

4. ISSUES IN DEVELOPING BOND MARKETS

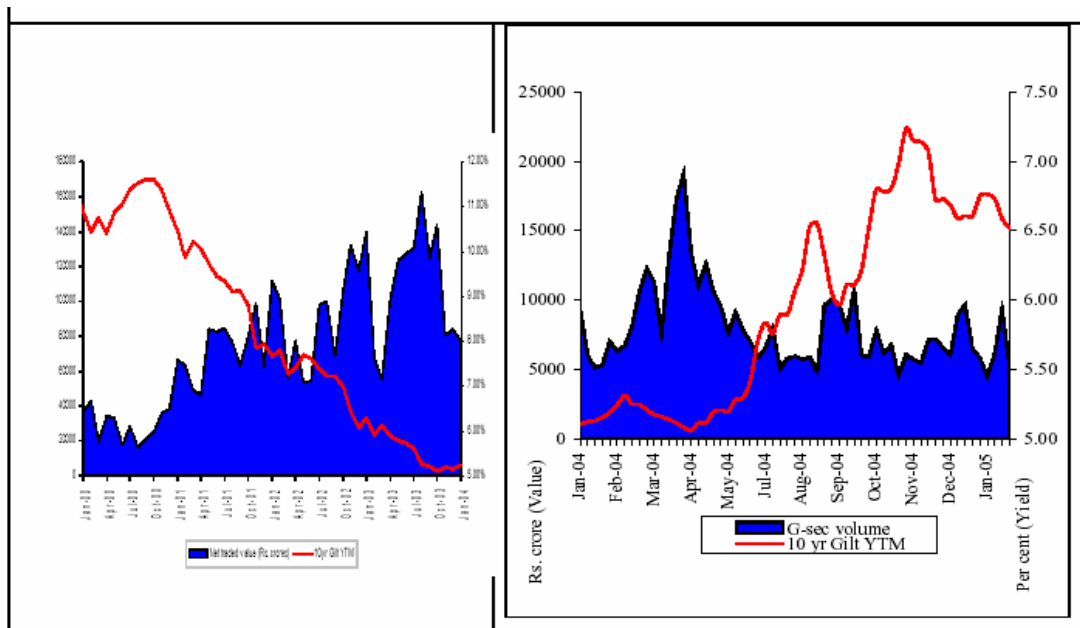
While secondary markets in equity and Government securities are well structured, the secondary market for corporate bonds is very primitive. The liquidity is very low and issues are fragmented.

4.1 Problems with the Indian Government securities market

As mentioned before, growth in the debt market has been biased in favor of growth in the Government securities market. As a result, a fairly widespread, efficient and liquid Government securities market exists in India. However, there are issues that come in the way of improved liquidity in the Government securities market.

Within the Government securities market, integration across tenor is as yet incomplete. Pressures of surplus liquidity, in particular, have often ended up distorting the yield curve. The narrowing of yield spreads in the 2-year to 10-year residual maturity segment (from 183 basis points to 63 basis points) and in the 10-year to 20-year segment (from 95 basis points to 77 basis points) during September 2001 to May 2004 made the yield curve in India one of the flattest internationally. During April-May 2004-05, abundant liquidity emanating from strong capital inflows drove the yields on 91-day and 364-day T-Bills below the weekly reverse repo rate of 4.5%. Furthermore, there were instances when the cut-off yield on 364-day T-Bills fell below that of 91-day T-Bills. A distorted yield curve reflects an unequal spread of liquidity in the market in that liquidity continues to be concentrated in some segments. Thus, yields reflect liquidity distortions rather than capturing the risks inherent in longer tenures. But this has turned out to be a global phenomenon and nothing peculiar to India – even Alan Greenspan was baffled with this “conundrum”.

Figure 6: Interest Rate Movements and Trading Volumes



Source: “Report of the internal Technical Group on Central Government Securities Market”, RBI, 2005

An important issue is that in the absence of instruments to take interest rate views, it is observed that the markets are active and liquid when rates are falling but turn lackluster and illiquid when rates rise. Low volumes render markets shallow and prone to price manipulations. It is necessary to have a developed interest rate derivatives market as also to allow market participants to short securities to take two-way positions, to ensure market liquidity irrespective of the direction of interest rates. Although IRFs and interest rate swaps are popular, the numbers of players in these limited products for interest rate derivatives are limited. Further, market players currently cannot short sell. The recent RBI initiative to allow the market to short sell government securities in a limited way may be a good beginning but might not improve liquidity in the market in a significant way. The number of actively traded securities is very low as compared with the total number of securities outstanding. At the end of February 2005, there were 121 Central Government securities with an outstanding amount of Rs. 8,953 billion. Of these, 44 securities with minimum outstanding issues of Rs. 100 billion or more accounted for 69% of the total outstanding amount. The turnover to total outstanding ratio dipped sharply from about 2% in 2003 to 1.5% in 2004, while it ranged between 3 - 38% for developed

countries. On a daily basis, hardly 10-12 securities are traded, of which the number of actively traded securities would be a mere 4-5 till now. Without active trades in the markets, the yield curve has several kinks, making pricing of securities difficult. This also leads to a situation where securities of similar maturity profiles trade at very different yields, with the liquidity premium sometimes going as high as 50 basis points.

