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The Indian Debt Market Conundrum

THE BULL BUNCH

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PERSPECTIVE ON BOND MARKET IN INDIA

We would like to start our report with a short story.

One day I asked my dad, what investment should I look for to earn fixed interest income. His immediate reply was to go for FD investment. And I'm sure this would be the reply for almost all middle-class houses in India.
The point to narrate this story is, the same bank offering FDs at the rate of 5% offers bond at 9.50%

Lucrative enough? So where is the problem, the problem lies in awareness. In the US, the Bond market is largely traded than the equity market. Not only lack of awareness but other factors like- The tradition of Indian investors. What Indian investors want? The culture that they have formed is of easy manageability, easy understanding and physical interaction.
All these factors are very well achieved by FDs which the bank provides. It is easy to enrol for FD. There is a physical interaction between bank officials and customer. There is transparency. People have faith and trust in banks. Their perception is banks are associated with the government. And even if they collapse there will be mitigation from the government. Corporate bond in that sense is at a distant. They have listed as the liquidity option. They are usually long term in tenure. The popularity of the company matters a lot in creating a safety perception. It requires evaluation of financials which is not everyone's cup of tea. The focus should be on- Why are FDs patronize and corporate bond are not patronized?

What should corporate focus on? Corporates require a plethora of marketing activities about bonds not only at the time of issue. What an investor in the bond market sees is, companies come during the time of issue and after that, there is no investor relation. For example, as in the case of equity Annual General Meeting are held, a sense of acknowledgement is obtained by the investor. In case of a bond, the companies come only at the time of issue and then they vanish. There is a lack of investor's comfort with bonds, constant effort should be taken with regards to servicing the bondholder. Corporate should create that comfort between the investors and bonds to get and maintain a source of financing.

Another important point which I would like to highlight is, what is been seen is the confidence of bondholder has evaporated over the period. In such cases, corporate should focus on sincere efforts to maintain financial health, to gain investor confidence. What concerns the investors is the ability to repay. And if this is well-achieved, the investors reflect confidence in bonds and they are willing to participate more. I would like to leave a question to corporate, what you as a corporate do to service the bond?

Another story would be highlighting risks in the corporate bond market:
Has anybody seen the movie "Bala"? It's a Bollywood movie casting Ayushman Khurana. His character in the movie has a condition where he loses his hair early. As a kid, he used to make fun of people. But as he grew up, he faced a dire situation. He was facing the bullies because he was getting bald at an early age. So, he found a friend in the form of a wig. When he wore the wig, he behaved like a superhero. In the same way, the A+ rating PSU bonds, are all Bala's with a wig. How do we know he is bald not? And there, IL&FS happens. And then the wig got blown off. The impact of this was to such an extent that people started believing he does not have hair at all. Meaning investors have lost confidence in the bond market. EPFO after DHFL collapse has stopped investing in the corporate bond market.
In very simple terms, if I had to quote risk in the corporate bond market, that would be of 3 types-

1. Good company
2. Not so good company
3. Bad

Companies at the lower end of the spectrum are trying to boost their image in the market. But, the investors are of the view that there is hardly any difference between them and a bad company. The well in line is offering 5% for a short term. The Bala's of the world are borrowing at 10%. The point I'm trying to highlight is the entire industry is divided into two- Have's and the Have Nots. In haves, there are any bond by Government and have not are the corporate bonds.

DEBT MARKET- CRYING NEED OF THE HOUR

To enhance the financial stability of a country it is vital to develop deep, vibrant and robust corporate bond market to mitigate financial crises and support the credit needs of corporate. There is no doubt that the equity market in India is quite well developed and plays a crucial role in the growth of Indian economy. At the same time, the Government Securities market in India has also experienced tremendous growth in the last decade. Despite a lot of policy and regulatory attention in the past, the corporate debt segment in India still requires a lot of focus on its development to make it more liquid.

