NSE-NYU Conference on Indian Financial Markets

Dr. R. H. Patil Auditorium, NSE, Bandra Kurla Complex

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Address by Chairman SEBI

"Developing Corporate Bond Market – The Unfinished Agenda"

A. Present Context

1. It cannot be overemphasized that if India has to grow at 8-9%, huge long term investments in the infrastructure space will be required. A vibrant bond market that facilitates such investments is, therefore, extremely essential for achieving the goal of elevated economic growth.

2. The issue of developing a liquid corporate bond market in India has engaged the attention of policy makers in India for a long time now. Various expert committees from Dr. R.H. Patil committee in the past to H R Khan Committee more recently have deliberated, identified and recommended suitable policy and operational frameworks for developing corporate bond market in India. Based on those recommendations, the Government, RBI and SEBI have implemented a series of measures.

3. Some of the recent steps taken, inter alia, relate to issuance of rupee denominated bonds overseas by Indian banks; partial credit enhancement; Tri-Party Repo mechanism; measures like Electronic book building mechanism for issuance of debt securities on private placement basis, Specifications related to International Securities Identification Number (ISINs) for debt securities to encourage liquidity and reduce fragmentation of issues; enhanced standards for the Credit Rating Agencies, etc.

4. These measures taken together have yielded positive results, going by the recent trends in corporate bond market. The bond issuances, for instance, touched INR 6.7 lakh crore in the year 2016-2017, growing over 28% from the previous year. Importantly, it marginally surpassed bank credit disbursements during the same year. This year, the good stories continues and a little over 4 lakh crores have so far been raised though issuance of corporate bonds.

5. In the secondary market also, the trading and reporting of corporate bonds have more than doubled during the last five years, with trading increasing from around Rs. 6 lakh crore during 2011-12 to about Rs. 15 lakh crore during 2016-17. This year during April-November, trading in corporate bonds have been to tune of Rs. 12 lakh crore as against around Rs. 9 lakh crores during the same period last year.

6. Further, a look at the CMIE[1]'s data on funding sources of corporate sector in India during last five years shows that, during FY 2012 to FY 2014 bank credit constituted 66% of their funding, which declined to 56% during FY 2015 and further to 33% in FY 2017. During the same period, share of corporate funding though issuance of bonds increased from 29% in FY 2012 to 39% in FY 2015 and further improved to 61% in FY 2017.

7. Going by the attention and traction that corporate bond market in India has witnessed in recent years, there is no reason to be pessimistic. Rather it

[1] Centre for Monitoring Indian Economy

should encourage us to undertake further measures, as may be necessary, to achieve the desired level of depth and liquidity in the market.

B. Way Forward

8. I, therefore, intend to highlight some of the issues relating to development of corporate bond at various legs such as primary, secondary, as also the derivatives markets and list additional measures that could accelerate the pace of development.

Primary Market

9. As I have mentioned earlier, corporate bond issuance in India has grown. The total outstanding has grown from about Rs. 9 lakh Crs in 2011 to about Rs. 26 lakh Crs now. It is important to understand the underlying demand scenario for the increasing supply of corporate bonds and draw important lessons.

10. Mutual funds have seen non-equity[2] assets under management grow from about Rs. 4 lakh Crs in 2011 to Rs. 11 lakh Crs now. Savings directed towards corporate bonds, as an asset class, by mutual funds has been one of the key triggers leading to an increase in issuances.

[2]AMFI; Non-Equity AUM includes Liquid and Government Bond Funds also

11. However, as MFs are key players on demand side, particularly with interest in shorter dated instruments; this has led to scenario where issuances are largely concentrated in 1 to 5 years maturity bucket.

12. Other institutional pools of domestic savings, which can generate far higher demand for longer dated corporate issuances, remain constrained. These are the insurance, pension and provident fund savings pools. A higher allocation by them to the corporate bond market would aid these savings to earn incremental returns and generate demand for corporate bonds. Additionally, as these institutions are long term investors and they generally hold their investments till maturity, they can act as an ideal counterpart on the demand side to the infrastructure companies needing to rely on funding through longer dated instruments.

