The corporate debt market in India

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1. Introduction

The Asian financial crisis of 1997-98 underscored the limitations of even reasonably regulated, supervised, capitalised and managed banking systems. The primary role of a banking system should be to create and maintain the liquidity needed to finance production within a short-term time horizon. The crisis showed that banking systems cannot be the sole source of long-term investment capital without making an economy vulnerable to external shocks. Against this backdrop and based on experience, it has been argued that bond financing reduces macroeconomic vulnerability to shocks and systemic risk through diversification of credit and investment risk.

From the perspective of developing countries, a liquid corporate bond market can play a critical role in supporting economic development. First, it supplements the banking system to meet the requirements of the corporate sector for long-term capital investment and asset creation. Second, it provides a stable source of finance when the equity market is volatile. Third, a well developed liquid corporate debt market has become even more crucial as an alternative source of finance since the decline in the role of development financial institutions (DFIs).

There has been no one process through which corporate bond markets have developed. However, based on experience from around the world, we can say that there are a number of preconditions for the growth of a local corporate bond market. We outline them below.

1. The share of the private sector in the economy is large and its financing requirements are met directly by the market through the issue of both equity and debt instruments.
2. Interest rates are completely deregulated, and financial markets integrated.
3. The government securities market is well developed, so that it can provide the benchmark yield curve for bond pricing.
4. Clearing and settlement systems are up to date, in terms of both infrastructure and investor protection. A well functioning depository system is in place for ease of issuance and trading.
5. There is a regulatory framework that provides for adequate disclosure, accounting standards, proper corporate governance and the like.
6. Laws are enacted to provide for regulatory oversight and investor protection.
7. A credible system of experienced rating agencies exists in order to get opinions about debt issues into the public domain.
8. The government has a clear policy with respect to the development of the corporate bond market.

Insofar as the preconditions for the development of a corporate bond market are concerned, India is fairly well placed. There is a developed government securities market that provides a dependable yield curve. The major stock exchanges have trading platforms for debt securities. The existing depository system has been working well. The Clearing Corporation of India Limited (CCIL) has been successfully settling government securities, foreign exchange and other money market transactions,

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and the settlement system has improved significantly in recent years. Settlement of government securities moved to a delivery vs payment system (DVP III)[2] on 29 March 2004, and the equity settlement cycle was reduced to T+2 on 12 March 2003. Real-time gross settlement (RTGS) has become operational for commercial bank transactions in several cities over the past year. Last but not least, there are several rating agencies in India with sound credit assessment capability and good track records.

The Securities Exchange Board of India (SEBI) and the RBI have taken steps, especially for improving transparency through appropriate regulations, viz. compulsory holding of securities in dematerialised form, limiting investment in unlisted paper, prescribing disclosure requirements for private placements by listed companies, mandating use of the order matching system of stock exchanges, etc. However, for further development of the market, some more issues need to be tackled in a concerted manner. Following the budget proposals for 2005-06, the Finance Minister has appointed a High-Level Expert Committee on Corporate Bonds and Securitisation to look into the legal, regulatory, tax and market design issues in the development of the corporate bond and securitisation market. The Committee is expected to submit its report shortly.

2. Main features of the Indian corporate debt market

2.1 Relative size and importance

For most developing countries, where dependence on bank loans is substantial, corporate bond markets are small, marginal and heterogeneous in comparison with corporate bond markets in developed countries. India has had a bank-dominated financial system. As a source of funds for the corporate sector, the share of the domestic capital market (debt plus equity) was 10.4% in FY[3] 2004-05 (April-March) while that of domestic borrowings from banks and financial institutions was 34.7%. In addition, corporations can have recourse to the overseas markets for raising equity, debt or loans. In recent times, the share of loans raised abroad has been significant - 23.3% in 2004-05.[4] The dominance of the banking system can be gauged from the fact that the proportion of bank loans to GDP is approximately 36%, while that of corporate debt to GDP is only 4% or so. By the same measure, the government securities market is nine to ten times as large as the corporate debt market.

