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Why a corporate bond market

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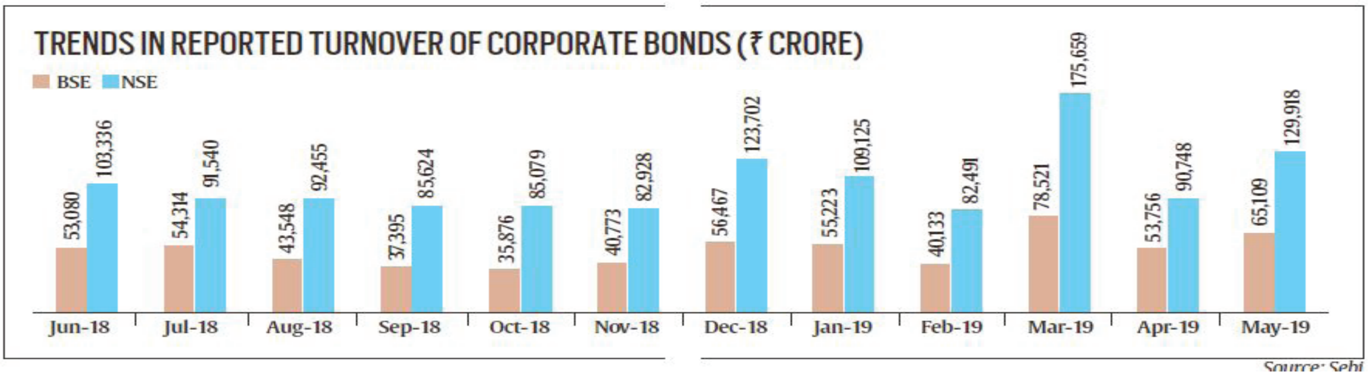
"FM Nirmala Sitharaman has announced fresh measures for developing such a market, after previous budgets and a number of panels had failed to work out a plan. Why does India need such a market, and what are the new measures?"

India's economic reforms since 1991 have led to seismic changes in many areas and sectors. But one segment where growth has been stunted in spite of the efforts by policymakers over the last three decades has been the development of the corporate bond market. Successive budgets and at least half a dozen committees mandated by the government, the RBI and the Securities and Exchange Board of India (Sebi) to work out measures to develop this market have largely failed. In this year's Budget, Finance Minister Nirmala Sitharaman has announced fresh measures to boost the development of India's corporate bond market.

What are these measures?

In her Budget speech, the FM had said that an action plan to deepen the market for long term bonds including for deepening markets for corporate bond repos, credit default swaps etc, with a specific focus on the infrastructure sector, will be put in place. She said Foreign Portfolio Investors (or FPIs) will also be allowed to invest in debt securities issued by Infrastructure Debt Funds. The FM also stated that a Credit Guarantee Enhancement Corporation, for which regulations have been notified by the RBI, will be set up in 2019- 20.



How will some of these measures help?

Unlike the Indian equities market where the daily volumes of traded stocks are high, signifying liquidity or enough opportunity for both buyers and sellers, the debt market is dominated more by trading in government bonds or securities. Most of the demand for these securities is from investors such as banks that have to mandatorily hold these bonds as part of regulatory norms. Over time, more Indian companies —both listed and unlisted ones — have started issuing bonds that offer semi-annual interest payments to investors. But these bonds aren't traded much, thanks to a limited investor base and low liquidity. This, in turn, leads to lower volumes of their trades compared to the other segment of the capital market. The aim of the government and regulators is to boost the liquidity and volumes and make the debt market more vibrant.

What is the importance of a corporate debt market?

In most international markets including the US, trading volumes in the debt market are much higher than those in stocks. Liquidity, too, is quite high with enough buyers and sellers willing to buy bonds with low credit ratings in the hope of receiving a big payoff. This enables companies to raise funds across different maturities including for infrastructure projects with long gestation periods.

In India, given the absence of a well functioning corporate bond market, the burden of financing infrastructure projects such as roads, ports, and airports is more on banks and the general government. This, in turn, puts lenders such as the banks under pressure as reflected in the ballooning of bad loans. For instance, in banks, such investments create an asset-liability mismatch. In other words, they are buying into long-term assets, such as a highway, with short term liabilities, that is deposits of three- to five-year maturities. Eventually, this not only results in inefficient resource allocation but also weakens the bank balance sheets.

How will a Credit Guarantee Enhancement Corporation help?

The proposed new corporation will help companies to boost their credit rating, which, in turn, will enable them to raise funds at cheaper rates. By allowing repurchase agreements or repos (that allow a company to raise funds by offering its securities and agreeing to repurchase it later) in AA rated bonds or securities, volumes could go up in the corporate bond market. More importantly, it can help improve liquidity especially if the RBI, like many other central banks of the world, uses it for its repo operations. The other measure —of allowing investments made by FPIs in debt securities issued by Infrastructure Debt Funds to be sold to a domestic investor within a specified lock-in period — should help offer an exit option for such investors and improve liquidity. Similarly, policymakers want to develop the segment for credit default swaps. This will mean protection against the possibility of a company or issuer defaulting on a repayment option and thus offering comfort to an investor willing to take a risky bet and, in the process, adding volumes.