13. Another significant source of demand for corporate bonds could come from the banking system, if the bank loan market was transitioned in part to the corporate bond market. The regulatory arbitrage that exists between a bank providing a loan and holding a corporate bond needs to be eliminated gradually to ensure cleaner bank balance sheets and liquidity in the corporate bonds. The large exposures framework of RBI is a right step in this direction, though the effectiveness of the same is yet to be measured.

14. The HNI / small corporate sector also hold fixed income assets and park surpluses in fixed income assets. However, a lack of funding against these assets restricts their ability to invest in these markets. While getting a loan against shares is par for the course, a loan against government securities or corporate bonds is hard to access. Allowing HNIs and small corporates to

access the corporate bond repo to borrow and lend could accelerate their interest in this asset class. Recently, RBI has come out with a framework for repo in corporate bonds. Both NSE and BSE have evinced interest in launching such an electronic platform. I am hopeful that these exchanges would soon start this activity.

15. On the supply side of corporate bonds, the majority of issuances in the primary market come from AAA rated issuers. We need to enable issuers going down the credit curve to access bond markets.

16. As per Bank for International Settlement's data, implementation of bankruptcy reforms has significant impact on issuance and trading of corporate bonds in countries where it has been implemented. The IBC implementation in India would provide additional confidence to investors, as it affords greater predictability of recovery and therefore can increase liquidity in even lower-rated papers. The corporate bond as a percentage of GDP in India was 17.9% in 2016 i.e. the year of notification of the IBC. It would be interesting to study the impact of the implementation of IBC in India on the growth of bond market in medium term, say over the next 3 to 5 years.

Secondary Markets

17. The secondary market in corporate bonds, particularly, has been even slower to develop. During 2016-17, the average daily volume in corporate bond market was approximately Rs 4,650 crores as against around Rs. 70,000 crores in central government securities. There are various factors

which have helped the development of secondary market for government securities, such as anonymous order matching platform, DVP-III settlement (guaranteed settlement), a well-developed funding product on G-Secs like repo/ CBLO, consolidation and re-issuance of securities. These measures need to be replicated in corporate bond market as well.

18. Currently regulators have mandated their respective entities to report and settle their OTC corporate bond trades through Clearing Corporations of Exchanges on DVP-I basis (without settlement guarantee). This reduces the ability of traders to trade efficiently in corporate bonds, as cash and securities are settled on a gross basis.

19. DVP-III settlement (i.e. netting of both cash and securities obligations) could increase trading activity and liquidity in the corporate bond market. This mechanism with settlement guarantee can be introduced in a phased manner for all transactions in corporate bonds and for all market participants. It could also be considered to provide tax incentives for such trades by aligning the tax treatment for DVP III traded bonds with that for equity trading subject to payment of securities transaction tax.

Derivatives

20. An active derivatives market is another inseparable part of the entire ecosystem for trading of any financial asset because of the two very important role of price discovery and risk management played by it.

21. A liquid interest rate derivatives market can be effectively used to hedge interest rate risk in government and corporate bond portfolios. However, in India, interest rate derivatives, both OTC and exchange traded, are yet to get adequate traction. The OTC markets see good volumes but they are restricted to a handful of players. The exchange traded interest rate futures markets remain constrained and average daily volumes are only around Rs. 1800 Crs (NSE+BSE).

22. Currently, there are various restrictions for market participants to trade in IRF. Insurance companies are not permitted to hedge existing investments in government securities or corporate bonds. NBFCs participating as clients are not allowed to take any trading position. They are only allowed to use IRF for hedging asset and liabilities. Housing finance companies have not been permitted to hedge their interest rate exposure using IRFs. There is a need to have a relook at the policy to develop interest rate derivatives market.

C. <u>Concluding Remarks</u>

23. To conclude, corporate bond markets have shown good growth in the last few years on the primary issuance side. This asset class, however, continues to lag as compared to other asset classes, whether equities or government bonds as regards trading and liquidity is concerned. While there is no magic bullet that is going to fix the "liquidity" problem in corporate bond markets, working on a range of areas, some of which I have mentioned, is likely to nudge the market towards greater transparency, better risk management for issuers and investors and more efficient capital raising.