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CORPORATE BOND MARKETS IN INDIA: A STUDY AND POLICY RECOMMENDATIONS

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Corporate Bond Markets in India: A Study And Policy Recommendations[1]

ABSTRACT

Vibrant, deep and robust corporate bond markets are essential to enhance stability of financial system of a country, mitigate financial crises and support the credit needs of corporate sector, which is vital for the growth of an economy. Our review of research and policy papers on the corporate debt markets in India reveals a persistent absence of an efficient, liquid and vibrant corporate debt market in India. Our paper seeks to flag this issue and help to fast track the development of the corporate bond markets in India.

Recent trends reinforce the need for strong policy measures to develop the corporate debt markets in India. A study of corporate bond market experiences across developed and emerging markets such as US, EU, Japan, China, Malaysia, Korea and New Zealand further underscores the importance of strong institutional and regulatory framework, along with support from policymakers for building robust corporate debt markets. A review of literature and an analysis of key trends in corporate debt market help us identify the issues with the three pillars of corporate debt markets – institution and regulators, market participants, and instruments. We find that this lack of depth and efficiency in the corporate debt market is mainly explained by inadequate infrastructure, illiquidity, regulatory gaps, limited investor and issuer base, and absence of benchmark yield curve across maturities. Finally, we apply the insights from literature review, the trend analysis and cross-country study to make recommendations to revive the Indian corporate debt markets. The recommendations span areas such as taxation, legal and regulatory, public policy, market micro structures, corporate laws, and banking regulations.

Key words: Corporate bonds, Municipal bonds, capital market, institutional development.

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I. INTRODUCTION

Corporates, governments and individuals rely on various sources of funding to meet their capital requirements. Specifically, corporates use either internal accruals or external sources of capital to finance their business. Funds are raised from external sources either in the form of equity or debt or hybrid instruments that combine the features of both debt and equity. The capital raised by companies through debt instruments is broadly referred to as corporate debt.

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.

Corporate bonds are transferable debt instruments issued by a company to a broad base of investors (including but not restricted to banks and other financial institutions). We distinguish between a) public debt (debt issued by central and state governments, municipal authorities) and b) private debt (bonds issued by private issuers: financial and non-financial corporates). We focus our study on private debt. Certain typical features of corporate bonds, including but not limited to the following, are a) corporate bonds are issued to the public (similar to equity instruments) b) listed on stock exchanges and traded in secondary markets c) are transferable d) possess a broad base of issuers (ranging from small companies to conglomerates and multinationals) and investors (including retail participants), and e) are under the additional purview of the regulators of the securities market other than the central bank or other banking supervisor.

Corporate bond markets are further defined as the segment of capital markets in the economy that deals with corporate bonds. There are three main pillars that make up the corporate bond market ecosystem – the institutions, participants and the instruments. The study of corporate bond market is essentially the study of these three pillars, their roles, responsibilities and actions in the corporate bond market. The institutions comprise of the securities market regulator, the banking regulator, the credit rating agencies, clearing houses, stock exchanges and the regulations and governance norms prescribed by these institutions. The participants comprise of the market players – investors on the demand side and issuers on the supply side. The term

'instruments' is used to indicate the form and features of securities issued in the corporate bond market.[2] Further, certain securities and derivatives, such as interest rate and currency derivatives and government securities, even though, not a part of the corporate bond market, play a significant role in ensuring its vibrancy and smooth functioning.

As stated above, the study of corporate bond market involves institutions, participants and instruments of the corporate bond market. Hence we propose to study the history and evolution of institutions and institutional framework to understand the issues pertaining to the macro-structure of bond markets. Similarly, an investigation into the diversity, volumes and characteristics of investors and issuers would help to uncover the core issues underlying the problems of illiquidity, lack of transparency and low-level equilibrium in the corporate bond market. A comparative study of cross-country experiences of corporate bond markets, focusing but not limited to development of the three pillars of the bond markets, will lend depth and perspective to our understanding of the shortcomings of the Indian market.

To further enhance our theoretical understanding, we propose to study the interplay of the three pillars and reveal practical issues through our analysis of trends in the corporate bond market in India. The analysis of trends will focus on a) regulatory initiatives and reforms to develop the bond markets, b) trends in investor participation (including their market volumes and shares and the volume of activity in primary and secondary markets) and issuer participation (in terms of volumes, types, credit ratings, etc.), and c) types of instruments dominating the corporate bond markets in India.

Through the methodology outlined above, we aim to arrive at comprehensive list of core issues that are restricting the development of corporate bond market in India and propose recommendations to address the same.

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[2] For instance, corporate bonds can have tremendous diversity with regards to following features

- type – debentures, deposits, commercial paper, project bonds, infrastructure bonds, securitized instruments
- maturity – long and short term, perpetual bonds, redeemable bonds, fixed maturity bonds of varying durations
- interest payments – fixed coupons, floating rate, zero-coupon bonds, cumulative bonds, coupon only bonds
- embedded derivatives – put and call options, floors and caps on interest rates, convertibility features
- protection – secured and unsecured bonds, senior and subordinated bonds
- legal terms

This paper proceeds as follows. Section II is a review of some of the most important and relevant literature. Next, Section III is a commentary on the trends observed in important variables associated with the corporate debt markets in India. Thereafter, Section IV presents our analysis of the issues and challenges faced by corporate debt markets in India. Finally, Section V contains a few policy recommendations and conclusions.

II. REVIEW OF LITERATURE

In any economy, a smoothly functioning debt market is considered crucial for development and stability. Armour and Lele (2009) postulate that economic structure is a determinant of financial structure. Since India is a predominantly services based economy, the financial structure automatically prefers equity market liberalization over debt market liberalization.

It is evident that there has been much deliberation on the corporate debt scenario in India but as the underlying theme for most of the analysis has been cross country experiences in the corporate debt domain, the application of these learnings to the Indian context needs to be cautiously exercised (Wells and Schou-Zibell, 2008).

The International Capital Markets Association (2013) argues that vibrant corporate debt markets bring substantial economic benefits and are important for all stakeholders concerned viz. companies, investors, economies and governments.

Good friend (2005) advocates the use of corporate bond markets by more transparent firms, to lower their effective interest costs. On the contrary, Luengnaruemitchai and Ong (2005) concede that there is no conclusive evidence establishing the superiority of either a bank dominated or a market dominated financial system but state that a well-diversified economy with balanced distribution across bank lending and corporate bonds is less vulnerable to a financial crisis.

From the perspective of a developing economy, the World Bank (2000) observes that “the corporate bond market in a country can substitute part of the bank loan market, and is potentially able to relieve the stressed banking system in a developing country of unbearable burden.” Development of corporate debt markets needs strong institutional and regulatory support. The World Bank (2000) specifically identifies seven necessary developmental components for the effective functioning of vibrant bond markets. Any “absence, deficiency or inefficiency” of any

of these components can potentially stall the development process. These components are (i) a disclosure and information system, (ii) a credit rating system, (iii) effective bankruptcy laws, (iv) market intermediaries, (v) institutional investors, (vi) a trading system and clearing platform and (vii) a depository system.

