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Corporate Bond Market in India: Obstacles and Opportunities

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Abstract:

Capital markets are the lifeline of an economy which spurs economic development and growth in the real sector by directing capital to creditworthy borrowers. Indian capital markets have significantly grown in the last decade. India's equity markets are quite developed, its G-sec market is also fairly large but its corporate bond market is lacked in both size and liquidity. A deep and liquid bond market augments financial savings and helps match the savers to the borrowers in an efficient manner and is quite important especially in recent times when India needs huge amount of funds to meet its infrastructural requirements. The paper studies the major obstacles which restrict the growth of corporate bond market in India.

Keywords : corporate bond market, Private placement of bonds, G-sec market

1. Introduction

Today India has a very large and liquid equity market and a vibrant government securities market. However, corporate bond market - one of the important segments of capital market is underdeveloped. India's equity market capitalization (relative to GDP) is at par with many other emerging markets, but its corporate bond issuance (relative to GDP) remains significantly below levels as compared to other countries. (Refer table 1)

Country	Spain	South Korea	China	Malaysia	Unites States	India
Corporate bond issuance as a percent of market capitalization	47%	30.9%	13.2%	10.8%	9.8%	5%

*Table 1 : Cross Country Comparison
Data of 2012*

Source: BIS quarterly Report

The importance of a flourishing bond market cannot be undermined specially in the current times when India needs huge investment to finance its infrastructure sector which cannot be solely met by commercial banks due to the problem of Asset Liability mismanagement. According to a report of the committee on Infrastructure Planning, India needs investment worth Rs 51 trillion for infrastructure in 12th 5 yr plan. Also banks themselves need a huge sum of non-equity capital to make them Basel III compliant.

2. Obstacles

A number of constraints that have limited the growth of corporate bond market are classified into 3 major groups- demand side, supply side and market structure related issues that are acting as hurdles in the development a vibrant corporate bond market.

3. The Demand Side Issues

3.1. Restriction on Institutional Investors

Institutional investors like banks, pension/provident funds, Mutual funds, insurance companies are the major players in the corporate bond market. However, their investments have been curtailed due to several regulatory restrictions. For instance, the Statutory Liquidity requirement (SLR) in banks requires them to hold one quarter of their assets in public sector bonds. Also they are restricted to invest only 10% of their total non - SLR investments in unlisted debt papers.

Further According to Deepak Parekh Committee Report on Infrastructure Financing, there is a regulatory asymmetry in the treatment of loans and bonds by banks as a result of which banks are more eager to advance loans rather than subscribe to bonds issued by the same company.

Internationally, insurance companies are among the largest participants in the corporate bond market. However, in India, insurance companies are permitted to hold a maximum of 25% of their portfolio in bonds rated less than AA. Again pension fund managers are regulated to invest fewer than 10% of the funds in corporate bonds that are investment grade. Similarly, Employees Provident Fund Organization and Public Provident Fund which have huge assets under their management, are subject to stringent regulatory restrictions. Without these long-term investors, it is difficult to see how the corporate debt market will take off.

3.2. Low Participation of Retail Investors

Another category of investors is retail participants. Despite a high savings rate as a proportion of a GDP (household saving rate is 22 per cent of the GDP in fiscal year 2012-13), Indian retail investors have not developed interest in the corporate bond market. There is a limited awareness, knowledge and understanding of bonds as an asset class. An illiquid secondary market along with relatively high rates offered on small savings schemes are disincentives to investment in corporate bond markets.

3.3. Lack of Demand for Lower Rated Bonds

Market preference for very safe AA+ assets with no market for issuances below AA thus creating a very thin debt market. As shown in the following table, the volume of bonds rated below A is around 5% of the total issue. Only investment grade securities are eligible for subscription by banks. This prevents banks from investing in bonds of lower rated corporations which may include infrastructure companies.

	AAA	AA	A	BBB	Non investment grade
2007-08	4542	1202	357	95	16
2010-11	5116	1826	904	693	427

Table 2: Rating wise distribution of corporate bonds (in Rs billion)

Source: NSE

3.4. Subdued secondary market

The key drawback of bond market is lack of liquidity which keeps retail investors at bay. According to a CRISIL report, the daily average turnover in corporate bonds is Rs. 3000 crore per day in fiscal 2013 which is quite low as compared with developed markets such as US (Rs. 100000 crore per day) or even India's equity market which has a turnover of Rs 13000 crore in cash segment and Rs 126000 crore per day in derivatives segment in the year 2013. The other measure to look at liquidity is ratio of traded volume to bond outstanding. India's ratio is 0.23% whereas China's ratio is 1.7%(Crisil).

Low activity in secondary market is partially due to buy and hold strategy of institutional investors. For instance, there is a tendency for banks to buy and hold bonds rather than trade in them because of regulatory norms which require bonds to be marked to market if it is part of trading portfolio, whereas they can be valued at cost if it is held to maturity.

