R Gandhi: Corporate debt market: what needs to be done – a reaffirmation

Inaugural address by Mr R Gandhi, Deputy Governor of the Reserve Bank of India, at the "CARE Ratings Debt Market Summit – 2015", Mumbai, 23 March 2015.

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Good morning ladies and gentlemen!

2. I would like to thank CARE Ratings for taking this initiative of holding this Summit on the corporate debt market. As I can see, the seminar is quite exhaustive in content and we will be having some excellent speakers representing various segments of the industry and hence it will be very interesting to hear their views. As a regulator, we in the Reserve Bank do have our own approach to the development of any market, but to hear the market participants is always important for us as it is only when we debate the issues that we can come to a workable solution. I am sure that we will have a lot to pick up from these deliberations that take place here today.

Corporate Bond Market in India – Current status

3. Indian Corporate Debt market has seen some growth in recent years, both in terms of number of issues and amount. The outstanding issues which were at 12,155 as at end March 2011 increased to 18,664 by end Dec 2014. During the same period, the amount outstanding increased from ₹ 8,895 billion to ₹ 16,485 billion. While the types issued included fixed rate bonds, floating rate bonds, structured notes and other types, the fixed rate bonds were predominant both in number and value. Another characteristic of the issuances was that almost all issuances were by financial sector entities. Yet another peculiar feature of our Corporate Bond market is that private placements are the norm. The public issuances which were ₹ 94.51 billion in 2010–11 increased to ₹ 423.83 billion in 2013–14, though it fell back to ₹ 90.49 billion in the current year till Feb 2015. The private placements were ₹ 2187.85 billion in 2010–11, ₹ 2612.82 billion in 2011–12, ₹ 3614.62 billion in 2012–13, ₹ 2760.54 billion in 2013–14 and ₹ 2692.45 billion in the current year till Dec 2014. The secondary market trading was ₹ 6053 billion in 2010–11, ₹ 5938 billion in 2011–12, ₹ 7386 billion in 2012–13, ₹ 9708 billion in 2013–14 and ₹ 10043 billion in the current year till Feb 2015.

4. Though the above mentioned figures do indicate a healthy growth in number and volume of corporate bond market activity, in comparison with government bonds market, the corporate bond market is dwarfed. A comparative position of the governments bonds and corporate bonds as on March 2013 as a proportion of GDP among the major Asian countries in the *Table (page 2)*, reflects India at a very low position vis a vis some of the major Asian countries.

Indian Corporate Debt Market – An Enigma

5. Thus corporate debt market in India has been quite an enigma. We keep talking of the issues that are in the way of its progress and the solutions that could address them. Yet, there has been limited movement in this area despite several attempts and there is some kind of gravity keeping us down. We had the R H Patil Committee Report on corporate bonds and securitization of 2005 which has served as a reference point for all of us. However, the progress in the growth of the corporate debt segment has not been too satisfactory and there is evidently a pressing requirement to revisit this subject. There have been several suggestions made – some have been implemented with mixed success.

Government and Corporate Bonds as percentage of GDP March 2013

Debt as % of	Government	Corporate	Total
Peoples	33.1	13.0	46.2
Hong Kong	37.8	31.4	69.2
Indonesia	11.4	2.3	13.7
Republic of	48.7	77.5	126.2
Malaysia	62.4	43.1	105.5
Philippines	32.2	4.9	37.1
Singapore	53.1	37.0	90.1
Thailand	58.6	15.9	74.4
Vietnam	19.8	0.7	20.5
India	49.1	5.4	54.5

6. Yet, as noted earlier, the debt market remains confined largely to financial institutions, and corporates are not much in the picture. Even within this limited perimeter, public issues are less frequent and the preference has been for private placement of debt paper. This is the starting point of the puzzle which we need to analyze.

7. Another part of the puzzle relates to our own achievement. We did experience close to double digit GDP growth in FY08 and our investment ratio was 38.1% in that year- with financing issues not coming in the way. On the face of it one may tend to conclude erroneously that there is no need to get too worried about the absence of development in corporate debt market. After all, have we not got investment rate of 38.1%? The reason why the problem does not appear to be magnified is because we are working at well below our potential. We are not realizing that the paucity in long term resources can severely come in the way of investment. Therefore, the question to be asked is as to for how long can we carry on with this situation.

8. We do have fairly large numbers that are required for financing both industrial growth of 8–10% in the next five years and funds required for infrastructure development. Presently as industrial growth is in the phase of stagnation and infrastructure well below satisfactory levels due to a varied set of factors around policy action, the demand for funds has not really reached the expected levels. Evidently this should not give rise to complacency and we should work in this period in building structures for growing our corporate debt market.

