5. FUTURE OF DEBT MARKETS

5.1 Factors that would contribute to the development of debt markets

Looking ahead, the resources needed for infrastructure development, the requirement of mutual fund industry, new pension system and the developing market for securitized products, rising concerns about the asset liability management on the part of banks/financial institutions along with the development of derivatives market should see the bond markets grow exponentially in the future. Some of the developments in each of these areas are narrated in the following paragraphs.

5.1.1. Infrastructure financing through Debt

The resource requirements for infrastructure development in India are enormous. An estimate indicates that the requirements are to the tune of US$ 150 billion or more during the next five years. Considering the long gestation period involved in infrastructure projects and given their liabilities (mainly deposits) which are short to medium term in nature, banks are constrained to finance this sector since their asset liability side is short term in nature. This certainly requires bond financing.

There exists a strong case for creation of specialized long term Debt Funds to cater to the needs of the infrastructure sector. A regulatory and tax environment that is suitable for attracting investments from Qualified Investment Banks is key for channeling long term capital into infrastructure development. Currently, most banks lack in–house capacity to evaluate project finance risk. As such, they provide debt financing for infrastructure projects largely only to the extent that they are able to participate in loan syndicates led by a handful of specialists.

Facilitating the creation of infrastructure focused Debt Funds and making it easier for banks to participate in such funds would allow much larger volumes of debt financing from the banks to be deployed to infrastructure development while distributing the associated risks more evenly across a greater variety of projects.

5.1.2. Securitization

Another important and a related issue for the infrastructure financing is the need for a market in securitized products. In India, the need for asset securitization is being felt in three major areas - Mortgage Backed Securities (MBS), Infrastructure Sector and other Asset Backed Securities (ABS). 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 (ARCs) and National Housing Bank. However, securitized debts are not included under the Securities Contract Regulation Act (SCRA) and hence cannot be listed on the stock exchanges for trading. Secondary market trading is not possible since these instruments are not listed in the 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. The current status of market for securitized products is in Annex 1

Box.1 Debt Market Restructuring Initiatives: Union Budget 2006-07

Over the past few years, due attention has been given to the development of the Indian debt market. As a matter of fact, the Union Budget, 2006-07 paid special attention to debt market restructuring. Efforts were taken to increase bond market liquidity and make it more broad-based and competitive. Following are some points of action that were included in the budget:

1. As part of the reforms in the banking sector introduced in 1993-94, capital was infused in the banks by issue of special securities. To date, the Government has injected Rs.168 billion into nationalized banks. Adding the perpetual securities issued earlier, the total net capital support stands at Rs.228 billion. Thanks to the capital support, a sound-banking sector has emerged. As a result, the budget proposed to wind down the special arrangements between the Government and the banks by conversion of non-tradable special securities into tradable, SLR Government of India dated securities. This will facilitate increased access of the banks to additional resources for lending to productive sectors in the light of the increasing credit needs of the economy and will simultaneously add to bond market volumes.

2. The Finance Minister has increased the limit on FII investment in Government securities from US$ 1.75 billion to US$ 2 billion and the limit on FII investment in corporate debt from US$ 0.5 billion to US$ 1.5 billion. This will help enhance the investor base in the debt market.

3. The Finance Minister has also raised the ceiling on aggregate investment by mutual funds in overseas instruments from US$ 1 billion to US$ 2 billion and has removed the requirement of 10% reciprocal share holding[5]. He has further allow a limited number of qualified Indian mutual funds to invest, cumulatively up to US$ 1 billion, in overseas exchange traded funds. This will facilitate the integration of the Indian bond market with the more developed, global markets and will enable investors to hedge their risks through international portfolio diversification.

4. The RBI had introduced the anonymous electronic order matching trading module called NDS-OM on its Negotiated Dealing System. In the first phase, RBI-regulated entities, banks and Primary Dealers were allowed to trade on the system. The system has now been extended to all insurance entities. In view of the encouraging response of market participants and to further deepen the Government securities market, the Ministry of Finance has proposed to extend access to qualified Mutual Funds, Provident Funds and Pension Funds as well.

5. The importance of the corporate bond market has been recognized and the budget felt the need to take steps to create a single, unified exchange-traded market for corporate bonds.

6. Given that the common debt market investor is increasingly being exposed to market based volatilities in return, the Budget has proposed the establishment of an Investor Protection Fund under the aegis of the SEBI. This will boost retail investor confidence and will help diversify the market base.

5.1.3. Pension Funds and new pension rules

Retirement planning in India is still in its infancy and is quite far away from the level of sophistication it has seen in most of the developed countries. The Joint family system that is characteristic of Indian households has been the primary reason behind a laggard

[5] Mutual funds were permitted to invest in overseas companies but only in those companies which were having at least 10% stake in domestic (Indian) companies.

retirement investment structure. However, with the gradual dilution of the joint family system, pension planning has begun to assume greater importance.

The emergence of the Pension fund industry has certain obvious forward linkages with the capital market of any country. Given the nature of returns required from pension fund investments, the debt market assumes an even more important role in assuring fixed returns. In light of this excessive addiction to safety, most pension funds in India invest heavily in Government securities. Further, investment restrictions imposed by statutory bodies（statutory bodies only exacerbate pension fund investment in other sections of the capital market like corporate bonds and equity）.