4. Supply-Side Issues

4.1. Concentration of Issuers

Corporate bond issuer profile is dominated by BFSI (Banking, financial Services and Insurance sector)which accounted for nearly 75% annual average issuances in last 10 years. While industry grew 6 times in the last 10 years, it accounted for only 22 % of total corporate bond issuances in 2013. (Prime Database , Crisil research)

4.2. High Level of G-sec Issuances

The high fiscal deficit of the Government of India (GoI) is financed by the issue of GoI bonds or government securities (G-Secs). This has the impact on crowding out private corporate debt issuance.

4.3. Complete Domination of Private Placement

Private placement is defined as 'an issue of securities by a company to a select group of persons (less than 50)', whereas a public issue is an offer made to the public in general to subscribe to the bonds. Most of the corporate debt in India is raised through private placement mechanism. In 2009-10, only 1% of the total resources mobilised by corporate raised through public issue (Table3). Corporate prefer raising funds through private placements as against public issues as the disclosures in case of public issues are more rigorous or onerous.

Year	Percentage share in total resources		total Resource Mobilisation including equity (Rs \$mm)
	Debt Public Issues	Debt Private Placements	
2007-08	0.5	57.4	20,10,031
2008-09	0.8	91.5	19,05,467
2009-10	1	76.7	24,70,454
2010-11	3.6	74	25,98,333
2011-12	11.9	83.9	29,99,047
2012-13	4.4	91.6	38,43,030

Table 3: Resources raised by corporate sector

Source: NSE

4.4. Bond-maturity is Quite Low in the Market

Short maturities are another significant problem in the bond markets. We don't really have longer term debt. The average maturity for bonds issued by Indian Corporations tends to range between 5 to 7 years on average. In contrast, in emerging Latin American countries several different varieties of bonds are available with maturities extending to 30 years. The average maturity in the US bond market has lengthened in the recent past and has been upwards of 12 years since 2007. Additionally, ultra long term bonds of maturities ranging from 30 to 50 years are also widely used. Longer term maturity bonds are typically useful investment avenues for long term investors such as pension funds. (Igata, Taki, Yoshikowa (2009))

4.5. Lack of Innovation

There are large varieties of bonds available in international bond markets. These are variable cash flow bonds like Step-up Bond⁵, Step-down Bond, Deep Discount Bond, Reverse Floater Bond etc. and index bonds like stock-, interest rate-, or bond index linked bonds, dual currency bonds etc. However, in India mostly fixed rate coupon bonds are prevalent. Although other securities are available in the market, but with a very less volume. (Table 4)

Year	Type of Coupon			
	Fixed	Floating	Zero	Others
2008-09	64.47	31.35	4.18	0.00
2009-10	64.47	27.49	4.31	3.73
2010-11	68.05	23.40	7.01	1.54
2011-12(Q1)	61.59	35.16	3.05	0.20

Table 2: Percentage Share of Corporate Bonds with Different Types of Coupon

Source: NSDL

5. Market Related Issues

5.1. Lack of pricing benchmarks

In a properly functioning bond market, the need for accurate and reliable benchmarks is pivotal. In fact, they define the structure of the interest rate and investors' expectations for future interest rate fluctuations. However Indian corporate bond market lacked 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.

5.2. Inadequacy of legal framework of recoveries in the event of default

In a market like India, it has been hard to recover loans from defaulting borrowers because there is a lack of proper, codified bankruptcy procedure. Also given that default rates are higher in India than in even many other emerging markets, this causes an undue amount of risk aversion for investors.

5.3. Overlapping jurisdiction of various regulators

SEBI regulates the capital market, while RBI oversees the banks. IRDA decides on how insurance funds operate while PFRDA regulates the pension funds. The authorities are guided by different motivations and often work at cross purposes causing friction.

6. Opportunities

There are many opportunities in the corporate bond market that could be trapped either by making changes in the regulations or by creating new products. The development of corporate bond markets is quite critical because it relieves the burden on the banking system to reach a much wider population. For example, there are high quality borrowers who can potentially issue corporate

bonds but are dependent on banks. If they move out of bank financing and go to market financing, there would be a significant amount of resources in the banking system that can reach a much wider population. And it can move us closer to the goal of financial inclusion.

It can be done through the following ways:

- One is encouraging involvement from retail savings market, that is, from mainstream middle-class investors who are investing today in a variety of asset classes but are not active in bond market. They have a huge potential which was seen from the recent launch of a 25 year deep discount bond by ICICI. The retail reaction to that was, far more positive than the market expected.
- To provide new investment avenues to public and institutional players, market regulator Sebi is working on fresh guidelines for municipal bonds - a popular financial product in developed countries like the US. The market for municipal bonds, also known as 'muni bonds', is yet to take off in India even though few municipalities here have offered such products in the past, while Ahmedabad Municipal Corporation in Gujarat was the first to launch such a bond way back in 1998.

These bonds are issued by urban local bodies to finance infrastructure such as water supply and sanitation. They serve as an efficient tool for local bodies to mop up funds and can be extensively tapped to meet funding needs of urbanization. Besides the US, other countries with a developed muni bond market include Canada and Russia.

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