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INDIA BOND MARKETS: ANALYSIS AND CHALLENGES AHEAD

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Abstract
India has a very advanced G-sec market, its corporate bond market is relatively under developed. The debt market in India consists of mainly two categories The Government Securities or the G-Sec markets comprising Central Government and State Government securities, and The Corporate Bond market. The objective of this study is to analyses the Indian bond markets with the clear perspective of challenges faced by bond markets in India. The second objective is to recommend the various measures that can be adopted by the regulator to develop the bond markets particularly in the legal structure, tax structure, settlements mechanisms, improvement of Risk appetite and structural reforms. The research is descriptive in nature. The data is collected from secondary sources like Bloomberg, RBI reports, Ministry of Finance reports etc. Tax structure needs improvement for attracting investment in bond markets; same is also true for stamp duty. To widen the investor base government should introduce the STRIPS in the markets as it is in the western part of the world.

Key Words: debt market, G-Sec markets, Corporate Bond, Stamp duty, tax rates, STRIPS.

1.1 Overview of the Government Securities Market

In order to finance its fiscal deficit, the government floats fixed income instruments and borrows money by issuing G-Secs that are sovereign securities issued by the Reserve Bank of India (RBI) on behalf of the Government of India. The Government bond market (also known as the non- g-sec market) consists of financial institutions (FI) bonds, public sector units (PSU) bonds, and corporate bonds/debentures.

The G-Secs are the most dominant category of debt markets and form a major part of the market in terms of outstanding issues, market capitalization, and trading value. It sets a benchmark for the rest of the market. The market for debt derivatives have not yet developed appreciably, although a market for OTC derivatives in interest rate products exists.

Financial reforms have significantly changed the Indian debt markets for the better. Most debt instruments are now priced freely in the markets; trading mechanisms have been altered to provide for higher levels of transparency, higher liquidity, and lower transactions costs; new participants have entered the markets, broad basing the types of players in the markets; methods of security issuance, and innovation in the structure of instruments have taken place; and there has been a significant improvement in the dissemination of market information. The Nineties have seen significant policy reforms in the government securities (G-sec) market. The early nineties saw the introduction of auction based price determination for government borrowings; development of appropriate instruments and mechanisms for the borrowing programme; a significant increase in information dissemination on market borrowings and secondary market transactions; and the development of the RBI’s yield curve for marking the G-sec portfolios of banks to the market.

2.0 Objective

The objective of this study is to analyses the Indian bond markets with the clear perspective of challenges faced by bond markets in India. The second objective is to recommend the various measures that can be adopted by the regulator to develop the bond markets particularly in the legal structure, tax structure, settlements mechanisms, improvement of Risk appetite and structural reforms.

3.0 Methodology

The research is descriptive in nature. It consists of comparison of various bond markets across the globe, along with the various instruments and bring the best in practices in India. The data is collected from secondary sources like Bloomberg, RBI reports, Ministry of Finance reports etc.

4.0 Overview of Corporate Bond Markets

A corporate bond is a bond issue by a corporation to raise money effectively in order to expand its business. The term is usually applied to longer-term debt instruments, generally with a maturity date falling at least a year after their issue date.

In India, most of the financial markets like equity, equity derivatives, currency derivatives, commodity derivatives, G-Sec, money and currency market including OTC currency derivatives, OTC interest rate derivatives relatively well developed

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while corporate bond market is not well-developed This is in contrast to other developed and emerging markets in the world. India's corporate bond market, about 30 percent the size of China's, is failing to expand to help Government of India (GOI) to meet its target of building infrastructure.

Corporate debt markets also function as a stable source of finance when the equity market is volatile. Generally, there have been two models for developing debt markets internationally. Whereas, in developed countries like the U.S., regulators stepped in to bring about an orderly way of doing business after the markets had by themselves developed reasonably, in several developing countries such as India, the regulators have had to assume the role of market developers.