However, due to growing fiscal concerns, Government is favoring defined contributory schemes. This along with the entry of private pension funds requires other investment avenues to enhance their risk return universe. This is likely to create greater demand for corporate bonds. A detailed analysis of the existing social security scheme and the new pension initiatives are in Annex 2

5.2 What needs to be done?

5.2.1 Investor base needs to be broadened:

Banks' investments in corporate bonds need to be encouraged especially by bringing in changes in the prudential regulatory mechanism which treats loans portfolio on par with investment portfolio. Currently, the investment portfolio (banks' investments in corporate bonds) has to be marked to market where as the same constraint is not there in the case of a loan extended to the same corporate. Implementation of Basel II might remove this anomaly over a period of time.

FII's need to be given higher limits for investments in corporate bonds since this is one major investor class which can bring volumes to the corporate bond markets. Some of the foreign funds do feel that, despite the recent hike in the limit up to which FIIs can invest

in corporate bonds (USD 1.5 billion), this amount is too small for taking any active interest in this market meaningfully.

The investment guidelines for the provident and pension funds need to be rationalized and they should be allowed to invest on the basis of rating rather than in terms of category of issuers. This may encourage these funds to invest in high quality corporate bonds. Such a change will also benefit these funds which can enhance their returns.

To encourage small investors, the bond market structure should emulate the equity market structure in the sense that a retail investor should be able to buy and sell bonds without any restriction on the minimum market lot. Currently an investor can buy even one share in the equity market.

5.2.2. Widening the issuer base.

There is a need to review the current guidelines for issuance, disclosure and listing of corporate bonds and they should be made simpler.

Currently banks are allowed to issue bonds of maturities over 5 years only for financing infrastructure sector. Since banks are one of the leading issuers of bonds, they should be allowed to issue bonds of maturities over 5 years subject to their asset liability matching norms. The development of an interest rate derivatives markets is a major prerequisite to facilitate this.

As has been said earlier, banks are one of the major issuers of bonds to augment their tier II capital and these bonds are in turn subscribed to by other banks (cross holdings). Regulatory caps should be fixed for such cross investments so that other participants are given an opportunity to subscribe to these bonds.

5.2.3. Development of derivatives market

Though the interest rate risk is mainly managed through interest rate swaps and forward rate agreements, the derivatives market for hedging interest rate risk is not fully developed in India. Further there is also a need for a market for short selling and when issued market for better price discovery and hedging. The RBI has already initiated certain steps in this direction but a lot needs to be done in this aspect which only can assure a deep and vibrant debt market. Allowing repos in corporate bonds is also necessary to improve interest in them.

5.2.4. Market making.

Market making should be encouraged for promoting the corporate debt market. This requires incentivising large financial intermediaries like primary dealers to take up this job. One way is to encourage the investment bankers involved in the placement of the bonds.

5.2.5. Addressing price distorting issues:

There is a need to rationalize and reduce the stamp duty. Since stamp duty is a levy by the State Governments, they have to be taken into confidence to to achieve this objective. Stamp duty also needs to be rationalized with regard to securitized debt.

TDS is another issue, which distorts the pricing of bonds. Like in the case of government securities, TDS needs to be abolished in the case of corporate bonds

The shut period (for reckoning the registered owner of the bond for payment of coupons) is very long in the case of corporate bonds and needs to be brought on par with that for the government securities, which is one day.

It is also necessary to standardize the day count conventions. Currently the day count conventions in the market differ depending upon the nature of the instruments and the nature of the transaction.

5.2.6. Listing norms to be eased

For already listed entities, there listing norms should be simpler; they should be allowed an abridged version of disclosure. On the other hand, unlisted companies issuing bonds to institutional investors and QIBs, rating should form the basis for placement. However, companies which are not listed and which are opting for the private placement mode should be subjected to stringent disclosure norms. Privately placed bonds should be mandatorily listed within 7 days from the date of allotment, as is the case with public issues.

The practice of suspension of trading/delisting of securities in case of non compliance with listing norms by an issuer needs to be replaced by heavy penalties on the promoters and directors of the erring company.

Debenture trusties should be made more responsible and accountable. They also should ensure that important information such as rating downgrades should be disseminated to the investors.

5.2.7. Developing a trade reporting system

There is an urgent need to put in place a mechanism that captures all the information relating to trades in corporate bonds, disseminate the same and keeps a data base of trade history. Various regulators should direct the regulated entities to report all the transactions done by them to the trade reporting system.

5.2.8. Trading, clearing and settlement mechanism

For improving the transparency and efficiency to the transactions in corporate bonds, anonymous screen based order matching trading systems should be encouraged. However, the authorities should keep in mind that multiple trading platforms also have the potential to impact the liquidity adversely. Simultaneously, the development of clearing and settlement mechanisms should be commensurate with IOSCO standards. Novation and

multilateral netting should form the backbone for risk mitigation and enhancement of liquidity.

5.2.9. Specialized debt funds for infrastructure financing.

As recommended by the High Level Expert Committee on Corporate Bonds and Securitization (HLECCBS), there is a case for creation of specialized Debt Funds to cater to the needs of the infrastructure sector. Such Debt Funds registered with SEBI should be given the same tax treatment as the one extended to venture capital funds.

5.2.10. Developing a market for debt securitization

Apart from reducing the stamp duty on debt assignments, pass through certificates (PTCs) and security receipts, the government should also endeavor to resolve the uncertainty in taxation issues pertaining to securitized paper.
With a view to remove any ambiguity in this regard, the Central Government should consider notifying PTCs and other securities issued by securitization SPVs / Trust as "securities" under SCRA.