The investor base is thin leading to volatility in the markets and enabling a few active players to effectively determine prices. A major portion of the Government securities are held by banks, resulting in the concentration of risk in the financial system.

Though the primary dealers have been very active in contributing to the primary and secondary market in Government securities, they could not perform one of the most important functions viz., market making in Government securities. Indeed their business models and the permissiveness of the current market regulations for trading activities by them might be unable to absorb the shocks in case they have to perform this function.

The current settlement system for trades in Government securities requires that the settlement is done on T+1 basis. This narrow settlement period while takes care of too much speculative activity certainly impacts the liquidity in the market

Apart from market liquidity issues, the Government securities market does not have any major problems to address. The infrastructure for trading, clearing and settlement are one of the best.

4.2 Problems with the Indian Corporate bond market

4.2.1. Corporates - bank financing versus bond financing

Traditionally the Indian Corporate sector used to source its funds requirements from the financial institutions – from the so-called development financial institutions (DFIs such as Industrial Development Bank of India (IDBI) and ICICI) for their long term requirements and from commercial banks for their short term requirements. Development of capital markets facilitated disintermediation and companies started tapping the bond/debenture markets in the eighties. However, the disappearance of development

financial institutions, which were the main source of long term finance, caused a vacuum but this should have been a great opportunity for developing a bond market but surprisingly this did not happen. Corporates took resort to their growing internal resources, raised resources through low cost equity taking advantage of the equity boom, borrowed abroad taking advantage of low interest rates and wherever needed to approach the long term debt option preferred the private placement route. Further, the bond financing, in the absence of hedging avenues, turned out to be more risky and less flexible in comparison to bank financing.

4.2.2. Risk management

The derivatives markets are not well developed do enable both issuers and investors to efficiently transfer the risks arising out of interest rate movements. As has been already mentioned though markets exist for interest rate swaps and interest rate futures, the number of participants are limited and the market is not broad and deep. There are no exchange traded interest rate futures or options. The mark to market regulations deters banks from investing in corporate bonds and prefer traditional lending route to finance corporates. However, once banks have to follow the Basle II norms they will have to periodically revalue their loans extended to corporates and this may rectify to some extent this anomaly.

4.2.3. TDS (Tax Deduction at source)

In the case of corporate bonds TDS is deducted on accrued interest at the end of every fiscal year as per prevalent tax laws and a TDS certificate is issued to the registered owner. While insurance companies and mutual funds are exempt from the provisions of TDS, other market participants are subject to TDS in respect of interest paid on the corporate bonds. Interestingly, TDS was viewed as a major impediment to the development of the Government securities market and was abolished when the RBI pointed out to the Government how TDS was making Government securities trading inefficient and cumbersome. Besides making trading inefficient and cumbersome, the different treatment meted out to insurance companies/mutual funds on the one hand and other market participants on the other also makes it difficult to introduce a uniform computerized trading system.

4.2.4. Stamp Duty

Stamp duty has been a source of revenue for the State governments. The Indian Stamp Act is an enactment of the central government. States have powers to make amendments to the Act. Section 3 of the Stamp Act stipulates that stamp duty has to be paid as per Schedule I to the Act. States have by way of amendment introduced schedule IA to the act indicating stamp duty payable in particular states. Duty is levied on financial instruments both either at the time of issue or on transfer or on both depending upon the nature of the instrument, issuer etc.,. These duties are perceived to be very high and act as a deterrent to the development of the bond markets. For instance the Indian Stamp Act prescribes a 0.375% duty on debentures (ad valorem). Promissory notes attract much lower duty of 0.05%. In the interest of developing the corporate bond market, there is a pressing need for rationalization of the stamp duty structure across the country. Since stamp duty impacts heavily the cost of issue of bond paper, it would be desirable to reduce stamp duty levels and also introduce a suitable provision which stipulates the maximum amount of stamp duty that is payable in respect of any single issue. This will not only bring down the cost of issuance but will also lead to the creation of a single stamp duty rate.