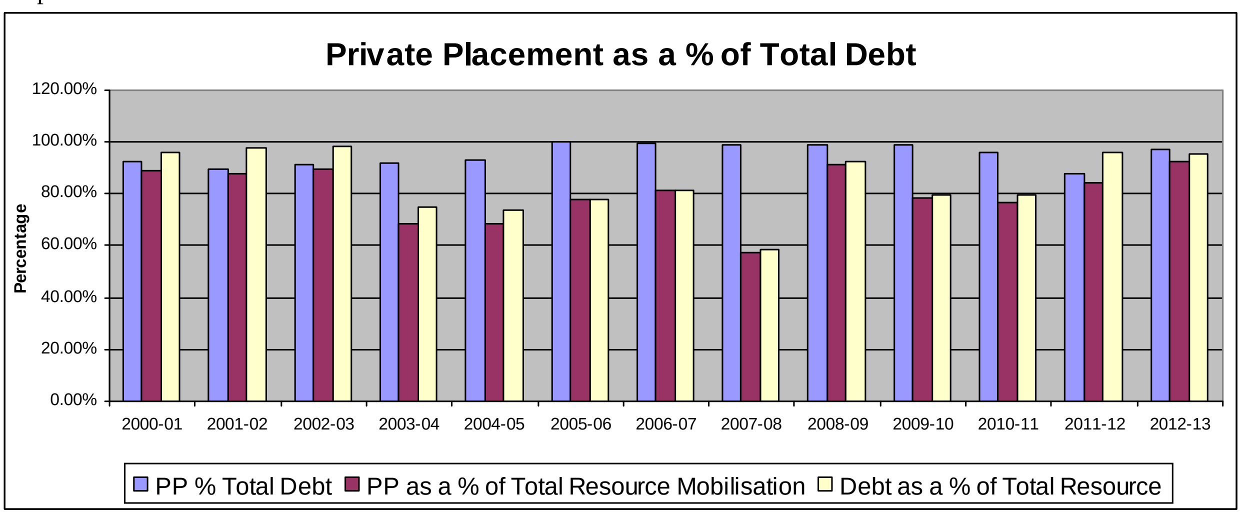
A well-developed corporate bond market is critical for a developing economy like India because it:

1. Enables Efficient Allocation Of Funds,
2. Facilitates Infrastructure Financing,
3. Improves The Health Of The Corporate Balance Sheets,
4. Promotes Financial Inclusion For The Small And Medium Enterprises (Smes) And The Retail Investors,
5. Safeguards Financial Stability And
6. Enables Development Of The Municipal Bond Market.

Corporate debt consists of broadly two types – bank borrowings and bond. Corporates borrow from banks and other financial institutions for various business purposes and for varying durations through non-standardized and negotiated bank loans. Bank finance takes the form of project loans, syndicated loans, working capital, trade finance, etc.

The Private Placement route has remained the most followed by the Corporates for raising the debt. The Private Placement as a % of debt has remained at over 90% levels throughout from 2000 to 2011, except for 2011-12 when the Public issue route gained a bit momentum.

Graph 1



Further probe into the Private Placement of the Corporate Bond revealed a sectoral classification of the issuers of the corporate paper in the Private Placement market

5.0 Challenges for the Bond Markets in India

5.1 Liquidity and Volumes

The Government Securities market is relatively liquid and generally serves the purpose of fiscal financing for the Governments and for infrastructure financing. The the Government Securities are still liquid with a number of participants primarily Financial Institutions, Banks and Primary Dealer operating within this segment due to the regulatory reasons. Therefore in terms of liquidity the Government Securities market fares better than the Corporate Bond Markets and the key challenge is to address the liquidity in the Corporate Bond segment.

Absence of a liquid corporate bond market acts as a key deterrent for investors to participate. Liquidity of corporate bonds is not just driven by demand and supply but also by transparent pricing observable by investors.

Factors impacting corporate bond market liquidity are -

(a) Issuer and investor base - Bulk of bond issuers in the corporate bond market consists of banks and financial institutions. With more than 98% of bond placements being private, availability of bonds for trading in secondary market is pre-empted by a handful of investors and limits price discovery in the secondary market.

(b) Lack of a benchmark yield curve - The corporate bond market in India lack a benchmark yield curve across maturities and hence pricing in the secondary market is not observable across all maturities which has a first order impact on liquidity. Preference for long term bonds (>10 years maturity) by trusted issuers like Banks hinder development of benchmark yield curve across maturities. This makes spread determination for non-banking entities (PSUs, corporates, SMEs, etc) for lower maturity bonds difficult to observe.