NSE's share in total trades of corporate bonds report decreased from 73.3 per cent in 2017-18 to 67.6 per cent in 2018-19. The total value of corporate bonds trades reported at BSE rose by 23.7 per cent to 5.9 lakh crore from 4.8 lakh crore in the previous year. Whereas that of NSE declined by 5.9 per cent to ` 12.4 lakh crore from 13.2 lakh crore, during the same period.
In terms of number of trades, the trades reported at BSE rose by 1.4 per cent to 2,44,174 in 2018-19 from 2,40,756 in 2017-18. Whereas that at NSE increased by 1.8 per cent to 63,346 in 2018-19 from 62,215 in 2017-18.

Secondary Market Corporate Bond Trades (Reported Trades)				
Year	BSE		NSE	
	No. of Trades	Amount (Rs. Crore)	No. of Trades	Amount (Rs. Crore)
2017-18	240756	480575	62215	1321738
2018-19	244174	593507	63346	1243215

Commercial banks are not a vehicle for long term financial needs. Indian corporate bond is a mere 15% of GDP. Whereas India largely depends on bank financing about 72%, other countries like the USA, Malaysia, only 40-45 per cent dependency is on banking finance. Corporate Bonds fulfill rest of the long-term financing needs. Here one needs to understand that bank credit is not the answer to all funding requirements.
Although lot changes have been made there is still the need to push for having vibrant bond market-

- For any financial market to work seamlessly there should be fine-tuning in both primary and secondary market. For the bond market, the share in trade value in the secondary market is only 1.5% of the total traded value

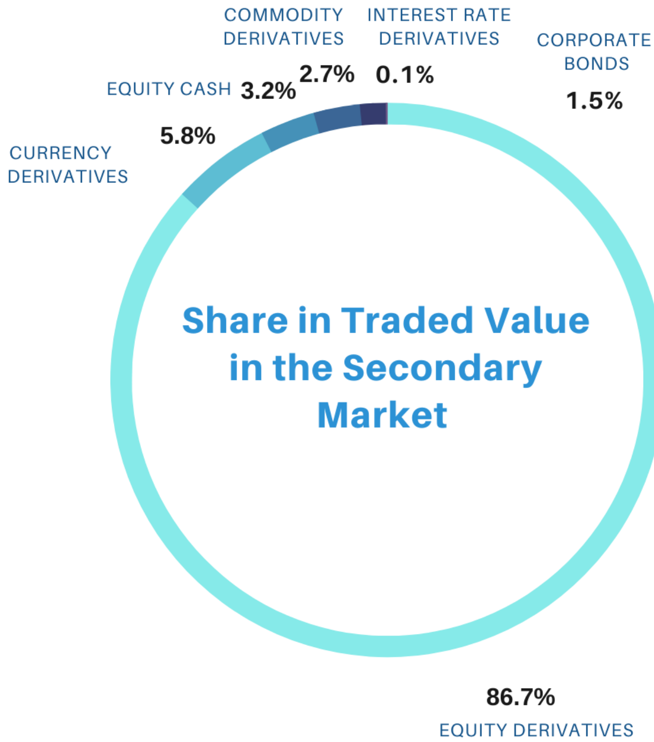


Figure 1: Source: SEBI Annual Report

- The total issuance is highly fragmented because of the dominance of private placements. Hence one can say that access through the primary market is also limited to a major extent.

Year	Debt Issue		
	Public	**Private Placement**	**Total**
2014-15	9,413.43	4,04,137.00	4,13,550.43
2015-16	34,111.92	4,58,073.00	4,92,184.92
2016-17	29,093.13	6,40,716.00	6,69,809.13
2017-18	5,172.56	5,99,147.00	6,04,319.56
2018-19	36,679.39	6,10,318.00	6,46,997.39

Source: SEBI Handbook of Statistics

- The number of participants in the market is relatively small. 40 banks and NBFCs and 40 MF and there is little diversity of view, and hence leading to little incentive to trade

- Retail participation remains low due to lack of knowledge and understanding of bonds as an asset class

- Lack of knowledge in terms of CDS market due to this potential of CDS has not been utilized to its full extent

- Trust of investors has been evaporated from the bond market due to past scams (Il & FS, DHFl, Franklin Templeton). Also withdrawing from the bond mutual fund scheme was seen in the last few months.