As has been mentioned earlier, the stamp duty is generally levied by each State Government, and they differ across States. Hence there is a need to take the State governments into confidence to rationalize the duty structure. A high level committee set up by Government of India established in 2005 has suggested the following matrix of stamp duty on corporate debt bond.

Table 8: Proposed Stamp Duty Structure

Maturity	Stamp Duty	Maximum Stamp Duty(Cap)
Up to 1 year	@ 0.05% of face value	Rs. 10 lacs
1 to 3 years	@ 0.05% of face value per year	Rs. 15 lacs
3 to 5 years	@ 0.05% of face value per year	Rs. 20 lacs
Above 5 years	@ 0.05% of face value per year	Rs. 25 lacs

Source: "Patil Committee Report", 2005

Further, the stamp duty applicable for a security differs on the basis of the class of investor. This discourages corporates from issuing bonds to certain class of investors like retail investors (either directly or through mutual funds), and to long-term investors like insurance companies, provident and pension funds. Apart from these inconsistencies, the duty structure is quite steep as compared to some of the developed markets (table 8).

Table 9: Comparison of Stamp Duty Rates across Singapore, Malaysia and India

Nature of Instrument	Singapore	Malaysia	Maharashtra, India	Delhi, India	Gujarat, India
Issue of Promissory Notes	Nil	Nil(Pvt. Debt Securities, ABS, Company Bonds)	0.5% 0.10% in case investor is bank/select institution	0.5% 0.10% in case investor is bank/select institution	0.5% 0.10% in case investor is bank/select institution
Issue of Debentures	Nil	Nil(Pvt. Debt Securities, ABS, Company Bonds)	0.36% (Unsecured Debenture)	0.36% (Unsecured Debenture)	0.36% (Unsecured Debenture)
Creation of Charge					
Non equitable Mortgage	S\$4(0.04%) for every S\$1000(Max S\$500)	RM5 (0.05%) for every RM 1000(Max RM500)	1%(Max Rs.5 lac)	2%(Max Rs.2 lac)	2%(Max Rs.2 lac)
Equitable Mortgage	S\$2(0.02%) for every S\$1000(Max S\$500)	RM5 (0.05%) for every RM 1000(Max RM500)			
Eg: For a Rs. 50cr. Issue	0.0027%	0.0024%	0.10%	0.04%	0.04%
Pawn/Pledge			1%(Max Rs.5 lac)	0.5%(Max 0.50 lac)	0.2%(Max Rs.1 lac)

Source: MAS, Bank Negara Malaysia, Indian Stamp Act and respective state stamp acts

4.2.5. Fragmentation

The size of the debt issues is generally small. There is no cap on the number of issues a company can make. Corporates, especially the medium and small once, would like to raise resources as and when required on cost consideration. In addition they take recourse

to the private placement route, which leads to creation of large number of small issues. Corporates thus tend to go for multiple issues primarily to avoid the hassles involved in going through the public issue route as also to limit the issue size to their current requirements. (Under the extant guidelines, if a bond issue is to be sold to 50 or more investors, the issuer has to follow the public issue route which is cumbersome, costly, and time consuming). This results in fragmentation of issues and is not conducive for the development of a liquid bond market. This however, could be corrected through regulatory caveats or by making public issuance structure simpler.

4.2.6. Information

Information is key to price discovery. While at a broader level, the spreads on a corporate bond decided on the basis of its credit rating and the sovereign yield curve, such a system may not be efficient and practical one. For instance, bonds of same rating but issued by different issuers trade at different prices and in the absence of credit migration matrix it would be difficult to assess the probability of default. This requires a centralized information system for historical trade data, which is not available in India. Such information would help both issuers and investors in fair pricing of the papers. Currently, only trades reported to the stock exchange are reported in the press. The deals done outside the stock exchanges and not reported to the stock exchanges do not get disseminated. Information of defaults is not published anywhere. Hence, there is a need to centralize such trading information which is good for the market as well as to the regulators.

Lack of such information also is a hindrance to the development of bond insurance industry.

4.2.7. Market Practices

Uniform market practices are a prerequisite for efficient markets. This is, however, not the case in Indian markets. For instance for a trade on stock exchanges like the WDM segment of NSE, the minimum amount of trade is Rs. 1 million but OTC market transactions, as they are supposed to be, are flexible as far as the trade lot is concerned. Coupon conventions also differ (such as Actual/360, Actual/Actual etc.) leading to

problems in settlements. Bodies like Fixed Income Money Market Derivatives Association (FIMMDA) has certain standardized practices though it is not yet a Self Regulatory Organization (SRO). As is the case with the Government securities market there is no central counterparty mechanism to guarantee and settle the transactions in the corporate debt instruments. The settlement has to be bilateral and the absence of novation (whereby the central counterparty, say, the clearing corporation, undertakes a guaranteed settlement) poses risk to the trading counterparties. The absence of multilateral netting also reduced the liquidity in the market.