Need to develop the Corporate Debt Market

9. The government has its own limitations when chipping in as the fiscal responsibility targets leave little scope for finding funds. Though the commercial banks do cater to the

investment needs of corporate and infrastructure sectors, they are also reaching their own limitations. We have gotten support from FDI and external borrowings, but they have their own pace and size. External borrowings are a good way out when global interest rates are low. But, the repercussions on our external debt are significant, and while we have been permitting ECBs into various sectors, the external debt levels have been rising which has servicing implications. Intuitively we can see that the capital market has to become progressively more relevant in this process of garnering long term funds.

10. Economists contend that the absence of an adequately sized corporate debt market leads to an oversized banking system in any economy. It also results in a large portion of the lending market being excessively regulated, without being subjected to free market forces. Such an imbalance is not desirable, because this becomes the perfect breeding ground for crony capitalism, sloppy lending by banks and careless investments by corporates. Financing of resources through corporate bonds rather than bank finance instills a greater sense of credit discipline among the borrowers as the default events are captured immediately and placed in the public domain. The disclosure requirements act as a big disincentive for default or delayed payment. It has been observed that borrowers take the regulatory norm of 90 days period for a default to be recognised as a Non-Performing Asset as a leeway for withholding the payment till the 89th day from the due date. On the other hand, even a single day default by an issuer of corporate bond will be recognised as default in the market and the information of default will be publicly available. Further, such information / risk will also be reflected in external credit ratings and traded credit derivatives on a real time basis. Pricing of credit also gets diluted in bank financing as credit facilities are extended not only on the basis of credit worthiness of the borrower but also the relationship between the banks and their borrowers. Financing through corporate bonds might remove such distortions to a large extent as investors will demand higher coupon for issues with lower credit worthiness, while borrowers with strong fundamentals and sound business get rewarded by lower cost of financing. Thus there are many advantages of an efficient, well developed and liquid corporate debt market.

11. The importance of a developed debt market viz., the corporate debt market for a country like India, which has an huge and ever growing capital funding requirement is widely acknowledged and although various measures on the regulatory and policy front have been introduced in recent times, concerted efforts from all market participants is required to develop and grow the largely untapped potential of the country's corporate debt markets.

Expert Committees

12. In India, progressively, a number of Committees and Groups were set up by RBI to study the bank financing / funding patterns vis a vis the corporate funding requirements. Prominent among them were the Tandon Committee, Chore Committee, etc. The committees uniformly recommended that corporate reliance on bank finance for short term recurring expenses need to be brought down. Chore Committee specifically recommended *the need for reducing the over-dependence of the medium and large borrowers – both in the public and private sectors on bank finance.*

13. More recently, a High Level Expert Committee on Corporate Bonds was set up under the chairmanship of Shri R. H Patil which submitted its report in December 2005 and made several recommendations including the need for rationalisation of stamp duty structure and issuance costs, tax deducted at source, encouraging securitization, repos and CDS in corporate bonds, enhancing issuer and investor base, simplifying issuance procedures, etc.

14. In the year 2009, the Committee for Financial Sector Reforms (CFSR) (Chairman: Dr. Raghuram G. Rajan) also looked into the issues inhibiting the corporate debt market and made several recommendations on similar lines. Some of the highlights were to bring all trading related regulation within the purview of SEBI, improve coordination between various concerned agencies where multiple regulators share concern, set up a working group on

financial sector reforms with Finance Minister as Chairman, the Committee, had recommended the sequencing approach for corporate finance, which entails developing a number of missing markets as well as complementary development of other sectors in the economy for a healthy development of the corporate bond market.

Current issues

15. There are some key issues that the corporate debt market faces. They need be tackled to facilitate improvement and growth of this segment. Foremost among these are as follows:

a) The abysmal liquidity and the consequent lack of depth in the corporate debt markets. The absence of a liquid corporate bond market acts as a deterrent to investor participation. Trading in Indian bond markets are characterized by trading in certain maturities and tendency of investors to 'buy and hold' instruments, both of which inhibit liquidity. Here the role of institutional investors such as pension funds, provident funds and insurance companies must be reassessed. They do need to take some more initiative and be aggressive in actively managing their portfolios. Their investment horizon should not be confined to AA and above only. This will add a lot of buoyancy to the market.

b) Low investor base – The investor base in the corporate debt market is confined to banks, insurance companies, PFs, pension funds and primary dealers. Retail participation remains low due to absence of knowledge and understanding of bonds as an asset class. It is imperative to consider innovative ways for expanding the investor base. The fund management industry can contribute significantly in attracting the retail investor to corporate debt.