AUM: Debt Mutal Fund Industry			
AUM (In crs)			
Scheme Name	**Feb/2020**	**Mar/2020**	**Apr/2020**
Open Ended Scheme			
Overnight Fund	53283.34	80174.2	82964.89
Liquid Fund	443108.33	334725.3	405393.37
Ultra Short Duration Fund	100964.63	72226.36	69014.42
Low Duration Fund	100987.06	81371.17	74518.89
Money Market Fund	84129.52	57016.65	56152.46
Short Duration Fund	104679.15	93444.33	91266.33
Medium Duration Fund	31032.81	28290.3	21351.49
Medium to Long Duration	10350.23	9804.8	9684.39
Long Duration Fund	1599.89	1669.58	1988.16
Dynamic Bond Fund	18987.4	18115.97	16968.15
Corporate Bond Fund	85262.93	81729.8	86292.53
Credit Risk Fund	61837.66	55380.52	35222.36
Banking and PSU Fund	78603.28	72475.88	79241.92
Gilt Fund	8456.94	9284.98	12014.59
Guilt Fund with constant	852.5	941.41	1052.05
Floater Fund	38179.73	32490.43	31615.28
Grand Total	**1222315.4**	**1029141.**	**1074741.28**

Source: AMFI

In the Mutual Fund industry, particularly during this lockdown period, we see there was more sell request which exponentially increased after the restructuring of Yes Bank, which hit their AT1 bonds. Nowadays, some corporates are paying salary without much revenue. Such companies are considering to take money out of their investments. So the selling of such sort takes up yields on corporates bond at the short end of the curve where the majority of investor park their money and daily returns are negative.

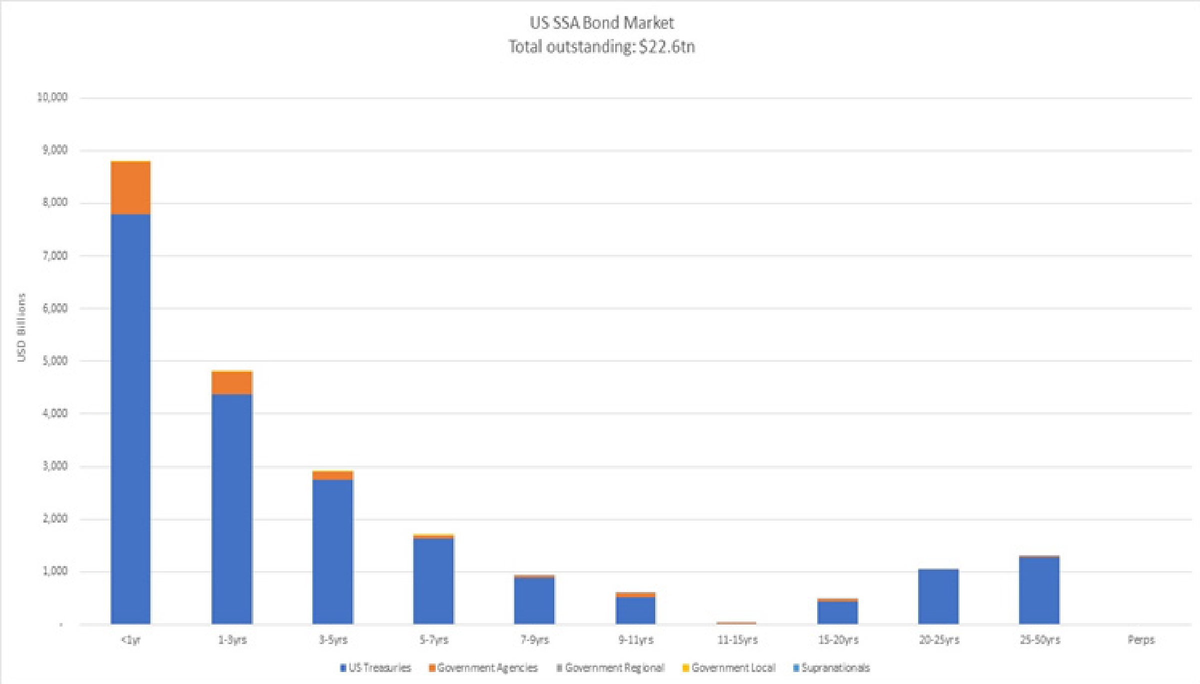
- There is a need for a flexible framework between the bond issuer and investor

It is important to see how the bond market works in countries such as the United States market. Most bonds pay interest twice a year in the U.S. markets. Investors invest in bonds because they provide offset exposure to volatile stocks.