Sengupta (1998) establishes a direct correlation between any firm's disclosure practices and its effective interest cost. Edwards et al (2007), while acknowledging merit in opposing arguments provides persuasive evidence of reduced transaction costs on allowing bond price transparency. On the other hand, Bessembinder and Maxwell (2008) are more skeptical and seek to achieve some middle ground. It is true that investors stand to benefit from increased transparency, due to reduction in 'bid ask spreads'. However, bond dealers experience reductions in compensations thereby shifting trading activities to other securities. Further, dealers are averse to carrying inventory and sharing research with investors.

According to Wells and Schou-Zibell (2008), the development of regulatory and financial supervisory framework plays an important role in the vibrancy of corporate debt markets. Luengnaruemitchai and Ong (2005), strongly emphasize regulation and policy as one of the development issues of corporate debt markets in India. Three objectives justify a strong regulatory support system: fair and equal treatment of investors, market integrity and containment of systemic risk.

According to Wells and Schou-Zibell (2008), the inconsistent, disorganized and overlapping institutional and regulatory framework has been one of the primary reasons impeding the development of strong corporate debt markets in India. These gaps have given rise to regulatory arbitrage with different market players reporting to different regulators depending on size and ownership.

Hakansson (1999) substitutes 'institutions and regulations' with the word 'mechanisms'. When bank lending and corporate debt is more balanced in an economy, the market gets an opportunity to assert itself, thereby providing a more effective hedge against systemic risk. Corporate debt markets inherently bring with them market discipline, through various mechanisms. Dissemination of timely, accurate and relevant information through a reliable financial reporting system is the first of such mechanisms. Secondly, transferable debt ensures the presence of a

pool of professional financial analysts, to provide objective advice to investors. Thirdly, it results in a more effective management of a default or bankruptcy case. Finally, the effect of market forces governing corporate debt also rubs off on bank lending, as the banks can ill afford to engage in uncompetitive lending.

The gradual and steady development of strong institutional and regulatory frameworks is necessary to sustain the momentum of corporate debt markets. The BIS (2006) provides interesting case studies to highlight this contrast. A sudden expansion of corporate bond markets without the necessary support structures is unsustainable and can cause strain on the financial system if the prevailing credit quality of corporate bonds is compromised or companies over-leverage their balance sheets. The paper specifically describes several policy initiatives in Malaysia which boosted the corporate bond market development.

The regulatory and institutional environment does indeed play a huge role in tilting the scales in favour of either bank lending or corporate bonds. Empirical studies reveal vast differences in the financial structures of the US and the European economy. The US economy is centered on corporate bonds, whereas the European economy prefers bank lending. This is because the institutional setup is vastly different in these economies. De Fiore and Uhlig (2005) have modeled the problem and observed that the Euro markets place much higher reliance on bank finance than the US markets, which are inclined towards bond finance. The paper has explored the contribution of agency costs in generating the rift observed above.

Luengnaruemitchai and Ong (2005) opine that crowding out by government bonds is one of the potential obstacles to healthy corporate bond markets. A high level of public debt crowds out corporate borrowing by reducing the appetite of financial institutions. This increases the cost of borrowing for corporates making bond markets an unviable source of funding (Ağca and Celasun, 2009). On the contrary, Raghavan and Sarwano (2012) conclude that in case of India, unlike economies like Korea, the development of the government bond market has in fact had a positive effect on the corporate bond market.

Hakansson (1999) contends 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.

Another important characteristic of vibrant bond markets is the availability of various instruments to choose from. The World Bank (2000) contends that though small issue sizes are mostly responsible for illiquidity in corporate debt markets, they can help cater to the specific investment needs of investors if they are diverse. Thus, investment banks should continue engineering a wide portfolio of debt instruments, in addition to "fine-tuning the parameters of individual instruments for specific clients". Luengnaruemitchai and Ong (2005), while acknowledging the complexity of the relationship between the derivatives market and the underlying cash market, concede that once the underlying market reaches a certain development stage, efficiency gains from derivative market (unbundling and reallocating risk) become apparent. Consequently, there is very high demand for such products in the US and European debt markets since they provide investors with a wide range of products and instruments to manage risks. As a result, they also facilitate better price discovery and liquidity in the underlying bond market.

Wells and Schou-Zibell (2008) point out that derivatives and swap markets are critical for the development of corporate bond markets. These tools broaden the investor base and lend the much needed liquidity to the market. These instruments also play a pivotal role in reducing costs, enhancing returns and managing risk; particularly interest rate risk. Diversity is required not only with respect to the type of instrument but also its investment grade and maturity length. For developed corporate bond markets, it is not necessary for them to be dominated by AAA rated bonds. Conversely, Igata, Taki, Yoshikowa (2009) mention that one of the important success factors of the US bond market is the continuing issue of high yield bonds (which are bonds rated BB and below). The US market recognizes the attractive risk return characteristics of high yield bonds which enable high growth companies to obtain financing. Besides investment grade, another credible success factor has been the maturity length of bonds[3].

[3] 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. These are typically useful investment avenues for long term investors such as pension funds.

In the Indian context, Mitra (2009) focuses on the supply side issues hampering the development of corporate debt markets in India and lists the lack of diversity in instruments as a major factor. Internationally, there are various types of instruments prevalent, such as step up bonds, step down bonds, deep discount bonds, reverse floater bonds, indexed bonds, currency bonds, etc. However, the Indian bond market is primarily dominated by fixed rate coupon bonds. Secondly, the average age of the bonds issued by Indian corporations is only 5 to 7 years.

Corporate bond markets are also deeply affected by the volume and diversity (or lack thereof) of market participants. The active market participant base in the US has catalyzed the development of corporate debt markets. According to Igata, Taki, Yoshikowa (2009), though the issuer base in the bond market is dominated by financial institutions, there is active participation from other sectors as well.

On the investors' side, Luengnaruemitchai and Ong (2005) identify two major investor bases: local institutional and foreign. The growth in local institutional investors such as pension funds, mutual funds and insurance companies clearly drives the local demand for corporate bonds. Foreign investors are an equally important component of the demand for corporate bonds.

The World Bank (2000) provides an interesting justification for liberalizing and deregulating bond markets. With increasing globalization, such opportunities for issuers and investors do not last very long. Investors compete for a finite set of opportunities provided by issuers and vice versa. As such the debt market is highly competitive. Therefore, anything that hinders their decision making capability will undermine the confidence of the participants. This is the primary motivation for having liberalized and deregulated markets.