Beyond the Budget, what else has been done to boost the bond market in the recent past?

Since 2016, the RBI has made the point that the bigger companies would have to raise part of their long-term borrowings from the corporate bonds market rather than from banks. New norms since then make it mandatory for companies with large exposures to raise 25 per cent of their incremental or fresh borrowings from the bond market. This policy has been put in place to force corporates to go to the bond market and to ease the pressure on banks. Regulatory rules also make it necessary for any company that plans to raise debt funds of over Rs 200 crore to execute it on an electronic platform. This is expected to improve transparency as well.

Why has the Indian corporate bond market failed to take off?

For years, the investor base in the corporate bond market has been narrow – marked by banks, insurance companies, pension retirement funds and now mutual funds. The FPIs are now prominent buyers of top-rated bonds given the attractive returns especially in the backdrop of a strong rupee. Most of these investors do not trade but hold these investments until maturity. With few buyers in the market or market makers who offer buy or sell quotes constantly, there is little liquidity. There is little or no incentive for market making. A majority of the bonds issued by companies are privately placed with a select set of investors in India rather than through a public issue; this is done to both save time as well as avoid greater disclosures. Foreign investors can now invest up to Rs 3,03,100 crore in these bonds and so far only a little over 67 per cent of this limit has been utilised. In 2019-20, investments by foreign funds in stocks have aggregated Rs 28,268 crore and Rs 10,949 crore in debt. Another peeve has been the varied stamp duty in states on debt transactions. But this will soon be sorted out with a uniform rate.

Have the recent corporate defaults been a dampener?

Indeed. An IL&FS subsidiary that had the highest rating defaulted on its obligations exposing credit rating agencies and, in turn, hurting institutional investors who bought into these and other similar bonds. The investors included the EPFO —India's largest retirement fund — and many mutual funds too. This is likely to dissuade investors, who may prefer to invest in safer avenues only. The new insolvency law was supposed to provide an extra layer of comfort too with a speedier resolution of stressed assets and a return of funds to bondholders. But that has not been the case with the deadline of 270 days being breached in many cases.

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Corporate bond

Why in the discussion?

- Recently, Finance Minister Sitharaman presented the budget for the fiscal year 2019-20 and said that corporate debt markets are important for the infrastructure sector.
- she said that the bond issue has decreased over the last two years. Market appears in the favor of private placements.
- she proposed several measures in this direction while emphasizing the need to extend Bond markets.
- The measures proposed by her include that the government will work with the Reserve Bank of India and SEBI to expand the corporate dimensional repo market in corporate debt securities.

What are Corporate Bonds?

- Corporate bonds are debt securities issued by private and public corporations.
- Companies issue corporate bonds to raise money for a variety of purposes, such as building a new plant, purchasing equipment, or growing the business.
- When one buys a corporate bond, one lends money to the "issuer," the company that issued the bond.
- In exchange, the company promises to return the money, also known as "principal," on a specified maturity date. Until that date, the company usually pays a stated rate of interest, generally semiannually.
- Corporate bond does not have an ownership interest in the issuing company, unlike when one purchases the company's equity stock.

Significance of Corporate Bond market

- They provide an important alternative source of funding for corporations, which will enable them to optimize capital structure in an environment of friction.
- Such a market should enable additional cash to fund operations or long-term expansion plans without diluting corporate control.
- Corporate bond market would spur corporate activity and thus economic growth.
- Investors such as pension funds and insurance companies should also welcome corporate bonds as an additional set of instruments in which to invest, providing, in theory, a better overall risk to reward trade-off since there would be more opportunities for diversification.
- Why Corporate Bond Markets are underdeveloped in India?
- In India, the development of a corporate bond maket has lagged in comparison with other financial market segments due to a number of certain structural issues that include the dominance of the corporate bond issuance by private placements, which accounted for more than 95% of the total issuance of corporate debt in 2014-15, and the issuances being concentrated in the 'AA' or higher rating, largely by public sector entities and financial institutions.
- The huge pile of corporate debt that is currently being held in the form of loans, especially by state-

owned banks is also posing some problems. At present, banks are not required to mark loans that they make to corporations to market, but are, of course, required to mark corporate bond holdings to market. This obviously makes corporate loans more attractive than corporate bonds as it offers an opportunity for banks' balance sheets to be shown healthier than they truly are.

- Other reasons: low primary issuance of corporate bonds leading to illiquidity in the secondary market, narrow investor base, high costs of issuance, lack of debt market accessibility to small and medium enterprises, dearth of a well-functioning derivatives market that could have absorbed risks emanating from interest rate fluctuations and default possibilities, excessive regulatory restrictions on the investment mandate of financial institutions, large fiscal deficit, high interest rates and the dominance of issuances through private placements.

Expected Questions (Prelims Exams)

1. In the context of corporate bond, consider the following statements-

1. Corporate bond is the debt securities issued by private companies.
2. Corporate bond is the debt securities issued by public companies.

Which of the above statement is/are correct?

(a) Only 1 (b) Only 2

(c) Both 1 and 2 (d) None of the above

Expected Questions (Mains Exams)

Q. What does corporate bond market mean and why is there a need of such market at present.

(250 Words)

Note: Answer of Prelims Expected Question given on 9 July. is 1(a).