4.2.8. Market makers

The role of market makers is significant in an incipient market but it is easier said than done. Since market makers are supposed to add diversity to the market, they assume a lot of risk in such a market and need to be backed up, both in terms of financial resources and the supply of securities. Currently the Indian markets do not have a class of such market makers in debt markets. To create such a class of market makers, one way is that the investment banks that help corporates to raise money from the market can possibly be roped in to market making in the bonds, which they have helped in issuance.

4.2.9. Narrow Investor base:

(a) In developed markets, provident and pension funds are large investors in corporate bonds. In India, these funds have been traditionally investing in Government securities for safety. The guidelines issued by Government to these funds for making investments are also skewed in favor of Government securities, Government guaranteed investments and PSU Bonds.

(b) Co-operative banks are permitted to invest up to 10% of their deposits in PSU Bonds and only scheduled co-operative banks are allowed to invest in private sector bonds. Allowing all co-operatives banks to invest in high quality corporate bonds would be helpful as co-operative banks have large deposits.

(c) Retail investors' participation in tradable fixed income securities is very negligible. One of the reasons is higher interest rates offered on Government's own small savings scheme, which is being addressed by bring these rates to align with market rates.

However, the minimum trade size, transaction costs and illiquidity of bond markets hamper the involvement of retail investors in this market.

(d) FIIs do not have a large presence in the debt markets. They use the debt markets for parking the funds temporarily and for portfolio management in a limited way. Their main interest is the equity market

4.2.10. Repo in Corporate Bonds:

Repos are currently allowed only in Government securities though there was a move to extend the same to corporate bonds by the RBI. Repos certainly create liquidity to the corporate bond market.

4.2.11. Trading, clearing and settlement mechanism

a) Trade Reporting System:

Currently information on all trades other than those done through or reported to stock exchanges is not disseminated.

b) Trading Platform:

Trades in corporate bonds are executed in three different ways:

- (i) Bilateral i.e, trades done by two counterparties directly to be settled through banking channel (for funds) and depositories (for securities)
- (ii) Broker facilitated - buyer and a seller are brought together by a broker who helps them execute a deal and finally he is obliged to report the deals to the stock exchange where he is registered
- (iii) Through an exchange where corporate bonds are traded in an anonymous order book system and the settlement happens through the clearing house/corporation with novation.

Institutions widely used the first two methods. In order to develop the market, it is required to put in place a trading platform that would cater specifically to institutional buyers and sellers since they form a large share of the corporate debt market. Globally, this market has been functioning as an over-the-counter market. The justification for a

separate trading platform for the institutional investors has been recently recognized by SEBI. Stock exchanges have been permitted to set up such a platform where individual trades of the value of Rs. 50 million and more can be executed without disturbing the price discovery process in the other wing of the market.

c)Clearing & Settlement System:

The trades in the secondary market are settled bilaterally between the participants. In the interest of overall market risk mitigation, it is essential that the clearing and settlement of trades in this market be handled in line with global best practices in settlement with well-established clearing and settlement procedures through recognized clearing and settlement agencies.

Currently there is no structured settlement system in the market for corporate bonds. The settlement risk is relatively high in case of direct deals and deals done through brokers and reported to the stock exchanges. Only a small proportion of trades executed through anonymous trading system of stock exchanges have a well-structured settlement system with proper risk guarantee of settlement. The kind of clearing mechanism that exists for the government securities market (novation and multi lateral netting through the CCIL) do not exist for the corporate debt market. This is all the more required for the corporate bond market since the risk is higher in the case of corporate bonds compared to government securities.

4.2.12. Securitization

The market for securitized products is not yet developed in India. While financial institutions and banks have made considerable inroads into housing and infrastructure financing, they are unable to expand their horizon without taking recourse to specification. However, there were a number of legal, regulatory, psychological and other issues, which needed to be sorted out to facilitate the growth of securitization. The extant law provides for securitization of debt by Asset Reconstruction Companies and National Housing Bank. However, securitized debts are not included under the Securities Contract Regulation Act

(SCRA) and hence cannot be listed on a stock exchange for trading. Secondary market trading is not possible since these instruments are not listed in stock exchanges. Recently, the Government has decided to suitably amend the SCRA to define securitized assets as a security, which can be listed on the stock exchanges and traded as any other marketable instrument.