Wells and Schou-Zibell (2008) state that, though India began securitization quite early compared to other Asian economies, the market has not yet taken off. They have also articulated how regulation hampers participation in the Indian context. Regulatory responsibility for bond markets is fragmented and often at cross purposes. Corporate bonds are regulated by SEBI, along with participants like brokers and mutual funds. Banks and primary dealers are regulated by the RBI, insurance companies by the Insurance Regulatory and Development Authority (IRDA) and pension funds by the Pension Fund Regulatory and Development Authority. Foreign investment has traditionally remained controlled, with SEBI and RBI imposing periodic limits on foreign

participation. Mitra (2009) identifies a few more such demand side factors. For banks a high SLR ratio, regulatory asymmetry in treatment of loans and bonds, and other restrictions on investments hamper their ability to freely invest in the corporate bond market. For example these restrictions prevent banks from investing in high yield bonds of lower rated corporations.

Khanna and Varottil (2012) elucidate the "Political economy of Bonds". According to them another critical issue accounting for the differences in equity market and debt market liberalization was the laws that needed reforms. On the equity side, management and controlling shareholders were largely in favour of equity reforms and consequently allowed for more room for negotiation and agreement. On the debt side, changes were necessary to bankruptcy laws, labor laws and judicial enforcement. At the time of liberalization the base of political power in India was support of labor unions and therefore any changes to labor or bankruptcy laws (allowing quick dismissal of labor) was not feasible. This hampered the growth of the manufacturing sector, further undermining the growth of the corporate bond market.

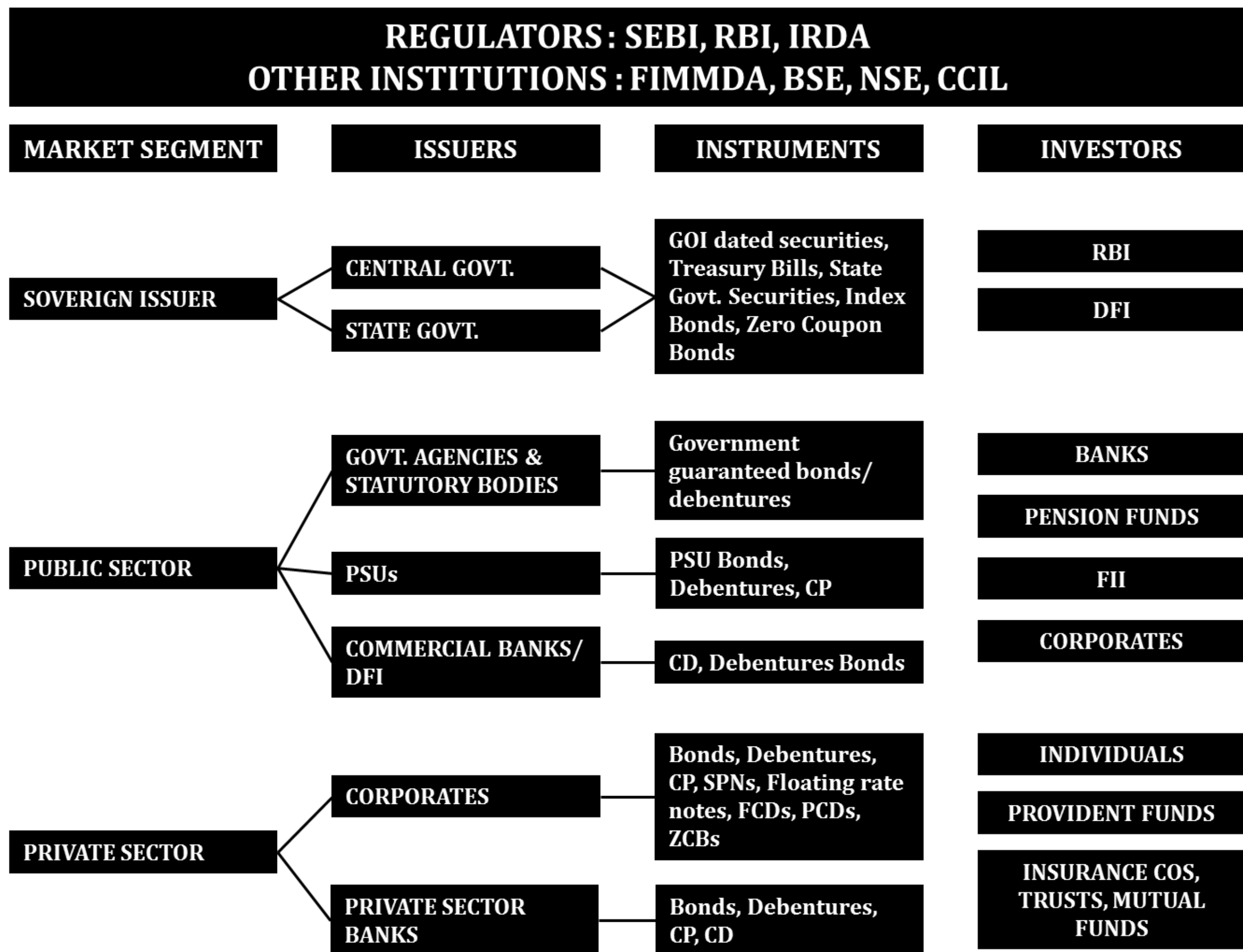
It can be argued that debt markets typically are well developed in mature economies like the USA, Japan or Germany and the development of corporate bond markets was preceded by that of stock and government bond markets, which in turn was preceded by years of capital accumulation through industrial development (World Bank, 2000). Naturally, emerging economies lag behind in corporate bond market development due to their nascent stages of capital accumulation.

III. RECENT TRENDS IN CORPORATE DEBT MARKETS IN INDIA

Reserve Bank of India (2011) observes that listed corporate debt forms only 2 per cent of GDP. This is significantly low compared to other emerging economies, such as Malaysia, Korea and China. Further, Government of India (2009) makes an important observation; even today most of the large issuers in the corporate debt market segment are "quasi-government" i.e. banks, public sector oil companies or government sponsored financial institutions. Of the rest, only a few notable names dominate the market.

Therefore, increasingly, there has been a lot of focus on the development of debt markets in India and it has garnered a lot of policy and regulatory attention. As such, we see an evolving institutional setup in the debt markets space (Chart 1).

Chart 1: Micro-Structure of Corporate Debt Market in India



Source: SEBI, Working Paper No. 9, Corporate Debt Market in India: Key Issues and Some Policy Recommendations, July 2004

The Corporate debt market is primarily regulated by three institutions namely the Reserve Bank of India, the Securities and Exchange Board of India and the IRDA. It is important to understand the context associated with each of the regulatory institutions. The RBI is the monetary authority in India and is therefore primarily interested in ensuring an adequate flow of credit in the economy, maintaining foreign currency market, and managing the twin objectives of economic development and price stability.

On the other hand the SEBI's outlook is more narrow- promotion, development and regulation of securities' markets in India keeping the investors' interests protected. The backbone of SEBI's action plan has been the SEBI (Issue and Listing of Debt Securities) Regulations, 2008 in an attempt to reduce costs and improve transparency in the corporate debt market.

