter and explore introduction of DVP-II settlement in initial stages and then move to DVP-III depending on development of the market.

18. An electronic trading platform similar to the CROMS platform for G-sec has been announced for repo in corporate debt. This needs to be taken forward quickly. Legal framework for recognizing and regulating such platforms may have to be put in place.

Rating Agencies

19. Rating Agencies play an important role by way of providing credit evaluation of the instruments like bonds issued by corporates. Their role came into focus internationally after the Global Financial Crisis and certain principles for reform of the rating agencies had been agreed internationally. In India also, SEBI had come out with certain transparency and disclosure norms for the Credit Rating Agencies ("CRAs") in 2010. CRAs. Based on the experience, the guidelines may need to be reviewed.

Bankruptcy laws

20. A robust and effective bankruptcy regime is essential to development of corporate debt market from investors' point of view. Steps, such as, reforming bankruptcy law, early resolution of bankruptcy cases and streamlining the procedures relating to insolvency would go a long way in achieving the same. The issue of insolvency of financial institutions established under statutes and bi-lateral netting among them during bankruptcy also need resolution. One of the most significant steps in this direction was the setting up of the Bankruptcy Law Reform Committee under Shri T. K. Viswanathan which has just submitted its report. The Committee has come out with the draft legal

framework for resolving matters of insolvency and bankruptcy which, when fully implemented, will have far reaching impact. Early enactment of this proposed legislation and the follow-up action will be a game changer for development of corporate bond markets.

Incentives

Cap on borrowings of corporate from banks for capital purpose

21. Restricting the proportion of borrowings by large corporates from banks and making such corporates use the market mechanism (such as, corporate bonds, commercial papers and other instruments) to meet a part of their short term as well as long term financing needs will help in the development of corporate bonds markets. Reserve Bank has already issued a Discussion Paper on "Large Exposures Framework and Enhancing Credit Supply through Market Mechanism" on March 27, 2015.

Resolving distribution tax related issue for securitization

22. Securitization of the corporate debt instruments would provide a big fillip to the market as it would improve risk transference and diversification and provide liquidity to the issuers. Subjecting income of SPV to tax hampers the growth of securitized debt. Market participants have been demanding that the taxation structure in securitized debt needs to be changed from distribution tax at SPV level to taxation in the hands of investors.

Rationalisation of stamp duty norms

23. In terms of the provisions of entry 91 of Union List, the Central Government has the power to levy stamp duty on issue of debentures. However, some state stamp laws also provide for duty on issue/transfer of debentures. Stamp duty laws need to be rationalised to provide an incentive to issuers and work is already on in this direction.

Use of corporate bonds a collateral

24. Post Global Financial Crisis has seen large scale use of non-sovereign papers as collateral by the central banks for providing liquidity during periods of stress. Similar enabling arrangement in India, subject of course to appropriate haircuts and other safeguards, could be examined. This will enhance the demand for good quality corporate paper.

Instruments

Activating the repo market

25. The reasons cited for lack of interest in corporate bond repo include non-signing of the Global Master Repo Agreement (GMRA), lack of lenders such as mutual funds and insurance companies in repo market, etc. Reserve Bank is engaging with other regulators to address these issues. It is also envisaged to widen the participation base in corporate debt repo by allowing more investors in repo market.

26. Internationally, GMRA is the standard document used by the market participants to undertake repo transactions. In India also, we have adopted the same document. Market participants need to highlight the specific issues in GMRA which need to be addressed.

Kickstarting CDS market

27. Unavailability of credit risk transfer mechanism in the corporate bond market works as a deterrent. Though CDS has been introduced in India, there is no activity in the market. One of the major constraints is restriction on netting of MTM position against the same counterparty for capital adequacy and exposure norms. Without netting, the trades in CDS have become capital intensive as banks and PDs have to provide higher capital charge on gross basis even if they are acting as market makers and having positive and negative position against the same counterparty. Netting has not been allowed due to lack of legal clarity. To provide clarity on the enforceability of netting including close-out netting, suitable amendments to provisions in the RBI Act are being proposed.

28. Regulators are also examining the possibility of allowing more entities to buy/sell protection through CDS. Availability of more number of protection sellers will encourage activity in the CDS market. In this connection, it may be necessary that financially sound insurance companies and other long term investors may be permitted to sell CDS protection subject to prudential norms prescribed by the regulators.

Rated Municipal Securities

29. As discussed earlier, a new asset class may be included for rated municipal securities under the IRDA & PFRDA investment guidelines.

Innovation

Use of banks' PCE facility by corporates

30. Partial credit enhancements (PCE) by banks may give a boost to the corporate bond market in its evolution phase. Taking into account the feedback received, RBI has now issued the final guidelines under which the banks may provide PCE to support (senior) project bonds issued by companies/SPVs, and thereby improve the credit rating of the bond issue making them more attractive to certain specific set of investors, such as the institutional and long term investors. It is expected that issuers will take advantage of the scheme to issue long term bonds.

Bond Index

31. Though indices, such as, Nifty 50 and the BSE Sensex index serve as popular benchmarks for equities, designing debt indices has posed challenges in India as the market lacks breadth and depth. Market participants, however, need a debt index to compare the performance in corporate debt vis-a-vis the performance of different asset classes. More work needs to be done in this area by benchmark and index companies.

Concluding Thoughts

32. A well-developed corporate bond market can truly address some of the travails of the existing bank-based financial system. Development of efficient and robust bond markets is a challenge globally and only a few jurisdictions can claim to have genuine local currency bond markets. Even in those markets, the concerns relating to market illiquidity are increasingly being highlighted. The recent IMF Global Financial Stability Report has discussed these factors at length. While many of the factors may not be of immediate relevance to our market, the experience may hold important lessons as the regulatory regimes and market systems across jurisdictions which are increasingly becoming homogenized. While regulatory changes are likely to have had mixed effects on market liquidity, several structural drivers, such as, concentrated holdings by institutional investors, growth of electronic platforms and high frequency trading, reduced market making, etc. have also played a part.

33. We will have to assess the implications of these factors, including the emerging regulatory regime, on corporate bond market development. While it is recognized that the regulatory regime may need to respond positively to some of the critical issues unless the structural factors mentioned earlier are addressed, it would be difficult to have a deep corporate bond market. Early implementation of the draft bankruptcy code

submitted by the Viswanathan Committee alongwith providing legal certainty to close-out netting for certain transactions would address the two key issues for enabling a credit market. Work is already underway in addressing some of the market infrastructure issues, including development of an electronic platform for repo in corporate bonds. Market making in corporate bonds has proved to be a challenging issue, particularly the funding of brokers. Banks are explicitly permitted to fund market making activities but at the end of day, it will be their call based on commercial judgement. Separate structure for market making with direct/indirect support of the Government could be a possible way out.

34. It is also important to recognize that the path towards creating an enabling environment may be fraught with event-specific hurdles which may take the process a few steps back. The recent case of default on a top rated bond is a case in point. More than the fact of default, some of the market practices that have come to light through media reports can dent the confidence of investors in the market. This particular instance reiterates the importance of strong market practices and institutional frameworks in development of healthy markets.

35. While there is a continuing, concerted effort to identify the constraints and address them in right earnest, we must, however, be careful that our pursuit of perfect bond markets does not end up as an endless chimerical chase. Bond markets are part of a broader ecosystem and it would be best if these markets evolve organically. As a regulator, our endeavor is to continually facilitate an enabling framework. The group set up under the aegis of the FSDC is expected to look into the whole gamut of issues, mostly focusing on the recommendations of all the earlier committees. One can expect more exciting times ahead for the development of the corporate bond market in India.