(**c) Investor Profiles and regulation** - Investor profile and market regulation further limits secondary market liquidity. With key investors like insurance companies preferring to hold till maturity and lack of activity from pension funds and FIIs in corporate bond market owing to policy limitation, only mutual funds and Banks are left to trade and offer volume in the secondary market.

d) Transparency in reporting and Information – The corporate bonds have more issuances under the Private Placement route than the Public Issuances and therefore the number of securities available for trading is also thin. The lesser number of securities available for the secondary market trading also means less market information available to the investor base and the low preference for the investors to invest in debt secondary markets due to lack of perfect pricing information being available to the investors.

e) Clearing and Settlements – The Government Securities market have 3 modes of settlements as – DVP I , DVP II and DVP III. The settlements in the Government segment is still guaranteed by the CCIL which mitigates the settlement risk of the investors. In case of Corporate Bond Markets, the settlement of the trade is a challenge as the settlement risks are high with varied nature of investors operating.

(f) Investment Grade Bonds - In addition, lack of quality bond papers in the market reduces the buoyancy of the corporate bond market. The Credit ratings mechanism by the

g) Market Making Despite of several initiatives over the past one decade, market making has been difficult to implement. Currently banks and FIs dominate the market for arrangers. However as they lend money through banking channels, their appetite for market risk is limited as compared to credit risk. Very few NBFCs / Brokers are arrangers owing to lack of funds and low appetite for market risk. To minimize underwriting risk, arrangers prefer highly rated corporate bonds. This makes access to market difficult for those who are not highly rated e.g. SMEs or not highly rated corporate bonds.

5.2 Credit Risk - Appetite for Non investment grade bonds

The investors in the Corporate Bond markets have a high preference for the investment grade bonds and thus the investor base for the varied bonds of the Non Investment grade bonds are also limited. Therefore this impacts the SME segment in approaching the Bond Markets to meet their financing requirements. Pursuant to the low investor base in the primary issuance markets for the Non Investments grade bonds, the secondary market is also impacted and the bulk of the financing need of the developing sectors of the country are still dependent on the Collateral based Bank Finance, leading to the heavy reliance on the Bank financing,

This poses as a serious challenge for the Bond markets to improve on the depth of the transactions and making the bond markets easily accessible to the developing and emerging sectors of the economy. Credit enhancements in the Bond markets are also thin with reliance on the collateralized assets as a security.

5.3 Legal Structures

A. Enforcement of Contracts

A bond is at its core a debt contract and usually provides for a number of contractual protections in its founding document (e.g., collateral as security, priority in bankruptcy, periodic interest payments).

Enforcement of contracts is riddled with difficulties in India. This is primarily due to excessive delays in enforcement through an overburdened court system, and also due to prohibitive costs of bringing a civil action. Often, borrowers have taken advantage of delays and other deficiencies in the country’s court system to deny appropriate remedies to lenders, thereby increasing the risk perception of lenders to debt contracts.

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B.Corporate Insolvency Regime

Some of the most important provisions of a debt contract relate to when and how a lender can collect on any collateral or effectuate a secured claim. This is often through the process of insolvency, winding up and liquidation. Process to swiftly move a firm through this process so that the assets can be distributed to lenders would serve a valuable function in the development of credit markets. The current regime for corporate insolvency in India is far from efficient, and has been subjected to considerable criticism. As in the case of enforcing contracts, the insolvency process is met with significant delays, such that the liquidation of a company can take up to 10 years to complete. Although a special body in the form of the Board for Industrial and Financial Reconstruction (BIFR) was set up under special legislation to enable recovery of sick industrial companies, the track record of the BIFR in ensuring timely recovery and rehabilitation of sick companies has been hardly successful.

Furthermore, when a company makes a reference to the BIFR, a moratorium automatically applies, thereby preventing creditors from initiating legal proceedings against the company, including for the recovery of debt or enforcement of collateral. Although the Reserve Bank of India has introduced an alternative corporate debt restructuring (CDR) scheme to encourage work-outs between borrowers and lenders that bypasses the delays of the judicial process, the schemes has met with mixed success. It is perceived to be favoring large lenders, leaving the small lenders vulnerable. Foreign lenders are not specifically covered, and have to opt in on a transaction specific basis. The dispersion of the corporate insolvency regime among several pieces of legislation and among different courts and regulatory bodies has further contributed to the failure of corporate insolvency process.

C. Standardization and Transparency

Given that bonds are designed to be tradable amongst debt investors their terms need to be sufficiently standardized to facilitate ease of trading. Similarly, sufficient disclosure is necessary so investors can price these terms. Non-standard terms (or opaque disclosure) would add uncertainty and make bonds less attractive as investments and probably reduce their liquidity. The law can facilitate standardization and transparency in fairly direct ways by mandating it and then enforcing these requirements. The current regime for corporate bonds in India hinders standardization in many ways. In any event, the diversity in regulations among different types of bondholders affects standardization and reduces liquidity in trading corporate bonds.