Since insurance companies are one of the largest components in the demand side of the corporate debt market, it is essential to note that the governing body, IRDA has kept pace with the supply side reforms initiated by the RBI and SEBI. IRDA ensures the participation of insurance companies in the corporate debt setup.

Shifting our attention to the various instruments available in the economy to provide credit to the corporates, Table 1 lays out the composition of sources of financing for corporates in India. It is evident from the trend for last decade that share of bonds in sources of finance for corporate has changed marginally, by 0.4 per cent, indicating stagnation of growth in corporate bond markets. On the other hand, reliance on bank credit, which is generally a costlier source of finance, has increased from 14.4 per cent to 17.8 per cent. Internal financing also continues to form a substantial source of funds for corporates, indicating inability of corporates to access bond market or bank lending for credit or unwillingness to do so.

Table 1: Composition of the sources of financing for corporates in 2000-01 and 2010-11

Source of Financing	**As % of Total Financing**		
	2000-01	**2010-11**	**Change in 2001-2011 (%)**
Retained Earnings	5.7	21.1	5.4
Depreciation	29.5	9.7	(19.8)
Internal Financing	**35.2**	**30.8**	**(4.4)**
Equity Issuance	17.2	13.8	(3.4)
Bank Credit	14.4	17.8	3.4
Bonds	3.5	3.9	0.4
Foreign Borrowings	0.5	3.2	2.7
Current Liabilities	25.5	24.2	(1.3)
External Financing	**64.6**	**67.5**	**2.9**

Source: Government of India, 2011

Foreign borrowings have also shown a healthy growth, indicating preference for cheaper foreign funds over costlier Indian debt markets. However, the recent depreciation in rupee exchange rate against major currencies has tremendously increased the foreign obligations of corporate and stressed corporate balance sheets. Thus, lack of vibrant corporate debt market has indirectly led corporates to take on excessive foreign borrowings, leading to severe foreign exchange losses now.

A comparative analysis of all emerging economies (Table 2) confirms that most of the emerging economies have a corporate bond market. Further, apart from bank loans, the most popular ones include partly convertible debentures (PCDs), fully convertible debentures (FCDs), deep discount bonds (DDBs), zero coupon bonds (ZCBs), bonds with warrants, floating rate notes (FRNs) / bonds and secured premium notes (SPNs). Of these instruments, fixed rate bonds emerge as the dominant option with maximum volume transacted. However, other securities are also available albeit the volumes are much lower (Table 3).

Table 2: Government and Corporate Bonds as percentage of GDP March 2013

Debt as % of GDP	Government	Corporate	Total
People's Republic of China	33.1	13.0	46.2
Hong Kong	37.8	31.4	69.2
Indonesia	11.4	2.3	13.7
Republic of Korea	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

Source: Asian Development Bank (Asian Bonds Online) and RBI

Table 3: Types of instruments issued (coupon) outstanding on March 2013

Type of Instrument	Number of Instruments outstanding	Net outstanding amount (Rs. Crores)
Fixed Rate	11,724	11,97,753
Floating Rate	1,184	23,553
Structured Notes	898	3,890
Other	2,068	64,948

Source: SEBI statistics on Corporate Bonds, March 2013

Securitized instruments too, are very limited in the corporate debt markets. The data for March 2013 shows the comparative position of securitized instruments in India (Table 4).

Table 4: Types of instruments issued (securitized and others) outstanding on March 2013

Type of Instrument	Active instruments	Demat Value (Rs. Crore)
Debentures/ Bonds	9,027	12,77,834
Securitized Instruments	801	43,873
Commercial Papers	1,167	1,08,758
Certificate of Deposits	1,408	4,40,692

Source: NSDL update, April 2013

We now focus on analyzing the investors and issuers in the corporate debt market. To provide a perspective to the analysis that follows we tabulate mobilization and turnover in the recent past. In 2011-12, the corporate sector raised Rs. 2,871 billion from the primary market, through issuance of bonds. The government raised Rs. 7,591 billion, or 72.6 per cent of total debt funds raised from primary markets.

Table 5: Overview of primary and secondary bond market

Issuer	Amount raised from Primary Market (in Rs. bn)		Turnover in Secondary Market (in Rs. bn)	
	2010-11	2011-12	2010-11	2011-12
Corporate/Non-government	2,017	2,871	1,592	1,761
Government	5,834	7,591	70,683	73,431
Total	7,851	10,462	72,274	75,191

Source: Indian Securities Market Review 2011-12, NSE

The comparative market capitalization table showing the proportion of various securities in the bond market capitalization at various dates giving us further evidence that government securities and securities issued by banks and financial institutions are the dominant securities.

Table 6: Composition of bond market capitalization by type of issuer

Type of Issuer	Market Capitalization (Percent of total)			
	2010	2011	2012	2013
Government Securities	61.61	60.80	57.86	56.19
PSU Bonds	5.15	5.31	5.71	6.20
State Loans	16.96	17.30	17.72	18.35
Treasury Bills	4.29	3.83	6.07	6.06
Local Bodies	0.08	0.09	0.07	0.06
Fin Inst.	2.39	2.81	3.36	3.51
Bank Bonds	5.22	5.11	4.45	4.27
Supranational Bonds	0.01	0.01	0.01	0.01
Corporate Bonds	**4.30**	**4.74**	**4.74**	**5.36**

Source: Wholesale Debt Market Monthly Reviews, NSE

We can see that in the past 4 years the capitalization structure has not moved appreciably and it has favored government debt. The table serves to highlight the supply side deficiencies in the corporate debt market in India. The issue sizes are nowhere near the ones required to compare with government securities. Even in the secondary markets, the story is not much different. The WDM turnover distribution again shows high turnover in government securities and Treasury Bills (Table 7).

Table 7: Distribution of WDM Turnover by type of issuer

Year	Govt. Security	T-Bills	PSU/ Inst.	Others
2008-09	69.7	16.9	8.9	4.4
2009-10	58.1	16.5	15.4	10.0
2010-11	54.5	17.6	19.6	8.3
2011-12	51.3	22.0	18.9	7.7

Source: Indian Securities Market: A Review 2011-12, NSE

We now move to the demand side i.e. investors in corporate bond markets. The investors in the Indian corporate debt markets can be essentially categorized into banks (Indian, foreign and primary dealers), trading members and others (MFs, FIs, Corporates). This clearly indicates a lack of diversity required for a potentially vibrant corporate debt market. The following table analyzes funds raised through bond issues under 2 major heads – public issues and private placements.

Table 8: Private placements of corporate bonds

Issues	2010-11		2011-12	
	Amount of Issue (Rs. bn)	**% of total issues**	**Amt. of Issue (Rs. bn)**	**% of total issues**
Public Issues	95	4.7	356	12.4
Private Placement	1,922	95.3	2,154	87.6
Total Issues	**2,017**	**100**	**2,870**	**100**

Source: Indian Securities Market: A Review 2011-12, NSE

Two significant trends emerge from the data. Firstly, most corporate bonds continue to be placed privately, resulting in low availability of bonds for trading in secondary market. It can be seen that as high as approximately 87.6 per cent of total debt issuances of corporate sector were privately placed in 2011-12. Secondly, government borrowing dominates both public and private sources of bond financing in India. As can be seen from the table below, even in the private placement market, the public sector dominates. This trend has worsened in recent years, showing reducing appetite for corporate bond or their inability to raise funds in the private placement market.