c) Preference of public debt – The huge supply of government papers in the country is one of the major impediments to growth of the corporate bond markets. Government borrowing and thereby the supply of government papers are seen to grow unabated year on year. We have seen that the government is progressively trying to rein in the deficit at the absolute level which will put less pressure on the market. Also the move of the Reserve Bank to gradually lower the SLR which can also be positive for the corporate bond market.

d) Limited instruments and products – There is need for a wide array of instruments and products to be available in the markets that would meet the diverse needs of its participants. There is lack of these in the Indian context which in turn inhibits development of these markets. CDS and IRFs have been some of the instrument that have come in of late and it is expected that these will grow. Of late, there has been some element of buoyancy in the IRF market which is a good sign. 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.

e) Market Infrastructure also finds mention as a factor affecting corporate bond market trading and thereby transparency and vibrancy in the market. Infrastructure facilities such as screen based automated order matching, central clearing and settlement, negotiated dealing system, etc. on the lines available to the government securities market would certainly facilitate and encourage secondary market trading, enhance market transparency and liquidity as well as develop scientific risk pricing. We need to improve the credit rating mechanism for corporate bonds and encourage market for lower grade ratings which inhibits the market.

f) Ease of issuances – Bond issuance is viewed as being costly and cumbersome compared with bank lending. For it to be attractive to the issuers to approach the corporate debt market, the ease and cost of issuance has to improve. The listing and disclosure requirements and procedures have to be simple and less complicated. The size, scale and tenure of issues must improve and need to be made more attractive by encouraging public offers instead of the current preference for private placements. It is expected that consolidation of bond issues through reissuance/s would improve liquidity and encourage secondary market transactions. However, care would need to be taken to prevent excessive batching of redemptions and consequent liquidity stress.

g) Market making – The growth and development of any market is dependent on market makers who can provide both buy and sell quotes. Although prevalent in the government securities markets, they are lacking in the corporate bond segment. Market makers not only assume risk, they add diversity to the markets. Therefore, we need to develop a class of underwriters and market makers in corporate debt bonds on the lines of Primary Dealers in the government securities market.

Policy Initiatives

16. What are we doing to tackle these issues affecting the corporate bond market? Several measures are being undertaken at the policy level to address these. Some of the recent initiatives by Government, the Reserve Bank, SEBI and other agencies in the direction of developing the corporate debt market are as follows:

a) *Trade reporting platform*: For improving transparency, reporting platforms for OTC trades in corporate bonds, Commercial Paper, Certificates of Deposits, Non-Convertible Debentures and securitized debt has been set up. Till recently, reporting of trades in corporate bonds was done at three different places (FIMMDA's FTRAC, reporting platform of NSE and BSE). Though multiple reporting platforms were available, majority of trades were reported on FIMMDA platform and cleared through one of the clearing houses of the stock exchanges. The reporting of secondary market trades in corporate bonds and securitised debt by RBI regulated entities has been shifted to stock exchanges with effect from April 1, 2014.

b) *Pooling account:* Clearing houses of the stock exchanges have been permitted to have a pooling fund account with RBI to facilitate DvP-I based settlement of trades in corporate bonds.

c) *Repo in corporate bond:* In 2010, repos in corporate bonds were permitted to regulated and other RBI permitted entities. Guidelines were further relaxed in terms of reduction of minimum haircut requirements and expanding the list of eligible collateral by permitting short term instruments like CP, CD and NCDs of original maturity less than 1 year. Scheduled Urban Cooperative Banks (UCBs) have also been permitted to participate in the repo market subject to adherence to conditions prescribed.

d) *Credit Default Swaps (CDS) on corporate bonds:* CDS on corporate bonds has been permitted to facilitate hedging of credit risk associated with holding corporate bonds. Based on market feedback, short term instruments like CP, CD & NCDs and unlisted but rated corporate bonds have also been permitted as eligible reference obligations.

e) *Encouraging participation of banks and PDs in corporate bonds:*

   i. In July 2014, banks have been permitted to issue long-term bonds with a minimum maturity of seven years to raise resources for lending to (a) long term projects in infrastructure sub-sectors, and (b) affordable housing. These bonds have been exempted from computation of net demand and time liabilities (NDTL) as well as Adjusted Net Bank Credit (ANBC) and are therefore not been subjected to CRR / SLR or priority sector lending requirements.

ii. The Reserve Bank has issued the instructions asking banks to consider raising Tier II capital through public issuance to retail investors.

iii. In order to encourage active participation of standalone PDs in corporate debt, investment norms have been relaxed by allowing them to invest funds borrowed from call money market subject to certain limits, enhancing investment limit in Tier II bonds of other PDs / banks / FIs from 5% to 10% of NOF and increasing the Inter Corporate Deposit (ICD) borrowing limit from 75% to 150% of NOF.