In terms of issuing corporate bonds and trading in them, although significant steps have been taken to create separate securities regulation and a disclosure regime for corporate bonds, it has not stimulated that market. In 2008, the Securities and Exchange Board of India issued a separate set of regulations for issue and listing of corporate bonds in the form of the SEBI (Issue and Listing of Debt Securities) Regulations, 2008. A separate set of listing requirements and a format of the listing agreement were prescribed for corporate bonds. However, facilities such as a shelf prospectus and “on-tap” issuance of bonds are available only to certain banks and financial institutions that are primarily in the public sector, and this appears to constitute a significant impediment in the use of the public offering route for corporate bonds. For example, the availability of a shelf prospectus facility would be advantageous for companies to access funds from the bonds market as and when they require funding, and that too without significant procedural hurdles, except for updating the prospectus in order to make it current. The present emphasis on private placements significantly undermines the goals of standardization and transparency.

Moreover, among overseas investors, only the foreign institutional investors (FIIs) registered with SEBI are eligible to invest in the corporate bonds market. That leaves other institutional investors without access to that market, thereby impeding its liquidity.

5.4 Tax Structure

a) Incentives for tax deductions

At present only the Infrastructure Bonds are eligible for the tax deductions under Sec 80 C, As a result there is less incentive for the retail investors to subscribe to the other bonds not offering any tax incentive.

b) Tax applicable on Foreign Institutional Investor

For the FII, the TDS on interest payments are taxed at 5% and the Withholding tax rates are also very high at 20% which is a dampener compared to the investments in the form of an equity investment, therefore the FIIs would have a preference over the Equity instruments rather than debt.

Corporate bonds and debentures could be brought on level grounds with equity as far as tax on long term capital gains is concerned. As per existing regulation a long term equity share (held for more than 1 year and on which Securities Transaction Tax (STT) is paid) is exempt from tax (section 10(38) of the Income Tax Act); however, the same provision has not been extended for corporate bonds.

c) Stamp Duty

There prevails a differential stamp duties levied by various State Governments on debt instruments. The stamp duty on partly secured (including partly secured by registered mortgage) and unsecured debentures are different across States. Stamp duty is a State subject and therefore the individual states exercise their own discretion in the setting up of the applicable stamp duties.

6.0 Measures Taken To Develop the Bond Markets

SEBI, RBI and the government have since worked together and under consideration of the various suggestions proposed by the committees set up earlier, have brought about a lot of reforms and structural changes as per the recommendations in terms of the regulations, issuance mechanism and trading infrastructure

Reserve Bank of India has taken various initiatives in this regard. Some of these are recounted below:

6.1 Liquidity and Volumes

Improving the Investor Base - FII limit for investment in corporate bonds has been raised by additional US$ five billion on November 18, 2011 taking the total limit to US$ 20 billion to attract foreign investors into this market. In addition to the limit of US$ 20 billion, a separate limit of US$ 25 billion has been provided for investment by FIIs in corporate bonds issued by infrastructure companies. Further, additional US$ one billion has been provided to the Qualified Financial Institutions (QFI). These measures are expected to bring in the much needed requirement of broadbasing the investor base and therefore improvement in the liquidity and depth in the bond market.

The terms and conditions for the scheme for FII investment in infrastructure debt and the scheme for non-resident investment in Infrastructure Development Funds (IDFs) have been further rationalised in terms of lock-in period and residual maturity.

Further, as a measure of relaxation, QFIs have been now allowed to invest in those MF schemes that hold at least 25 per cent of their assets (either in debt or equity or both) in the infrastructure sector under the current US$ three billion sub-limit for investment in mutual funds related to infrastructure.

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Steps for Investor base improvements

Banks were permitted to classify their investments in non-SLR bonds issued by companies engaged in infrastructure activities and having a minimum residual maturity of seven years under the Held to Maturity (HTM) category;

The provisioning norms for banks for infrastructure loan accounts have been relaxed. The exposure norms for PDs have been relaxed to enable them to play a larger role in the corporate bond market. Banks have been given flexibility to invest in unrated bonds of companies engaged in infrastructure activities within the overall ceiling of 10 per cent.