Table 9: Distribution of funds from private placements in government and corporate bonds

Funds raised from Private Placements (In Rs. bn)						
Year	**Private Sector**	**As % of Total**	**Public Sector**	**As % of Total**	**Total Funds**	**As % of Total**
2008-09	956.89	47	1083.68	53	2040.57	100
2009-10	2332.94	68	1099.58	32	3432.80	100
2010-11	1214.53	51	1169.43	49	2383.96	100
2011-12	619.11	28	1560.71	72	2179.82	100

Source: Handbook of Statistics, 2011-12, RBI

Equal responsibility for lack of volumes in secondary market lies with lack of diversity in investors. Banks are the largest group of investors in corporate debt markets in India. However, they continue to be highly regulated by RBI. Hence participation of banks in secondary trading is limited, stunting the depth and liquidity in secondary corporate bond markets.

Insurance companies, provident and pension funds also invest in corporate bonds due to the nature of their long term liabilities. However, these entities are generally long term investors and tend to hold bonds till maturity rather than trade for short term profit making.

The government is aggressively wooing FIIs to invest in Indian debt markets for multiple reasons. In 2012, the government hiked the investment limit for FII in government and corporate debt markets. Further, the government reduced the lock-in period for investments to 1 year and residual maturity of investment at the time of purchase by the FII should be only 15 months.

Table 10: Regulatory limits on investment by FIIs in Indian bond markets

Category	Cap (US$ bn)	Other conditions
Government Debt	30	Investment in treasury bills upto US$ 5.5 bn
Corporate Debt	51	Investment in commercial papers only upto US $ 3.5 bn
Total	81	

Source: SEBI

The limit in government bonds was further increased to US$ 30 bn in favor of long term funds in June 2013, in the aftermath of massive withdrawal by FIIs from debt markets in India. The FII limit enhancement is a welcome move towards increasing the liquidity in the corporate debt markets. However, an analysis of the actual utilization of investment limits by FIIs reveals that majority of the inflows have been directed towards government securities.

Table 11: Utilization of investment limits in debt markets by FII

Categories[1]	Utilization of debt limits (Actual Investment/Debt Limit, in %)			
	Mar -12	Jun -12	Sep -12	Nov- 12
Government Securities				
Government Debt-Old	89.1	93.0	94.7	95.7
Government Debt-Long Term	69.6	31.8	73.5	80.0
Corporate Debt				
Corporate Debt-Old	85.7	84.2	90.9	91.0
Corporate Debt-Long Term	10.9	17.9	41.9	20.0

[1]The 'old' category is a combination of detailed sub-categories of instruments in older SEBI regulations. 'Long term' category includes bonds of residual maturity of more than one year. The utilization of investment limits for corporate bonds is significantly lower than those of government bonds. Further analysis reveals that of total FII investments in Indian debt market, 45 % is sovereign bonds and 21 % in financial companies, leaving little investments for non-financial corporate entities.

Source: STCI

Table 12: Composition of FII Debt investments in India as on February 15, 2013

Sector	Investment	
	(in Rs. bn.)	**% of Total**
Banks	0.75	0.04
Other financial services[1]	370.59	20.91
Total Financial Services	**371.34**	**20.95**
Capital Goods	3.73	0.21
Chemicals and Petroleum	0.04	0.00
Food & Beverage	0.76	0.04
Healthcare	1.25	0.07
Household products	0.95	0.05
Media	1.90	0.11
Metals and Mining	5.05	0.28
Oil & Gas	57.6	3.25
Pharmaceuticals	4.08	0.23
Realty	2.55	0.14
Telecom Services	9.30	0.52
Utilities	8.16	0.46
Sovereign	**781.00**	**44.07**
Others[2]	524.61	29.6
Total	**1772.32**	**100**

[1] Other Financial Services" includes Financial Sector other than "Bank". Sub-category under "Other Financial Services" are as follows: Financial Institutions, Holding Companies, Housing Finance Companies, Investment Companies, Other Finance companies (including NBFCs)
[2] BSE had classified more than 3400 number of issuers into 31 sectors. SEBI has decided to rely on the BSE classification. Any FII investment outside those 3400 issuers is classified under "Others".

Source: SEBI

Conspicuous by their absence are India's large number of retail investors. It is found that probably retail investors haven't quite understood the concept of risk and return in the bond market. Debt instruments are perceived as a 'safe option' providing a guarantee, safeguarding capital with regular coupon payments. Any delay or default is dealt with too severely, by shunning the corporate debt markets altogether. There is an urgent need to increase investor awareness along with other policy measures facilitating retail investments.

The participant wise distribution of WDM turnover indicates that the investor distribution has remained more or less constant even in secondary markets. Mild indications of a gradual shift in volume toward trading members are noticed.

Table 13: Participant wise distribution of WDM turnover

Year	Turnover (%)				
	Trading Members	FIs/ MFs/ Corporates	Primary Dealers	Indian Banks	Foreign Banks
2008-09	44.7	3.4	6.6	18.1	27.3
2009-10	49.2	2.6	4.6	19.8	23.7
2010-11	53.5	2.4	4.2	13.1	26.8
2011-12	54.5	4.5	4.2	15.3	21.6

Source: Indian Securities Market: A Review 2011-12, NSE

There is no strength in numbers either. The top 50 trading members account for the entire WDM turnover in all the four years considered for review.

Table 14: Share of Top 'N' Trading Members in WDM turnover (As % of Total Turnover)

Share of Total WDM Turnover (%)				
Top Trading Members	**5**	**10**	**25**	**50**
2008-09	69.9	82.9	98.4	100
2009-10	73.7	85.3	98.0	100
2010-11	73.6	86.1	98.7	100
2011-12	77.5	89.1	99.4	100

Source: Indian Securities Market: A Review, NSE

Diverse investors with diverse needs and requirements are a prerequisite for healthy corporate debt markets. Since the investor mix of the Indian corporate debt markets consists of participants with similar outlooks, it is obvious that their investments reflect this similarity. We find evidence for this argument in the following data. The share of top 10 securities increased to 44.2 percent in 2011-12 from 38.6 percent in 2010-11 (Table 15).