The corporate debt market in India has been in existence since Independence. Public limited companies have been raising capital by issuing debt securities in small amounts. State-owned public sector undertakings (PSUs) that started issuing bonds in FY 1985-86 account for nearly 80% of the primary market. Due to falling interest rates and adequate availability of funds, corporate issuance has shown a noticeable rise in recent years (Table 1). The reduction in the share of debt in total resource mobilisation in the last two years can be attributed to buoyant equity markets.

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[2] In the DVP III mode of settlement, both the securities leg and funds leg of transactions are settled on a net basis.

[3] Financial Year.

[4] RBI Annual Report.

Table 1

Resource mobilisation by the corporate sector

(INR billions)

FY[1]	Public equity issues	Debt issues			Total resources (2+5)	Share of private placements in total debt (4/5*100)	Share of debt in total resource mobilisation (5/6*100)
		Public issues	Private placements	Total (3+4)		(%)	(%)
1	**2**	**3**	**4**	**5**	**6**	**7**	**8**
2000-01	24.79	41.39	524.34	565.73	590.52	92.68	95.80
2001-02	10.82	53.41	462.20	515.61	526.43	89.64	97.97
2002-03	10.39	46.93	484.24	531.17	541.56	91.16	98.08
2003-04	178.21	43.24	484.28	527.52	705.73	91.80	74.75
2004-05	214.32	40.95	553.84	594.79	809.11	93.12	73.51

[1] Financial Year (April – March).

Sources: Prime Database*; Indian Securities Market Review*, National Stock Exchange (NSE).

When compared with the government securities market, the growth of the corporate debt market has been less satisfactory; in fact, it lost share in relative terms until FY 2004-05 (Table 2).

Table 2

Resources raised from the debt markets

(INR billions)

Financial year	2000-01	2001-02	2002-03	2003-04	2004-05
Total debt raised	1,850.56	2,040.69	2,350.96	2,509.09	2,050.81
Of which: corporate[1]	565.73 (31%)	515.61 (25%)	531.17 (23%)	527.52 (21%)	594.79 (29%)
Of which: government	1,284.83 (69%)	1,525.08 (75%)	1,819.79 (77%)	1,981.57 (79%)	1,456.02 (71%)

[1] Excluding euro issues.

Sources: RBI; NSE; Prime Database.

2.2 Private placements

The bulk of debt raised has been through private placements (Table 1). During the last five years, private placements, on average, have accounted for nearly 92% of the total corporate debt raised annually. The dominance of private placements has been attributed to several factors, including ease of issuance, cost efficiency and primarily institutional demand. PSUs (at both the central and state government level) account for the bulk of private placements. The corporate sector has accounted for less than 20% of total private placements in recent years, and of that total, issuance by private sector manufacturing/services companies has constituted only a very small part. In 2004-05, the bulk (64%) of fund-raising through private placements was by financial institutions and banks (in both the public and private sectors). Note that large private placements limit transparency in the primary market.

2.3 Preference for rated paper

Ratings issued by the major rating agencies have proved to be a reliable source of information. The data on ratings suggest that lower-quality credits have difficulty issuing bonds. The concentration of turnover in the secondary market also suggests that investors' appetite is mainly for highly rated instruments, with nearly 84% of secondary market turnover in AAA-rated securities. In addition, the pattern of debt mutual fund holdings on 30 June 2004 showed that nearly 53.3% of non-government security investments were held in AAA-rated securities, 14.7% in AA-rated securities and 10.8% in P1+ rated securities.

3. Market structure

3.1 Primary market

The primary market for corporate debt securities can exhibit certain features that limit their secondary market liquidity. These limiting features include: 1) "buy and hold" strategies legitimately followed by most institutional investors in corporate debt securities; 2) small issue sizes that fulfil the specific needs of the issuer or investor; 3) stringent investor protection guidelines in the primary market; 4) imperfections in the tax structure; 5) mandatory investment in government bonds; 6) lack of proper market infrastructure; and 7) the inability of small- and medium-size enterprises to access the debt markets.

