India's Corporate Bond Market: Issues in Market Microstructure
Shromona Ganguly, RBI Bulletin

This article examined various demand and supply side factors affecting the growth of the corporate bond market in India.

Development of the corporate bond market in India remains crucial for meeting the financing requirement of industry and infrastructure sector. Despite various initiatives undertaken in the past, there is little change in the overall market microstructure of the corporate bond market in India. The demand for corporate bonds as an investment is mostly confined to institutional investors who are in turn constrained by prudential norms for investment as in the case of the insurance companies and mutual funds. Demand for corporate bonds by foreign investors is constrained by FPI investments limits, while banks prefer loans to bonds, as loans can be carried to their balance sheets without being marked to market.

On the supply side, the high cost of borrowing via debt instruments vis-à-vis other forms of raising finances and inadequate liquidity in the corporate debt market deter firms from market issuance. Large corporates can raise debt from the overseas markets at lower cost than cost of borrowing through the domestic market-based sources. Small outstanding stock of individual issuances inhibiting secondary market trading, non-availability of functional trading platform with central counter party (CCP), and non-uniform stamp duties on corporate bonds across various States are the major operational issues of the corporate bond market in India.

Developing the corporate bond market assumes crucial importance for India especially in the context of channelling funding to long term infrastructure. Further, the total volume of trading in the secondary market for corporate debt has increased at a modest pace. In India, the proportion of firms using banks as the primary source of working capital is higher than most developing countries. Further, the proportion of loans requiring collaterals as well as the value of collateral as proportion of loan are amongst the highest in India. This indicates the prevalence of asset-backed lending in India, which is essentially a feature of a relatively less developed financial system with limited expertise to gauge the credit risk of unsecured lending.

There has been gradual increase in the proportion of debt raised through market-based sources like bonds, debentures and commercial paper (CPs), though banks accounted for 45% of total debt of these firms. The share of other non-bank non-market based sources of debt, such as loans from promoters and inter-corporate loans moved in the range of 2-4%, while foreign currency borrowing accounted for 14% of total debt. Preliminary analysis of the sources of debt across various size-categories among non-financial firms reveals that the preference for market based debt is confined to the larger non-financial firms. For the smaller-sized firms, many of which may lack credit rating and the economies of scale enjoyed by the larger firms in the private placement market, banks remain the primary source of debt funding. In case of financial companies, the proportion of debt raised through debentures and bonds stood at around 28-30% of their total debt. However, like non-financial companies, the higher proportion of debentures and bonds in total debt financing is confined to larger-sized financial companies. The total resource mobilisation by Indian corporates through public/private/rights issues is dominated by debt while equity accounts for close to 38% and bulk of the debt is placed privately.

The analysis of corporate debt market shows dominance of finance and infrastructure companies with a low share of manufacturing companies. In the primary market, the bulk of bonds issued were 2-5 year tenor range (56%). The high rated bonds accounted for more than half of total amount outstanding in the primary segment during the last two years. Similar sector-wise and rating wise composition has been seen in the secondary market. Finance and infrastructure companies together accounted around 80% of total traded value and around 80% of total secondary market trading was accounted by highly rated bonds.

The mutual funds (MF) industry has played an important role in the development of corporate bond market in India by catalysing innovation, price discovery, liquidity and transparent bond valuation. Assets under management (AUM) of short term debt have increased at a rapid pace with corporate bonds and CPs accounting for close to 77% of total fund invested. Sector-wise, bonds issued by real estate, NBFCs and PSUs constitute about 1%, 19% and23%, respectively, of the total investment incorporate bonds by the debt MFs and the other category accounts for close to 57% of their total investment.

The dominance of private placement in India's corporate debt market implies that all the characteristics of a well-developed market do not exist and prevailing conditions reflect information intensive relationship-lending market in which investors act like banks in collecting information pertaining to the borrower, which is not publicly available. In the private placement market, insurance companies are the major players as they find such investment attractive due to long-term and fixed nature of their liabilities. The private placement market for corporate debt is dominated by private financial companies.

Based on the available data, an attempt has been made by the author to understand how the coupon rates in the private placement market is impacted by terms of the loan, security-specific factors as well as the general interest rate environment. More specifically, an attempt has been made to empirically understand whether the positive relationship between risk and return holds in the private placement market for corporate debt as well. Empirical analysis of the determinants of coupon rate in the private placement market warrants the consideration of two sets of key variables i) security specific characteristics such as riskiness of the security, sector (private/public), nature of operation (financial/non-financial), tenor, and nature of lending(secured/unsecured) ;ii) macro-variables reflecting the general interest rate environment and spread of AAA rated corporate bonds3 over the benchmark 10 year G-sec rate as indicative of market perception of riskiness of corporate bonds.

Empirical analysis shows that on an average a 5.02%difference was found in the coupon rates between the AAA rated bonds and risky bonds (BBB or below). Coupon on bonds issued by public or financial companies was found to be lower. The results indicate that even in the private placement market, investors have significantly higher risk perception about low-rated bonds. This possibly explains the reason for predominance of AAA rated bonds in India's corporate debt market.