iv. Banks and standalone PDs have been allowed to become direct members of stock exchanges for undertaking proprietary trades in corporate bonds.

v. Credit enhancement by banks – As per a recent policy announcement made, it is proposed to permit banks to offer partial credit enhancement to corporate bonds by way of providing funded and un-funded credit facilities for infrastructure projects but not by way of guarantee. The final instructions are expected to be issued shortly.

f) Foreign Portfolio Investors (FPIs):

i. Rationalisation of investment limits: FPI investment limits have been rationalised, whereby existing limits and subdivisions have been merged in two broad categories – government securities and corporate bonds. The sub-limits for FPIs in Government securities ($10 billion) and dated securities ($15 billion) and other categories have been merged to retain the overall cap of $25 billion. In case of corporate bonds, the ceiling of $1 billion for qualified foreign investors (QFIs), $25 billion for FPIs and $25 billion for FPIs in long-term infra bonds, have been merged – retaining the overall cap for corporate bonds at $51 billion.

ii. Rationalization of allocation of debt limits: Method for allocation of debt limits in corporate bond market through auction has been changed. As per revised scheme, FIIs can now invest in Corporate Debt without purchasing debt limits till the overall investment reaches 90% after which the auction mechanism would be initiated for allocation of the remaining limits. Consequent to the changes, the restrictions on re-investment by FPIs, shall no longer apply in respect of limits held / investments made by FIIs in the Corporate Debt category, till the limits are available on tap.

iii. Withholding tax rate: The rate of withholding tax on interest payments on the borrowings of Infrastructure Debt Funds (IDF), investments made by a non-resident in rupee denominated long-term infrastructure bonds and interest on FIIs' investment made in bonds issued by Indian companies and Government securities have been reduced from 20 per cent to 5 per cent.

iv. New Foreign Portfolio Investor (FPI) Regulations: Recently, SEBI has notified new FPI regulations to put in place an easier registration process and operating framework for overseas entities seeking to invest in Indian capital markets. The new regulations replace the existing SEBI regulations for FIIs and the new class of investors, FPIs, would encompass all FIIs, their sub-accounts and QFIs.

v. The Budget for 2015–16 has proposed to extend the period of applicability of reduced rate of tax at 5% in respect of income of foreign investors (FIIs and QFIs) from corporate bonds and government securities, from 31.5.2015 to 30.06.2017.

g) Credit enhancement by IIFCL: It has been mentioned in the Union Budget 2013–14 that IIFCL will provide partial credit guarantee to enhance ratings of bond issues, enabling channelization of long-term funds for infrastructure projects. IIFCL is presently undertaking pilot transactions under its Credit Enhancement initiative.

h) *Introduction of Rupee linked offshore bonds by International Finance Corporation (IFC):* With an objective to signal confidence in the Indian economy and encourage inflows of USD in India, IFC was permitted to float a rupee linked bond overseas for an amount of USD 1 billion. IFC received very good response and the limit has been fully utilized by IFC.

i) Domestic Issuance of bonds by IFC: Approval has also been given to IFC to issue bonds in India worth ₹ 15000 crore for infrastructure financing. This will also facilitate development of benchmark yield for long term corporate bonds.

Way forward

17. Going forward, we expect a special impetus to the growth of corporate debt market in our guidance to the banks to issue long term bonds to support infrastructure and housing projects. Further, in order to meet the capital requirements under the Basel III Framework, banks will tap the market with their Additional Tier 1 bonds, besides Tier 2 bonds. These developments can usher in emergence of quasi government yield curve, which can serve as benchmark for corporate issuances. When the Basel 3 Framework relating to Large Exposure norms take effect, and as banks reach their limits in supporting direct lending to the corporate sector, corporates be nudged to resort to market borrowing. On top of this, the expected robust economic growth will also compel the corporate sector to approach the market. Keeping all these in perspective, we need to ready ourselves with the following measures to usher in a vibrant corporate debt market:

a) regulatory and administrative reforms to institutionalize debt markets,

b) involvement of market-makers who can provide two-way bid-ask quotes,

c) enhancement of investor base,

d) increasing the efficiency of these markets through better reporting, settlement and clearing platforms,

e) emphasis on the reduction of information asymmetry.

Conclusion

18. To conclude, the debt markets is undoubtedly a very essential segment of the country’s financial markets and vibrancy in these markets is imperative to meeting the massive funding requirements of the country. I am confident that this Conference proceedings and discussions will lead to specific suggestions for action and provide clarity on issues.

19. I thank you all of you for your time and attention.