6.2 Issuer Reforms

SEBI rationalized the provisions of continuous disclosures made by issuers who have listed their debt securities and not their equity shares on the stock exchanges. The necessary changes were made in the SEBI (Disclosure and Investor Protection) guidelines as below :

- For public/ rights issues of debt instruments, issuers now need to obtain rating from only one credit rating agency instead of from two. This is with a view to reduce the cost of issuances. In order to facilitate issuance of below investment grade bonds to suit the risk/ return appetite of investors,
- the stipulation that debt instruments issued through public/ rights issues shall be of at least investment grade has been removed.
- In order to afford issuers with desired flexibility in structuring of debt instruments, structural restrictions such as those on maturity, put/call option, on conversion, etc have been done away with

SEBI released the Issue and Listing of Debt Securities regulations in 2008 and further promoted the simplifying and rationalising of debt securities where the equity of a company is listed, and such company wishes to issue debt instruments (whether by way of public offering of private placement), as large amount of company related information is already in public domain and material developments are available as per the equity and listing agreement on a nearly continuous basis minimal incremental disclosures are sufficient; and where the equity of the issuer is not listed, and such a company raises

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debt capital (whether by way of public offering of private placement) detailed disclosures, (fewer than equity securities disclosures though), are required. Further the draft listing agreement for Debt securities were proposed to simplify the process for the issuer.

6.3 Improving Transparency and the settlements mechanisms

Reporting Platforms – Improvement in transparency

SEBI has instructed BSE and subsequently NSE for set up a reporting platform for the Bonds. Further to promote transparency in corporate debt market, a reporting platform was developed by FIMMDA and it was mandated that all RBI-regulated entities should report the OTC trades in corporate bonds on this platform. Other regulators have also prescribed such reporting requirement in respect of their regulated entities. This has resulted in building a credible database of all the trades in corporate bond market providing useful information for regulators and market participants. Clearing houses of the exchanges have been permitted to have a pooling fund account with RBI to facilitate DvP-I based settlement of trades in corporate bonds.

SEBI issued a circular on Mandatory Settlement of Corporate Bonds

Trades through Clearing Corporation according to which, from Decembe2009, all SEBI, RBI and IRDA regulated entities we re directed to clear and settle their trades the through the National Securities Clearing Corporation Limited (NSCCL) or the Indian Clearing Corporation Limited (ICCL).

The settlement is on T+1 or T+2 on DVP1 basis without any guarantee of settlementfrom the clearing corporations. SEBI to ok up with concerned authorities for pension funds and rural cooperative banks, subsequent to which EPFO also directed all PFs to settle their trades through NSCCL or ICCL; and NABARD and RBI directed all state and rural operative banks to settl e their trades through NSCCL or ICC

6.4 Steps in improvement of Risk appetite

Credit Default Swaps (CDS) have been introduced on corporate bonds since December 01, 2011 to facilitate hedging of credit risk associated with holding corporate bonds and encourage investors participation in long term corporate bonds. Since India is in the primitive stage of this new instrument, series of regulatory restrictions are imposed by the RBI to protect the economy from all the malpractices occurred in the recent sub-prime crises. Some of such restrictions, expected to slow down the growth of CDS in Indian market, includes:

- Participants eligible in the CDS market would be classified as Users and Market Makers.
- Users, such as commercial banks, PDs, NBFCs, mutual funds, insurance companies, housing finance companies, provident funds, listed corporates and FIIs, are permitted to buy credit protection only to hedge their underlying credit risk on corporate bonds.
- Market makers, such as commercial banks, primary dealers, NBFCs having sound financials and good track record, would be permitted to buy protection even without having the underlying bond.
- The reference entity in a CDS contract shall be a single legal resident entity.
- CDS will be allowed only on listed corporate bonds as reference obligations. CDS can also be written on unlisted but rated bonds of infrastructure companies and unlisted/unrated bonds issued by the SPVs set up by infrastructure companies.
- Since the users are envisaged to use the CDS only for hedging their credit risks they should not maintain their CDS position naked at any point of time during the contract.
- Users cannot exit their long CDS positions by entering into an offsetting short position. Long CDS position can be squared off either by unwinding the contract with the original counterparty or, in the event of sale of the underlying bond, provided the CDS positions is also passed on to the new buyer, subject to the consent of the original protection seller.
- The credit events specified in the CDS contract may cover: Bankruptcy, Failure to pay, Repudiation/moratorium, Obligation acceleration, Obligation default, Restructuring approved under Board for Industrial and Financial Reconstruction (BIFR) and Corporate Debt Restructuring (CDR) mechanism and corporate bond restructuring.
- The parties to the CDS transaction shall determine upfront, the procedure and method of settlement (cash/physical/auction) to be followed in the event of occurring a credit event.
- In case of transactions involving users, physical settlement is mandatory, but market makers can opt for any of the three settlement methods.