Table15: Share of Top 'N' securities in WDM turnover (As % of Total Turnover)

Share of Total WDM Turnover (%)					
Top Securities	**5**	**10**	**25**	**50**	**100**
2008-09	31.3	43.1	60.4	72.5	83.9
2009-10	24.2	35.1	53.1	65.6	77.9
2010-11	26.7	38.6	51.7	61.5	74.2
2011-12	36.4	44.2	52.6	61.5	72.1

Source: Indian Securities Market: A Review, NSE

Rich insights can be gleaned from the analysis of trends in corporate bond market. While RBI and government of India have set up successive committees and implemented several reforms to revive the market, their efforts do not seem to have yielded the desired impact in corporate bond markets. Further lack of diversity and numbers in issuers and investors seem to have trapped the market in a vicious cycle of low liquidity. However, the most overarching theme whether in primary or secondary markets, is the dominance of government bonds. Whether its private placements, FII or other institutional investors or trading activity in WDM, government bonds dominate by far and adversely impact investor activity in corporate bonds, thereby stunting the development of corporate bond market in India.

Municipal Bond Market

Another noteworthy feature of the bond markets in developed economies is the municipal or local government bond market. The USA and Japan have the world's largest municipal bond markets today. Among the emerging economies, the Chinese bond market is perhaps the largest in terms of outstanding debt. Fahim (2011) states that there were approximately $3.7 trillion outstanding in municipal bonds in 2011 in the USA. Mainly state and local governments raised debt for the development of America's infrastructure. Tracing the evolution of American local government bond markets, Fahim observes that the major impetus for growth came from the pressing need for state and municipal governments to increase spending in the wake of a 15 year drought in the 1960-70s. Municipal and state government debt grew 611 per cent in a 21 year period to support migrating populations, housing demands and infrastructure needs.

Two types of bonds are issued by most local government authorities across the world. These include the general obligation bonds which are secured against the government's taxing power

and the revenue bonds that are secured by exclusive pledge of project revenues. Hybrid bonds combine features of both revenue and general obligation bonds.

IV. ISSUES AND CHALLENGES IN DEVELOPMENT OF CORPORATE DEBT MARKET IN INDIA

1. Multiple and overlapping financial supervisory bodies

The Indian financial regulatory structure is quite complex with a lot of overlapping and ambiguous regulatory jurisdictions. With multiple agencies entrusted with the task of regulation and supervision, the lines of jurisdiction become blurred often leading to inefficiencies in the regulatory process. This sometimes has regulatory bodies working at cross purposes to each other often causing friction.

2. Legal impediments

Several missing and inadequate legal structures are observed in the context of corporate bond markets, the most prominent being those relating to enforcement contracts and corporate insolvency. A corporate bond is essentially a debt and the expeditious enforcement of debt contracts is a natural concern for lenders. In India enforcement contract litigation is often embroiled in delays and deficiencies of India's overburdened legal system, not the least of which are prohibitive costs. This lack of remedial opportunities increases the risk of corporate bond lending.[4]

Similar inefficiencies have been observed in cases of corporate insolvency. Analogous to enforcement contracts, the process of liquidation and winding up of companies is important because it determines the distribution of assets to the lenders. In India, the RDBF Act and the SARFAESI Act form the pillars of insolvency laws. However, these are not sufficient since they address only debts due to banks and financial institutions and not ordinary creditors. As far as ordinary creditors are concerned, the only recourse available is ordinary civil court litigation[5].

[4] In fact the World Bank ranks India 182nd out of 183 countries evaluated on the parameter of enforcing contracts in its Doing Business Report.

[5] According to a World Bank survey, the completion of a corporate bankruptcy in India takes about 10 years and India ranks at position 128 in the world (which is actually an improvement over the years).

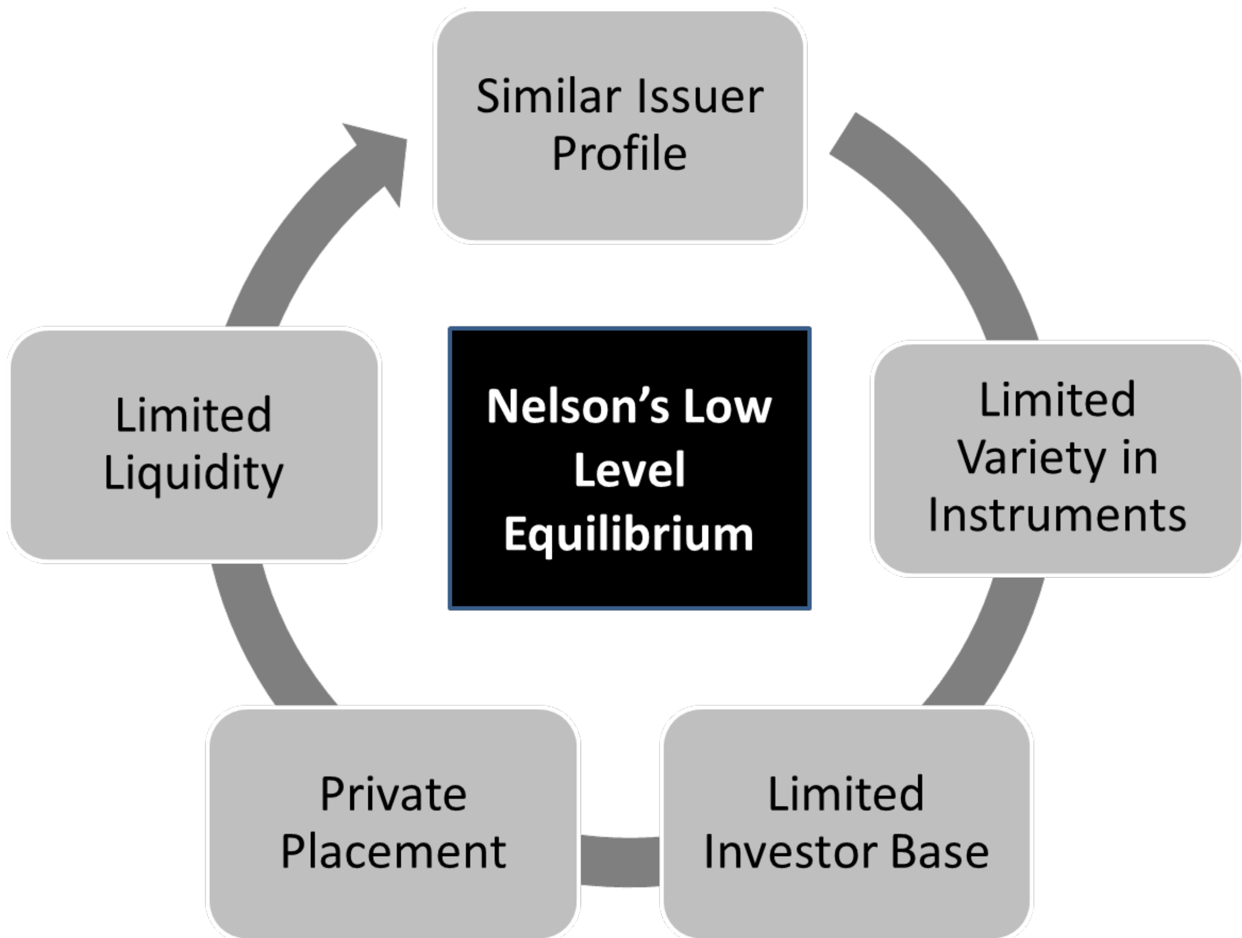
3. Lack of a benchmark yield curve

The availability of a liquid government securities market is often observed to be a prerequisite for the development of corporate debt markets in India. The presence of a well-defined yield curve provides a price discovery mechanism for private institutions. The government securities market yield curve provides a natural floor for the borrowing costs of the private sector and facilitates the pricing of cash flows off the curve. With a dependable yield curve, the private issuer only needs to concentrate on the credit spread for its issue. The Government's and investing banks' preference for 10 year securities has resulted in a lack of a reliable yield curve across maturities, which has in turn hampered the pricing of corporate bonds. Indian government bonds are generally 10 year bonds with a few issues of longer issues stretching to 25 or 30 years. The corporate bond market mirrors this behavior and maturities typically range in the 5 to 10 year range[6]. The lack of yield curve has also been stressed in the Financial Stability Report (RBI, 2013).