Broadly speaking, there are four types of investor: 1) banks and financial institutions; 2) insurance companies, provident funds and pension funds; 3) mutual funds; and 4) retail investors. From the point of view of prudence, investment guidelines for institutional investors make a number of stipulations regarding permitted holdings, ie class of paper, percentage of the corpus, rating of the debt securities, etc. Since institutions are the principal market players, their participation has a significant bearing on the development of the primary market. We discuss these below.

3.1.1 Banks and financial institutions

As noted earlier, banks and financial institutions have been the main issuers of debt instruments. The data in Table 3 show that they dominate on the investment side as well.

However, the contribution of banks and financial institutions through investment remains small as a proportion of the total resources mobilised by the banking system. The position improves dramatically when we compare the investment contribution with the credit extended to medium-sized and large enterprises, instead of with total conventional bank credit. (We make this second comparison on the grounds that only medium-sized and large enterprises have the ability to raise resources from both the loan and capital markets.)

The nationalised banks are generally active investors in PSU bonds and Tier 2 bonds of other banks. Corporate bonds can be construed as quasi-loans if they are issued privately on mutually agreed terms. In the recent past, due to competitive pressures and abundant liquidity, banks had been lending through this quasi-loan route to highly rated corporations at rates much below their prime lending rate.

Table 3

Investment in corporate debt by banks and financial institutions

(INR billions)

Instrument	End-March 2003	End-March 2004	End-March 2005
Commercial paper	40	38	39
Units of mutual funds	63	118	126
Shares	102	97	134
Bonds/debentures	1,132	1,124	1,137
Total	**1,337**	**1,377**	**1,436**
Conventional bank credit	7,079	8,157	10,688
Of which: granted to medium-sized and large enterprises	2,352	2,472	2,902

Source: RBI Annual Report.

3.1.2 Insurance companies, and provident and pension funds

Pension funds are the principal investors in corporate bonds in the United States and other developed markets, providing much-needed long-term capital. In India, the provident and pension funds are required to invest in accordance with prescribed guidelines that are orientated towards safety of the funds. As a result, the preference has been for government securities and bonds of public sector entities. A very small proportion (10% of accruals to the fund in a year) is available on a voluntary basis for investment in private sector bonds. Of the total corpus of statutory provident funds (including the Employees Provident Fund) amounting to INR 1,750 billion as on 31 March 2004, INR 490 billion[5] was invested in corporate bonds (mostly those issued by public sector entities). As is the case with the life insurance companies, their interest is in longer-dated paper.

3.1.3 Mutual funds

Mutual funds lend support to the corporate debt market mainly through their participation at the shorter end of the yield curve. Unlike some of the other investors, the mutual funds are susceptible to volatile inflows/outflows, and therefore, to an extent, secondary market activity in the corporate debt market is guided by their behaviour, ie volumes go down when the total corpus of mutual funds goes down and vice versa. The data in Table 4 illustrate the dynamic changes in the asset profile of the mutual funds.

3.1.4 Retail participation

India’s gross domestic savings amounted to INR 6,717 billion in FY 2003-04, accounting for 24.3% of GDP. Retail investors’ investment in financial assets represents around 47% of their total savings, and is broadly invested as follows: bank deposits - 36.7%; small savings schemes, etc - 15.5%; provident and pension funds - 14.1%; and life insurance policies - 12.8%. Their investment in shares and debentures of private corporate business is very marginal (1.1%). According to preliminary data for 2004-05, the shares of bank deposits and small savings schemes have risen to 37.1% and 19.0% respectively, while the share of investment in shares and debentures is practically unchanged at 1.4%.[6]

The principal factors driving retail investment are tax benefits, returns, liquidity and safety. Perhaps the investment needs of the individual are adequately met through bank deposits and the small savings

[5] Source: EPFO Balance Sheet and IDBI Capital Markets Ltd.