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Unrated Bonds - Banks have been given flexibility to invest in unrated bonds of companies engaged in infrastructure activities within the overall ceiling of 10 per cent.

Interest Rate Futures
Currently, the RBI has permitted the Interest Rate Futures on the following underlying instruments to hedge the interest rate risks. These Interest Rate Futures can be cash settled with respective Stock Exchanges on maturity.

(i) 91-Day Treasury Bills;
(ii) 2-year, 5-year and 10-year coupon bearing notional Government of India security, and
(iii) Coupon bearing Government of India security.
There is a strong need for the regulators to permit the exchange traded derivatives further to the other products as well, such as

Repo in Corporate Bonds – RBI has permitted the REPO in Corporate Bonds rated AA and above by the rating agencies, in order to facilitate liquidity in the system, The salient features of the Repo is that the REPO can be entered into for any security of more than 1 year remaining life and with a credit rating of AA or above.

6.5 Tax Incentives
Government has since introduced special incentives for the promotion of the Infrastructure bonds and have provided for special relief to the retail investors participating in the eligible issuances of the Infrastructure Bonds, This step has widely helped to bring in the much needed investors in financing the infrastructure based projects through the participation in the Infrastructure Bonds.

The tax rebate has been provided by the government which is in the form of an additional deduction under Sec 80 C of the Income Tax Act.

6.6 Other reforms - Structural Clarity

Clarity on the agency responsible for different segments of the corporate debt market were given as below
1. SEBI will be responsible for primary market (public issues as well as private placement by listed companies) for corporate debt;
2. RBI will be responsible for the market for repo/reverse repo transactions in corporate debt. However, If it is traded on exchanges, trading and settlement procedure would be determined by SEBI.
3. SEBI will be responsible for the secondary market (OTC as well as Exchange) for the corporate debt;
4. The above framework would apply irrespective of the parties (bank or non bank involved in a transaction;
5. The views in respect of trading of unlisted securities and derivatives on corporate debt (other than repo/reverse repo) would be taken as and when the need arises.
6. OTC as well as exchange based transactions need to be reported to reporting platforms(s);
7. All the eligible and willing national stock exchanges need to be allowed to set up and maintain reporting platforms if they approach SEBI for the same. SEBI needs to coordinate among such reporting platforms and assign the job of coordination to a third agency;
8. The trades executed on or reported to an Exchange need not be reported to a reporting platform;
9. The participants must have a choice of platform. They may trade on OTC or any exchange trading platform;
10. Existing exchanges could be used for trading of corporate debts. NSE and BSE could provide trading platforms for this purpose. There is no need to create a separate infrastructure;
11. There would be no separate trading platforms for different kinds of investors. Institutional and retail investors would trade on the same platform;
12. Only brokers would have access to trading platform of an Exchange. Banks would have the option of becoming a broker or trading through a broker. RBI, may if considered necessary restrict a bank to trade only on proprietary account as a broker.
13. SEBI rationalized the provisions of continuous disclosures made by issuers who have listed their debt securities and not their equity shares on the stock exchanges.

7.0 Conclusion
A vibrant corporate bond market provides a suitable alternative to conventional bank finances and also mitigates the vulnerability of foreign currency sources of funds. In India, the regulators have taken proactive steps and provided the market

with tools of risk management. Efforts are on to enable wider participation the market and create scope for market making. However, development of debt market is not a one-off affair. We have been able to foster the development of a deep and liquid G-Sec market in India and there are issues that need continued coordination and cooperation between the market participants and the regulators to develop private bond market for making India's bond market truly global debt market.

Despite various efforts, the corporate bonds market has not expanded to any meaningful extent. This is so even though the financing needs of the Indian economy, particularly in the infrastructure sector, are severe and that a robust bonds market may typically be in a position to meet those needs.

SEBI and RBI have taken constructive steps as per the recommendations of various committees and the result has been that the markets have shown development and growth compared to the trading levels in pre-reform periods, however the Indian Bond market still remains in its nascent stages and is yet to come up to the levels of the other Asian peers in terms of the liquidity and depth.
Tax structure needs improvement for attracting investment in bond markets; same is also true for stamp duty. Stamp duty on Indian FIS is very different and complex as different states has different stamp duty rates. To widen the investor base government should introduce the STRIPS in the markets as it is in the western part of the world.

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