4. Nelson's Low Level Equilibrium

The Indian debt market is trapped in a low level equilibrium succinctly depicted in the following figure.

[6] In July 2013, Mahindra & Mahindra became the first company to issue a 50 year plain vanilla rupee denominated bond.



Beginning with a narrow issuer base dominated by banks, financial institutions and quasi government bodies (PSUs) there is limited diversity among the issuers. Consequently they cater to a limited set of investors interested in investing in such firms and there is no variation in the kind of instruments. Due to this trend, other investors mostly stay clear of the market since the market is unable to cater to their unique requirements. Considering the limited investor base, it is better for issuers to opt for private placements and have no incentive to list securities. Further, this hampers participation and liquidity in the market. Thereafter we return to the same narrow issuer base which is willing to issue bonds in the illiquid market. There is an urgent need to break this vicious circle.

V. CONCLUDING DISCUSSION

Though it is reasonable to infer that once a logical set of recommendations are implemented the problems plaguing corporate debt in India would be eliminated paving the way for a vibrant bond market, these are difficult issues. There have been numerous academic and government of India reports dedicated to the issue and the possible recommendations have been accepted by one and all. However, our focus below is to harp on a few recommendations which we believe are crucial in the entire reform process. While a few of them are independent, in light of recent developments, the others represent critical proposals that have not received the required amount of policy attention in recent times.

1. Tax Reforms

It is widely acknowledged that favorable tax regulations often positively impact the development of financial markets in an economy. India's efforts to develop the corporate debt markets could enjoy a similar success story by replicating the liberal tax mechanism provided to the equity market. Specifically, the following reforms could be helpful.

a) For Retail Investors:

The only corporate bonds allowed for eligibility under section 80C of the income tax act are those of companies in the infrastructure space. The scope could be expanded to include corporate bonds of other entities as well. Alternatively, a separate window like the one created for infrastructure bonds under section 80CCF could be created for corporate debt investments. Till the time Indian corporate debt markets are conducive to direct retail participation, such investments could be mandatorily through debt mutual funds (on the lines of tax exemptions to ELSS) with a 3 to 5 year lock-in period. This will provide investors a tax efficient higher yield alternative to bank fixed deposits.

b) For Foreign Investors:

Currently tax deduction at source on interest payments (to FIIs) stand at 5 per cent on investments in rupee denominated corporate bonds. This comes as a very recent amendment, and the withholding tax rates till May 2013 were quite high at 20 per cent. It may be worthwhile to award exemption to foreign investors from withholding tax, to

incentivize their participation in corporate bonds. The trend to date suggests that FIIs have generally been biased toward equities and government securities, both of which provide better liquidity; hence such incentives might be necessary to make corporate bonds competitive as an investment option. This will not only improve non-resident participation in the domestic market but also pave the way for increased offshore corporate bond issuances.

c) For all investors:

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. A similar provision for listed corporate debt securities will improve participation from all investors.

Though in the short term these measures are bound to reduce the Centre's revenues, in the long term the revenues from additional STT (due to increased turnover) and benefits to the economy of a vibrant corporate bond market are substantial.

2. Participation from Insurance Companies and Pension funds

At present, at least half of the exposure of insurance companies is required to be made in government securities, 15 per cent in infrastructure bonds and the rest in equity markets, mutual funds, debt and money market instruments[7].

Insurance companies inherently face the problem of asset liability mismatch and are on a constant tight rope to balance assets and claims and withdrawals. Therefore it is imperative that they invest in instruments with wide ranging maturities. If insurance companies are allowed sufficient headroom for investment in corporate bonds, it will provide issuers with a huge and diverse investor base, effectively providing a means to break Nelson's low level equilibrium. Secondly, the proposals to allow insurance companies repos in corporate bonds and proprietary trading membership for debt trading on stock exchanges should be rolled out as soon as possible.

[7] A portfolio comparison of LIC with that of US insurance companies shows that almost 46% of the portfolio of US insurance companies is invested in corporate bonds whereas the same for LIC is barely 13% (non PSU).

On similar lines pension funds face the problem of asset liability mismatch and therefore there is an urgent need for their presence in the corporate debt market space.

This will result in a healthy competition for funds between the government securities market and the corporate debt market; with the government no longer enjoying monopoly over cheap domestic funds. This will prompt the government bond market towards better price discovery through correct pricing and establishing a benchmark yield curve. Further, as one of its indirect effects, the rising cost of borrowing for the government will trigger fiscal discipline.

3. Credit enhancement

While the twelfth five year plan requires infrastructure funding of almost $1 trillion, it is highly improbable that the Indian banking system is capable of taking this up on their balance sheet. There is a desperate need to arrange for low cost funds for the infrastructure sector through new products, one of which is credit enhancement. Credit enhancement is a technique used to upgrade the credit rating of an asset backed security to improve its marketability[8].

Bank issued letters of credit (LOC) are another one of the most common methods of credit enhancement. The LOC attaches the banks strength and rating to the issue and provides the borrower with a lower cost of borrowing[9].

Credit enhancement schemes are especially critical in the Indian context because, currently insurance companies and pension funds are not permitted to invest in corporate bonds below investment grade. Since a credit enhancement mechanism allows companies with lower ratings to issue investment grade bonds, it will encourage participation of such institutional investors in the bond market.

4. Creation of Corporate Bond Indices

A bond index should be created to measure the performance of corporate bonds issued in the country. Single or multiple indices can be created and bonds of similar maturity or rating can be grouped together to allow investors to gauge the performance of bonds. These indices should

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[8] Specifically for the infrastructure sector, the country's first credit enhancement program has been launched by IIFL and the scheme has already garnered strong interest among Indian corporates. However, there is a need for more such schemes in the immediate future.

[9] Very recently, India's first ever USD credit enhanced bond was issued by Suzlon with a stand by letter of credit from the SBI.

also be made investible so that investors can invest in a basket of bonds. Goltz and Campani (2004) state that corporate bond indices can perform three major roles. Firstly, they act as a measure of market performance. Secondly, corporate bond indices can be used as a medium for investment. Finally, they can be used to benchmark performance where index returns are considered as neutral performance.

