Revving Up the Bond Market*

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In the final stretch of his tenure as Governor of the Reserve Bank of India, Raghuram Rajan chose to make one more effort at revving up India's bond markets. A number of measures aimed at galvanizing the debt market, culled out of past studies and extended by the H.R. Khan Committee set up under Rajan, have been announced. These measures have also been welcomed by all those who see the absence of a vibrant corporate bond market as a major weakness of the Indian financial structure.

The thrust of the measures is to expand the market for and increase the volume of trading in corporate bonds, so as to make the bond market an important source of funds for corporate investments. This is sought to be done in at least four ways. First, by making it easier to acquire corporate bonds, with foreign portfolio investors being allowed to trade directly in corporate bonds without involving brokers, and with retail investors being inducted into direct trading in the debt market by removing restrictions on transfer of government securities from the Reserve Bank of India (RBI) to the depositories. Having whetted their appetite for debt in the government securities market, retail investors are expected to move into corporate bonds as well.

Second, the measures seek to increase the liquidity associated with corporate bonds by (i) making those bonds eligible to be considered as collateral in the RBI's operations under the liquidity adjustment facility; and (ii) allowing brokers to participate in the corporate bond repo market.

Third, they are aimed at expanding the size of the corporate bond market through measures that encourage banks to issue new bonds. These include allowing banks to issue rupee denominated bonds (or 'masala bonds') in foreign markets in the form of higher yielding Perpetual Debt and other debt instruments that can qualify as either Tier 1 or Tier 2 capital when computing capital adequacy. Banks would also be allowed to issue such masala bonds to mobilise capital for infrastructure financing and lending for affordable housing.

Finally, and most significantly, banks are being roped in to render bonds less risky by extending the already existing partial credit enhancement (PCE) scheme. In September 2015, the RBI introduced a scheme under which banks were allowed to provide partial credit enhancement to bonds issued by corporate entities and special purpose vehicles. This involves providing a non-funded but irrevocable line of credit linked to a bond issue, which companies can access to meet commitments in case they find themselves unable to meet interest or amortisation payments on the bonds. There were conditions set on this facility including the requirement that the rating of the bond issue must be "BBB minus" or better before the credit enhancement and that the aggregate PCE provided by all banks to any bond issue cannot exceed 20 per cent of the bond issue size. The essential aim of the PCE scheme is to reduce the risk associated with a bond and enhance its rating. With the banks taking over part of the risk, the bonds can be upgraded to investment grade, making them eligible for purchase by insurance and pension funds. According to CARE Ratings[i], even the 20 per cent enhancement scheme would elevate a BBB rated bond to the A or AA category. The new measures implemented include one that increases the aggregate

PCE exposure of the financial system to any bond issue to 50 per cent (from 20 per cent) of the size of the issue, with a ceiling of 20 per cent on the exposure of any single bank. This could possibly take a BBB bond to the AAA category, making it an acceptable instrument for relatively more risk averse investors like insurance companies and pension funds.

Thus by increasing the size of the bond market, enhancing its liquidity by ramping up the volume of transactions in bonds, and reducing the risk associated with those instruments, the measures aim to give the market the fillip needed for it to come of age. It is important to note that while these measures are being presented as part of a market-friendly reform process, the bond market here is not expected to evolve autonomously to mitigate information and transaction costs as that approach suggests it should. Rather the government is seeking to engineer the emergence and expansion of a market it sees as required to support long term investments. If the bond market does emerge as an important source of long term capital in India, it would be because of intervention and not deregulation. This in itself is not negative, so long as it is recognised that this is what the government is doing and the implications of its specific actions for other markets and different players in the financial system are made clear.

The factor that motivates the RBI's intervention is the belief that the need for a bond market for financing long term investment, and, more importantly, supporting investments in areas like infrastructure which involve projects with long gestation lags, has increased immensely. In the past a large part of such financing was supported with allocations from the budget in the case of public sector projects or with credit from the development finance institutions (DFIs) for both public and private projects. The DFIs themselves were supported with concessional funds from the RBI and the government, especially the former, which had a separate window for the purpose. That era has, however, ended.

The government's failure to mobilise adequate resources through taxation and its post-reform emphasis on fiscal consolidation, which limits its borrowing, has reduced its capital spending. This requires the private sector to play a greater role in capital intensive industries and infrastructure. On the other hand, a consequence of Indian-style financial liberalisation has been the conversion through reverse merger of the DFIs into regular commercial banks. ICICI Bank and IDBI Bank are all that is left of the erstwhile industrial financing infrastructure. This has meant that the burden of financing private investment in capital intensive areas including infrastructure has fallen on the commercial banks, especially the public sector banks. However, the maturity and liquidity mismatches between the funds sourced by the commercial banks and investments in large industrial and infrastructural projects has resulted over time in rising non-performing assets in the books of these banks. So they too are retreating from financing of investment in these areas. Hence, besides foreign borrowing, a liquid bond market has become the only possible alternative to clear this financing bottleneck and support such investment. To realise that alternative, investors looking for long term investment opportunities and offered the expected yield and the required liquidity as insurance have to be brought to market in adequate numbers.