There are three major types of bonds in the U.S. Markets issued by Government, Municipalities and the Corporates. Bonds preserves capital and provides fixed-income security. Interest income from municipal bonds is tax-free in the hands of the investors.
It is very essential to build confidence in the minds of investors.

Even the municipals have to publish its annual financial information, notices and operating data with Municipal Securities Rulemaking Board (MSRB). Corporate bonds are to be registered with the Securities Exchange Commission.
The Sovereigns, Supranational and Agencies (SSA) Bonds amounts to $22.4 trillion whereas Corporate Bonds constitutes $10.9 trillion.

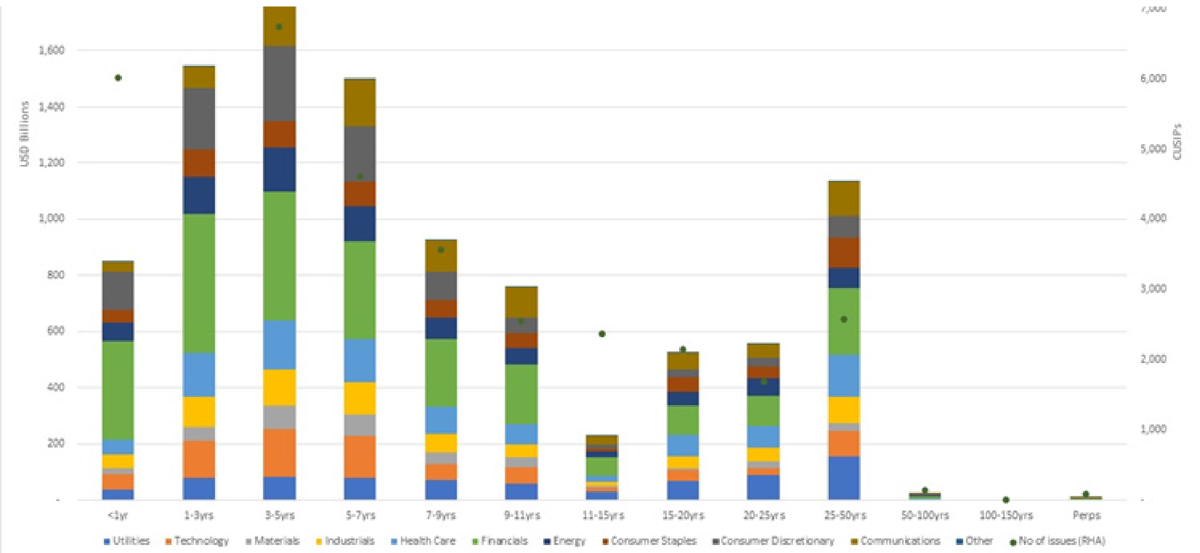
USA SSA Bond Market



Source: IMCA analysis using Bloomberg data in August 2020

91% ($20.7 trillion) of the Sovereigns, Supranational and Agencies (SSA) bonds constitutes of US treasury bills which mature within 1 year making the bond market more liquid from investors viewpoint.

The Corporate Bond market (domestic) has a market size of $9,974 billion. 28% of bonds are issued by financial institutions consisting of 40,268 different Committee on Uniform Securities Identification Procedures (CUSIPs).