The overall market microstructure of the corporate debt market in India is yet to evolve in terms of enabling vibrancy and depth. Both the primary and the secondary segments of the market continue to be dominated by issuance of bonds by infrastructure and financial services companies while the share of manufacturing firms is negligible. The placement of corporate debt remains largely private, accounting for as high as 98% of the total amount raised, on an average. The investor base in the corporate bond market remains narrow due to high risk perceptions. In this context, the role of credit rating agencies (CRAs) in disseminating information on the issuers of corporate bonds remains critical. Credit rating agencies also help in identifying the presence of junk bonds in the market.

The 2016-17 Union Budget announcement of setting up of Credit Enhancement Fund could leverage the access of the infrastructure companies into the corporate bond market, complemented by the large exposure framework laid down by the Reserve Bank. Going forward, the development of quasi-bond products and operationalization of the 2018-19 Budget announcements mandating large corporates to raise 25% of their funding needs from the bond market could go a long way towards developing a vibrant and liquid corporate bond market in India.

Source: www.rbi.org.in

National Monetary Authorities and the Global Financial Cycle
The Sixteenth L.K. Jha Memorial Lecture delivered by Professor Hélène Rey from London Business School at RBI Mumbai, December 14, 2018.

Financial globalisation has increased massively since the 1990s. The great financial crisis of 2008 has stopped that progression. A number of offshore financial centres are managing an increasing amount of world wealth as information technology and financial innovation make it simpler to move funds overseas. Many of the services provided by offshore centres are legal but some facilitate tax "optimisation". Some of the most widely cited benefits of financial globalisation, enshrined in the psyche of economists and policy makers alike are risk diversification and better allocation of capital. The author finds that the welfare gains of financial integration due to better risk sharing and better capital allocation are small even for capital scarce and risky emerging economies.

Global factors are major determinants of international capital flows. Economists have identified cycles in the real rate of interest and in the growth rate of advanced economies as important push factors for capital flows. Several studies have found that movements in the VIX (Chicago Board Options Exchange Market Volatility Index) are strongly associated with capital flows. Similarly, risky asset prices around the world co-move negatively with the VIX. For a large part, they do not reflect sector-specific, country-specific or company-specific factors but rather one global factor. As credit cycles and capital flows obey global factors, they may be inappropriate for the cyclical conditions of some economies. For some countries, the global cycle can lead to excessive credit growth in boom times and excessive retrenchment in bad times. As excessive credit growth is one of the best predictors of crisis, global financial cycles can be associated with surges and retrenchments in capital flows, booms and busts in asset prices and crises. The picture emerging is that of a world with powerful global financial cycles. It is also a world with massive deviations from uncovered interest parity.

In international macroeconomics and finance, economist often think within the framework of the "trilemma": in a financially integrated world, fixed exchange rates export the monetary policy of the centre country to the periphery. The corollary is that, only floating exchange rates enable monetary policy independence. The trilemma misleads us by assuming that domestic monetary and financial conditions shaping the macro economic situation of a country can be conveniently summarised by this one single variable, the short-term interest rate. In a world of globalised finance where financial conditions such as spreads, risk premia, cost of funds are exported from the centre country of the international monetary system, monetary policy independence is constrained, including for countries with flexible exchange rates.

A growing body of empirical evidence finds that US monetary policy shocks around FOMC (Federal Open Market Committee) meeting windows are transmitted internationally and affect leverage, as set prices and spreads, capital flows and credit creation around the world including in jurisdiction with flexible rates. The effect of US monetary policy shocks on mortgage spreads is of the same order of magnitude in the US and in Canada for example. Thus, while flexible exchange rates help external adjustments of countries following large macro economic shocks, they cannot insulate economies from the global financial cycle, in particular, during the boom phase of the cycle.

National authorities have certain policy options to insulate their economies and manage the impact of the global financial cycle. The options include imposing targeted capital controls, limiting the credit growth and leveraging during the upturn of the cycle, using macroprudential policies on banks and non-banks. Imposing stricter regulation on all financial intermediaries creating credit - bank or non-banks and decreasing procyclical fiscal incentives are some of the policy measures of national authorities.

There are now many tools available to macroprudential authorities in different countries. The policies associated with banks are counter cyclical buffers, sectoral risk weights, while for borrowers the policies are debt to income ratios and loan to value ratios. However most of the existing panoply of tools can be applied only to the banking sector. Since a lot of recent credit creation takes place outside banks - as for example the rising share of Non-Banking Financial Companies in total credit in India, it becomes more crucial that macroprudential authorities and central banks have the power to modulate credit growth in the non-bank sector as well.

Macroprudential authorities should be independent. In return for their independence, macroprudential authorities should be accountable to elected bodies. Their mandate on financial stability should be as transparent as possible and well explained to the parliament and general public. This involves pointing out to the citizens, the very large costs of financial crises. Avoiding financial crises is a difficult thankless task as in best cases nothing dramatic happens. It should nevertheless be a policy priority.

Source: www.rbi.org.in