5. Measures for attracting retail investors

Regulators and policymakers, especially SEBI have consistently focused on ensuring retail participation in equity markets and had achieved a fair amount of success in the same. Similar measures need to be implemented to draw retail investors to corporate bond markets.

a) On lines of equity markets, the regulators should consider higher quota for direct investment by retail investors in debt issues.
b) Further, it has been observed that retail investors prefer investing in the markets via mutual funds. In fact, due to lackluster performance of equity markets retail investors are increasingly favoring debt mutual funds over equity mutual funds.[10] An indirect impetus can be provided to retail participation in bond markets by offering quotas to mutual funds in debt issues. This will also encourage mutual funds to invest in corporate debt markets alongside G-Secs.
c) The large lot sizes act as deterrents to retail participants who would prefer the smaller and easily tradable equity securities. An analysis of publicly issued corporate bonds and listed on NSE reveals that only 6 out of 157 bonds have face value below Rs. 1000. Hence, bonds of smaller lot sizes should be made available to retail investors.[11]
d) Increase the ease of trading and reduction in transaction costs through encouragement of demat trading for listed bonds.
e) Variety of tax benefits to retail investors on lines of those provided to equity investments. This has been discussed in detail below.

As discussed above the current corporate debt market scenario is not conducive to retail participation, and will require quite a few reforms to make it so. This is bound to be a time

[10] In March 2013 and March 2012, debt mutual funds attracted Rs. 141,754 cr and Rs. 1,05,572 cr respectively. Contrast this with equity mutual funds which saw an investment of only Rs. 33,737 cr and Rs. 37,307 cr in the same periods.
[11] A similar move in the G-Secs along with an introduction of retail segment on NSE did not prove to be largely successful.

consuming process. In the meanwhile, it will be worthwhile to explore the possibility of carving out a specialized retail bond market following the Australian experience[12].

6. Public issue and listing of corporate bank borrowings

In the private equity market, funds invest in strong private companies for a period of 4-5 years and help the companies achieve their potential growth. At the end of their investment horizon, the funds typically achieve their exit and make gains through a public issue of the shares of the investee company. Post an IPO, the private equity fund either achieve a complete stake sale or continue to retain a reduced stake to further participate in the growth of the company

An attempt can be made to replicate this model in the corporate debt market. Banks (or consortium of banks) and corporate borrowers can make a public issue of the whole or part of the existing bank loans. The gains from this are manifold. Firstly, the presence of bank exposure to the corporate issuer is likely to bolster investor confidence in the quality of the debt issue and hence attract participation from investors. Secondly, it can reduce the cost of borrowing for corporate debt issuers. Third, banks can make a gain through the listing of corporate loan, either in form of commissions/fees on listing or through a share in the interest savings that accrue to the corporate issuer through the listing. The listing of bank loans will help banks reduce their exposure to certain corporates or corporate groups, if desired, and also release liquidity to lend at higher yields to other borrowers. Further, listing of securities on an exchange and the accompanying compliance and disclosure requirements are in themselves, mechanisms that monitor and discipline corporate governance and performance. This is likely to reduce transaction and monitoring costs for banks and other investors.

7. Developing municipal bond market in India

There is a huge untapped potential for the municipal bond market in India. Various measures can be undertaken to meet urban infrastructure financing through capital markets such as creating a national body that can act as financial intermediary and issue municipal bonds on behalf of its members (local urban bodies), remove the fixed cap on coupon rates and allow bonds to be issued at market rates. Further, several experts are of the view that ‘soft financing’ through JNNURM had adversely impacted the fiscal discipline of urban local bodies. Tightening of funds

[12] For more details view Annex 1

or imposition of additional restriction on loans from JNNURM would force urban local bodies to approach capital markets for funding. This will compel issuers to manage projects schedules and revenues judiciously.

8. Enactment of new robust bankruptcy laws

India needs to setup robust bankruptcy laws similar to Chapter 11 of the United States Bankruptcy Code which will allow financially distressed companies to anticipate insolvency and attempt a turnaround before it gets worse. The current insolvency infrastructure under Board for Industrial and Financial Reconstruction (BIFR) applies only to industrial companies and is plagued by poor enforcement mechanisms. The criterion for "sickness" is erosion of net worth for a period of more than 5 years. However, the firms that generally end up applying for BIFR do so only on complete erosion of their Net worth. Inevitably this has slowed down liquidation of hopelessly insolvent companies and resulted in institutional creditor losses.

Therefore India needs a bankruptcy law which will help such companies turn around faster. Further, these laws should extend to all companies and not only be restricted to industrial companies. If these laws provide satisfactory recourse to lenders, it will greatly benefit the corporate debt market in India. Recognizing this fact, Reserve Bank of India Executive Director R. Gandhi recently said that India needs an efficient bankruptcy law in the corporate debt market segment.

The objective of this paper has been to address the urgent need to fast track the development of Corporate Debt markets in India. For this purpose we tried to draw lessons for the same from both mature and other emerging markets and identified several important issues to form a backdrop for our policy recommendations. It needs to be explicitly stated however, that the issues identified here are not exhaustive but merely indicative of the form, range and complexity in which they have continued to hamper the growth of corporate debt markets in India. Further, our study of other debt markets strongly suggests that the inherent idiosyncrasies in every market prevent us from drawing out a time bound schedule for its development in India. Therefore, the speed of development will primarily depend on, among other variables, strong political will and focused execution of policy reforms. Lastly, we would also like to draw attention to the fact that

more often than not the reforms are not an immediate cascading effect of the implementation of the suggested policies but a gradual evolution born out of an iterative improvement process.

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ANNEXURE 1: FEATURES OF 'SIMPLE CORPORATE BONDS' IN AUSTRALIA

The Issuer	The issuer must have continuously quoted ASX securities on issue and be subject to the continuous disclosure regime.
Minimum Subscription	A minimum aggregate issue of at least $50 million.
Price	The price payable for each bond must not exceed $1,000.
Australian Currency	The bonds must be denominated in Australian dollars.
Debenture	The bonds must be debentures (as defined in section 9 of the Act).
Quoted	The bonds must be quoted on a prescribed financial market, such as the ASX.
Fixed Term	The bonds must be for a fixed term of not more than 10 years.
Principal	The principal must be paid to the bondholder at the end of the fixed term.
Interest Rate	The rate at which interest is payable must be either fixed or floating. A fixed rate must not be decreased during the term of the bonds, but may be increased.
Redemption	The bonds must not be redeemable prior to the term expiring except at the option of the bondholder, or an acceptance of an offer to buy back the bonds, or a change in law which impacts on taxation liabilities, or a change of control of the issuer, or fewer than 10% of the bonds remain on issue.
Senior Unsecured	The bonds must not be subordinated (other than to secured debt) and must rank equally to unsecured debt of the issuer.
Not convertible	The bonds cannot convert into another class of securities.
Offer	The bond must be offered at the same price for each investor.