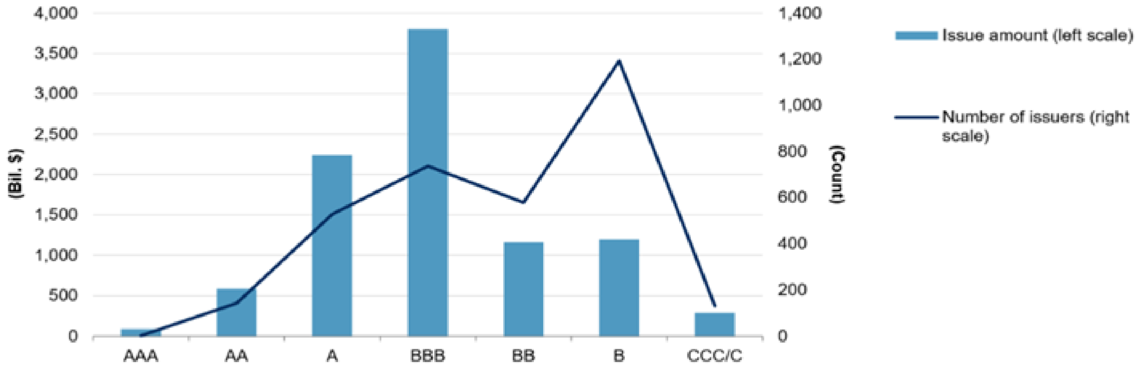
Source: IMCA analysis using Bloomberg data in August 2020

The Indian debt market has dominance only from the infrastructure and financial sectors whereas the U.S. markets have participants from various sectors such as utilities, technology, materials, industrials, health care, etc.

As per the S&P data, BBB category bonds have major debt around $3.8 trillion out of which 77% comprises from nonfinancial companies.

Chart 2 | Download Chart Data

Distribution Of U.S. Corporate Debt By Rating Category



Issue amount includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings from financial and nonfinancial issuers. Issuer count is based on the total number of issuer credit ratings for U.S. corporates. Data as of Jan. 1, 2019. Sources: S&P Global Fixed Income Research.

Source: S&P Global

The major reason why there is a high investment in BBB bonds is that the investors believe that there is a scope of development and progress in such companies as compared to the AAA bonds. The later has a saturated market growth. People in the United States describe the bond market as the safest asset in the world and hence they invest in bonds for fixed income security.

Issues:

1. Limited Buyers:

a. 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.

b. The FPIs are now prominent buyers of top-rated bonds given the attractive returns especially in the backdrop of a strong rupee.

c. Most of these investors do not trade but hold these investments until maturity.

d. 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.

2. Private Placement: 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.

3. Stamp Duty: The varied stamp duty in states on debt transactions.

4. The Indian corporate bond market has low & unstable trading volumes. The corporate bond market remains largely about top-rated financial and public sector issuances.

Historic CDS Changes from 15 December 2015.

Year	Change	Min	Max	CDS Range
2015	-6.80%	92	108.8	
2016	-10.70%	73.5	134.5	
2017	-20.10%	69.5	132	
2018	61.70%	66	115.3	
2019	-40.80%	58.1	114.3	
2020	62.60%	59	271.5	

India Credit Ratings historical data

Date	S&P	Moody's	Fitch	DBRS	Column1
18-Jun-20			BBB-		
1-Jun-20		Baa3			
22-May-20				BBB	
8-Nov-19		Baa2			
16-Nov-17		Baa2			
5-Nov-15				BBB	
9-Apr-15		Baa3			
5-Nov-14				BBB (low)	
12-Jun-13			BBB-		
18-Jun-12			BBB-		
23-Jun-11				BBB (low)	
18-Mar-10	BBB-				

10Y Bond Yield Spread - India vs Main Countries

India 10Y vs	Current Spread	Chg 1M	Chg 6M	Analysis
Germany 10Y	651.2 bp	14.3	-8.9	
France 10Y	623.2 bp	17	10.7	
Japan 10Y	598.4 bp	8.4	-13.9	
United Kingdom 10Y	576.0 bp	11.6	-5.7	
Spain 10Y	574.4 bp	19.3	29.9	
Canada 10Y	542.9 bp	6.2	-9.6	
United States 10Y	529.5 bp	2.4	-24.1	
Italy 10Y	514.1 bp	29.5	50.4	
Australia 10Y	509.6 bp	8.1	-38.1	
China 10Y	283.9 bp	-4.6	-64.6	
Russia 10Y	-22.4 bp	-11.2	44.3	
Brazil 10Y	-129.7 bp	-36.5	35.7	

From being Moribund into one that is vibrant and large - What needs to be done?