Unfortunately, the penetration of the corporate bond market is almost marginal in the Indian financial sector. In 2014, while the ratio of bank deposits to GDP stood at 64 per cent, and that of domestic credit to the private sector at 52 per cent, the ratio of outstanding corporate bonds to GDP was only 14 per cent.[ii] By the end of 2015 while corporate bond penetration in India was at around 17 per cent of GDP, the figure was close to 45 per cent In Malaysia and 75 per cent in South Korea. Moreover, at the end of 2015, government securities (G-Secs, State Development Loans and Treasury Bills) accounted for 72 per cent of value of outstanding bonds, with corporate paper (bonds, commercial paper and certificates of deposit) contributing the balance 28 per cent. [iii]

Thus, though the value of outstanding corporate debt securities has risen quite steeply in recent years, from Rs. 8,89,510 crore in 2010 to Rs. 20,19,296 crore in 2015-16, India's bond market does show signs of weakness. This comes through even from RBI figures[iv] on resources mobilised by the private and public sectors in recent years from the primary debt and equity markets through public issues and private placement. Debt does dominate here. In 2015-16, of the total of Rs. 4.66 trillion mobilised, as much as Rs. 4.23 trillion was through debt issues. Further, as much as 61 per cent was mobilised by the private sector, in a market which was for long dominated by public sector firms. However, of the total resources mobilised, an overwhelming amount of Rs. 40.8 trillion (or 88 per cent) was through the private placement route rather than through public issues. Clearly, the market to which any would-be corporate borrower could turn is limited in its scope. More well established and promising companies could take the private placement route, where institutional investors are the major players, but the others have to rely on the banks. Not surprisingly, instruments in the AA or AAA category still accounted for around 80 per cent of new bond issues, and even by the end of 2015 financing with corporate bonds was just above a quarter of investment that had been financed with bank loans.[v]

It is understandable, therefore, that while the new measures announced by the RBI make an effort to introduce the retail investor to direct trading in the market, the actual emphasis is on the institutional investors. Even the global evidence is quite clear that small investors are exposed to the debt market through institutions like mutual funds, insurance companies and pension funds. So the government's effort seems to be to use the latter as means to bring a larger share of household savings into the corporate bond market. It has done this in the past by persuading public sector insurance companies and pension funds to allocate a larger share of their investments to the market for corporate bonds. In addition, under the new pension scheme of the government, subscribers are required to choose some level of risk exposure as part of a move from defined benefit to defined contribution schemes. But, given the fiduciary obligations of investment managers in these funds, they tend to be cautious when following government advice, making private placement the preferred route for investments in corporate bonds. That does not help strengthen the corporate bond "market".

To address this problem, the new measures aim at improving the rating of corporate bond issues, so as to make them feasible for institutional investors. This is expected to have two consequences. First, it would make more conservative institutional investors more bond-savvy. With banks, which are increasingly unwilling to directly carry the risk of substantially enhanced lending to the corporate sector, made to indirectly carry some of the risk in the system, the doors of the bond market are to be opened wider for institutional investors. Second, increased activity and reduced risk in the bond market would open it up to issues by less favoured firms, making the market an important source for long term capital. This it is hoped will help resolve a problem, which has been created by the government's own policies, of an unavoidable dependence for finances on a market that is still to mature. But in the process it is exposing banks, insurance companies, pension funds, and those who place their savings in these institutions to increased risk.

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[i] Care Ratings, Partial Credit Enhancement: A Push to the Corporate Bond Market, September 25, 2015, available at http://www.careratingsmaldives.com/India/Partial Credit_Enhancement-_A_push_to_Corporate_Bond_Market.pdf, and accessed 31 August 2016.

[ii] Figures from the World Bank's Global Financial Development Database available at http://www.worldbank.org/en/publication/gfdr/data/global-financial-development-database, and accessed on 31 August 2016.

[iii] Figures from CRISIL (2015), The CRISIL Yearbook on the Indian Debt Market, 2015, Mumbai, available at https://www.crisil.com/bond-market/pdf/2015/crisil-yearbook-on-the-indian-debt-market-2015.pdf, accessed 30 August 2016.

[iv] Reserve Bank of India, Annual Report2015-16, Appendix Table 5, RBI: Mumbai, p. 174.

[v] CRISIL (2015).

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