[6] Source: Central Statistical Organisation.

schemes offered by the government. Furthermore, currently the returns on the small savings schemes are much higher than those on bank deposits, government securities or highly rated corporate debt. Insofar as marketable instruments such as shares and debentures are concerned, a retail investor can buy or sell on the exchanges through a broker, or participate indirectly through a mutual fund. In India, banks do not offer a buy/sell facility for retail investors in stocks or bonds across their branch networks. Finally, in the case of corporate bonds, due to poor liquidity in the secondary markets, the cost of entry/exit can be prohibitive for the retail investors.

Table 4

Assets under management by mutual funds

(% of total)

Instrument	End-March 2003	End-March 2004	End-March 2005
Debt	59.9	44.8	31.6
Equity	12.4	16.9	25.6
Money market instruments	17.3	29.9	35.9
Government securities	4.9	4.3	3.0
Others	5.5	4.1	3.9
Total	**100.0**	**100.0**	**100.0**

Source: Association of Mutual Funds in India.

3.2 Secondary market

The secondary market plays a number of key roles, including: providing effective price discovery; shifting risk; pricing new issues; offering an alternative mode of investment; aiding management of resources; and enforcing discipline on the issuer. As mentioned earlier, a few problems hampering the growth of the secondary market are linked to the primary market. In a nutshell, corporate bonds are issued in small quantities, subscribed to by institutional investors and held to maturity. Not surprisingly, trading in corporate debt accounts for only 3% or so of the total debt traded in the market. Moreover, the trading is concentrated in few securities, with the top five to 10 traded issues accounting for the bulk of total turnover. The secondary market for retail trades is minuscule, accounting for only 0.03% of the total trading volume in FY 2003-04.[7]

Several measures have been taken by regulators to promote the corporate debt market, especially the secondary market. Banks, financial institutions and primary dealers have been asked to hold bonds and debentures, privately placed or otherwise, in dematerialised form only. In addition, SEBI has already mandated that all bond trades on the Bombay Stock Exchange and National Stock Exchange be executed on the basis of price/order matching, as is done in the case of equities. However, this regulation does not apply to bilateral trades settled within two days. Listed companies making debt issues on a private placement basis are also required to comply with disclosure requirements. There are also restrictions on the extent to which regulated entities can hold unlisted corporate paper.

Consolidation of primary market issues is critical for the development of the secondary market. In order to improve the liquidity of a bond - and therefore the demand for it - it is desirable to reach critical mass in that particular issue. Some of the advantages of reissuing existing bonds for the purpose of consolidation are: 1) improved liquidity in the particular bond; 2) better information about the bond; and 3) more accurate valuation of the bond. As consolidation reduces the demand for a liquidity premium,

[7] Source: National Stock Exchange Fact Book.

the issuer enjoys a lower cost of borrowing. However, it should be kept in mind, that unlike a sovereign issuer that frequently accesses the market, a corporate issuer has little incentive to work towards the development of the market.

Similarly, adoption of standardised market conventions as in the case of government securities for day count, interest on delayed payments, bond covenants, trading, reporting, and market valuations are all necessary for development of the secondary market. The other measures aimed at improving market liquidity relate to the appointment of market-makers for corporate bonds, permitting repos in corporate bonds, etc.

3.3 Trading, clearing and settlement

Trading in India's corporate debt market is largely over-the-counter and dominated by institutions. Deals are struck either directly between counterparties or through the intermediation of brokers over the phone. Trades facilitated by brokers have to be reported to the exchange by them, which aids post-trade information dissemination. In addition, corporate bonds are also traded through the electronic order book system on the exchanges. However, this method is not very popular due to lack of retail interest in marketable debt instruments.

Unlike the government securities market, the corporate debt market does not have a clearing and settlement infrastructure in place. Transactions are settled bilaterally, with the seller giving instructions to the depository for transfer of the security, and then receiving the cheque from the buyer. In the absence of DVP, the seller is at higher risk than the buyer, as he is required to part with the security before receiving payment. However, in the case of trades on the stock exchange, settlement occurs through the associated clearing house/corporation.