While there have been some important steps in the corporate bond market, a lot needs to be done. Some of the issues which need to be addressed are as under-

- Bond pricing collapsing leaving existing holder sitting on certain capital losses but bond yield move in opposite direction to prices, this benefit should be pitched to the new investors who will get better returns from the coupon this will be the welcoming news to despairing income in income investors who are watching dividend shrivel.

- Even though corporate bonds may be illiquid as compared to equity but they are fundamentally less risky given the corporate governance and give the holders seniority in the companies capital structure

- The issue that constantly triggers the foreign investor to invest in corporate bonds of India is of credit risk or default risk. This is one of the main concerns of foreign investors. We need to evolve or develop a system as we see in equity markets, wherein the exchange clearinghouses and depositories guarantee the settlement. Although there is indirect mechanism such as credit default swaps (CDS), it could be suggested that the existing depositories could extend their operation to include some good PSU paper at outset and cover the credit risk to kick start this market segment. The scheme could be expanded depending on the experience

- Retail participation a must thing which should be done

- High need to develop bond investor relationship- In this context, it is required a roadmap should be shown to the bond investor, they should be aware of how the corporate is going to utilize their funds, human beings require acknowledgement and so does the bond investors.

- Measures should be taken to encourage public offers

- Through retail participation number of players will increase and this will create an environment that would increase secondary market activity

- The aim is to create how investors view government securities in the same way corporate bonds should be viewed and treated by the investors. For this corporate needs to be sincere and the bond market should be easy to understand, manageability should be taken care of by the entire structure of the bond market

- Credit spread and funding costs- It is essential to understand the difference between credit spreads and funding costs when we are talking about corporate bonds. Credit spread going up does not necessarily mean that the cost of funding for an issuer will go up.

- The investors haven't been welcoming with the latest SEBI guidelines for Multicap funds to invest at least 25% each of their assets in the large-cap, mid-cap, and small-cap segments. The performance of small and midcap funds doesn't give a sense of security to the investors; hence they hesitate to invest in the same. It can be a tip for the mutual funds financed by debt. This can be of benefit to the debt market through successful debt-oriented products attracting investors.

Market determined yield on the security it issues is the factor that determines the cost of funding. Risk-free and credit spreads are the two components of yield. RBI monetary policy impacts the risk-free rate but not the credit spreads.

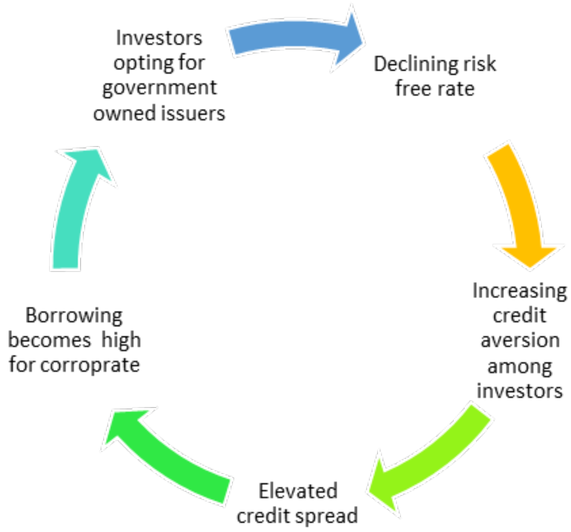
Credit spread reflects the premium that the investor charges over and above the risk-free rate, taking into account the inherent riskiness of the underlying bond. What is happening since IL & FS episode, the risk-free rate is coming down steadily, RBI action of reducing policy rates and large-scale open market operations to inject liquidity in the financial system.

G-sec	Year 2018 %	2020 %	
5 year bond	8.4	5.5	
3 year bond	7.5	4.5	

The 5-year risk-free interest today that is in 2020 is at 5.5% which was earlier in 2018 at 8.4% in 2018 (before IL & FS) The three-year risk-free interest has declined even more to about 4.5% over this period.

Monetary policy does not affect the credit spreads, the impact of the policy action on the actual cost of funding will not be the same as the reduction in the risk-free rate. If risk aversion goes up, the investor will demand a higher price for the credit risk which will result in rising spreads.

The risk-free rate is declining but owing to high-risk aversion, credit spreads have remained elevated. Hence funding cost has not come down by as much as the risk-free rate.



• To make corporate bond market more vibrant, primary dealers play a vital role. They are the players of the market, the market maker. Primary dealers have enhanced the liquidity of GoI securities through market making same proactiveness is not seen in case of the corporate bond market. The same implementation to be applied for corporate bond as well.
• Wide spread between bonds of the same ratings issued by private companies and those owned by the government indicates a strong perception of the implicit government guarantee enjoyed by public sector companies. The perception needs to be changed. The perception is shaped by corporate defaults and associate policy responses.
• A cut in repo rate and a widened window between repo and the reverse rate was a benefit for the government bond. RBI introduced LTRO for the corporate bond market in the last quarter. The European market introduced this concept in the 2008 crisis. LTRO ensured

the banks have enough funding in a repo on a long-term basis to fund corporate houses. However, later they realized this funding should go to corporate bonds and commercial papers. RBI introduced one lakh crore TLTRO on 27th March 2020 where not more than 10% of the money should go to one issuer.

- When taxation is concerned, one should make a point that interest on listed bonds do not have TDS viz-a-viz the various debt schemes of Mutual Fund. The long-term capital gain tax is charged on buying and selling, and is 10% and a holding period of 1 year in direct trading in corporate bonds which as compared to mutual fund taxation rate is 20% and holding period is 3 years. So, by direct investment in bonds retail investors can have better tax planning. The action to be taken here is to spread the awareness among investors

- As we see UPI mechanism for equity market. Such mechanism should bond market too.

If there was a magic wand for potent change – A Wishlist

Debt Allocation Strategy

The debt market has seen various changes in the recent past. The sudden spike in retail inflation in Dec to 7.35% from 5.54% in Nov has surpassed the RBI's comfort level. These changes will impact the performance of debt products, including duration funds.

1. We will urge investors to base their decision to rejig portfolios on recent data. The need to review the asset allocation should arise if there is a significant deviation from the goal or if there has been a material event which changes the portfolio's characteristics.
2. Given the current situation, a portfolio skewed towards short- to mid-duration funds could be potent, as such categories are usually low to moderate on both duration and credit risk.
3. Good-credit-quality short-duration bond funds with up to three to four years of portfolio maturity, like these, will be less volatile than long bond funds in response to interest rate fluctuations.
4. Small savings schemes are offering attractive rates compared to the repo rate of 5.15%. It's good to make use of these products.
5. Short-term debt funds (high credit quality): For a period of 12-18 months', funds having roll-down maturity with better yields and moderate duration will buffer the effect of inflation and interest rate movement and give stable returns.
6. The best approach will be to implement a 70:30 allocation favouring short to medium duration (two-three years) versus long duration. Dependence on bank finance should be 30-40 percent and funding for long term projects should be done through corporate bonds at least 70 percent.
7. Innovative products- there are deficiencies in structured products, products such as market-linked bonds, nifty link bonds should be made available and accessible to the larger audience
8. Investors can shift their viewpoint and invest in Debt-funded mutual funds. There should be some criteria which encourages people to invest around 10% in debt-funded mutual funds likewise in the latest guidelines by SEBI guidelines for Mid and Small cap funds to invest in small and medium enterprises. This will definitely boost the scope of debt markets as the number of participants in the market will increase.

Other recommendations to boost the market:

1. Developing the segment for credit default swaps (CDS): This will mean protection against the possibility of a company or issuer defaulting on a repayment option. This will offer comfort to an investor willing to take a risky bet and, in the process, adding volumes. CDS should be used widely

2. 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. It should help offer an exit option for such investors and improve liquidity.

Conclusion

More players can be brought into the system by fostering confidence among retail investors. The investor base can be expanded through investor awareness. Structured product availability and accessibility would be the cherry on the cake. To reduce risk aversion among investors there is a strong need to strengthen the rating companies and valuation entities to instil confidence among the investors. And also, to make the corporate bond more liquid there is a need to have an active fixed income derivative market.

Expansion of the investor base is a prerequisite for the corporate bond market, which will further encourage innovation and competition in the market and enhance liquidity. From an investor's perspective, there is a need for open-mindedness and commitment for long-horizon with the corporate bond market. The aim is to bonding with bond markets.

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