There is a recognised need for compulsory trade reporting to a central authority by all participants, and a structured clearing and settlement system for corporate debt.

4. The structured finance market

Securitised debt is yet another investment avenue offering higher risk-adjusted returns to investors, customised solutions for borrowers and a balance sheet management tool for originating banks and institutions. Over the last decade, the Indian markets too have recognised the immense potential that securitisation has to offer, with the result that structured finance has grown exponentially (Table 5). Nonetheless, there are some legal, regulatory, taxation and other issues that need to be addressed for facilitating the growth of securitisation in India. Illustratively, securitised debts are not included under the Securities Contract Regulation Act and hence cannot be listed in a stock exchange, thereby inhibiting secondary market trading. Further, securitisation done through special purpose vehicles in the form of trusts is non-taxable whereas a corporate structure for special purpose vehicles is taxable.

Asset-backed securities (ABS) are not only the dominant structured product category, but also the fastest-growing. The growth of the ABS market can be attributed to a number of factors, including: 1) the growing retail loan portfolios held by banks and other financial institutions; 2) investors' familiarity with the underlying asset class; 3) the relatively short tenor of such issues; and 4) the stable performance of past pools. Growth of the mortgage-backed securities (MBS) market, on the other hand, has been slow, despite the underlying growth in the housing finance market. Factors impeding the growth of the MBS market include: 1) the relatively long tenor of MBS; 2) a lack of secondary market liquidity; and 3) the prepayment/interest rate risk arising from prepayment/repricing of the underlying loans. As regards corporate debt obligations, the growth has been tardy because the investment decisions are often influenced by the "base rating" of the underlying corporate assets in the corporate debt obligations pool and not on the rating of the instruments. Similarly, the partial guarantee structures have not been popular for enhancing the rating of debt obligations.

Table 5

Trends in issuance volumes

(INR billions)

Structure	2002	2003	2004	2005
Asset-backed securities	12.9	36.4	80.9	222.9
Mortgage-backed securities	0.8	14.8	29.6	33.4
Corporate debt obligations/ loan sell-offs	19.1	24.3	28.3	25.8
Partial guarantee structures	4.0	1.9	–	16.0
Others	0.0	0.4	0.5	10.0
Total	**36.8**	**77.7**	**139.2**	**308.2**

Source: Investment Information and Credit Rating Agency of India.

5. Foreign investment

Currently, foreign institutional investors (FIIs) registered with SEBI are allowed to invest a maximum of USD 1.75 billion in government securities and treasury bills, and USD 500 million in other debt securities without any minimum maturity or holding period restrictions. These modest amounts are more in the nature of treasury management tools for FIIs which operate in the equity markets.

While the need for foreign capital, particularly for infrastructure development, is recognised, any increase in limits will depend on the market acquiring more depth and liquidity (to withstand the flows), as well as on convergence between domestic and overseas interest rates (to prevent speculative flows).

6. Looking ahead

For most developing countries, where dependence on bank loans is substantial, corporate bond markets are small, marginal and heterogeneous in comparison with corporate bond markets in developed countries. India has a bank-dominated financial system that was, until recently, supplemented by DFIs specialising in project finance. First, because of the conversion of DFIs into banks, an institutional gap for long-term finance now exists in India. Second, for the commercial banks themselves, the proportion of long-term deposits (longer than five years) to total deposits is showing a declining trend. Because of regulations relating to debt issuance and asset-liability management, banks may not be able to fill the gap in long-term finance. Third, Indian enterprises now have the ability to raise funds in foreign capital markets. Indeed, an underdeveloped domestic market can push the better-quality issuers abroad, thereby accentuating the problems of developing the corporate debt market.

The ability to raise funds efficiently has implications for the overall growth of the economy. The development of the corporate debt market, therefore, remains critical for achieving and sustaining high growth rates of 8% or so.