Strengthening India’s corporate bond market

Low private investment, sputtering exports, and stunted private consumption growth have raised calls for a fiscal stimulus, with some even suggesting breaching the fiscal deficit target of 3.2% of gross domestic product (GDP) for the year.

A fundamental reason for the slowdown in the economy is the twin balance sheet problem. India’s companies have been bogged down by high debt, and the balance sheet of India’s public sector banks, which have historically financed economic growth, have been weakened by persistently high bad loans. This has led to a slowdown in the credit cycle, pushing companies to increasingly tap non-bank sources of financing such as external commercial borrowings (ECBs), commercial paper (CP), or corporate bonds.

Former Federal Reserve chairman Alan Greenspan famously referred to the bond market as the “spare tyre” of the credit market that can supplement the banking system during periods of distress. In India’s case, this is reflected in the fact that the share of non-bank credit to total new debt rose from just 20% in 2015 to about 53% in 2016. Prior to 2012, much of the non-bank credit comprised ECBs. In subsequent periods, the rupee depreciation shifted debt funding to domestic sources, mainly CP. But CP is a short-term instrument, and infrastructure projects with long gestation periods require long-term financing, which could be best met through the bond market.

India’s corporate bond market, however, is still underdeveloped and therefore unable to meaningfully share the credit burden of the banking system. Several committees, most notably the RH Patil Committee in 2005, the Percy Mistry Committee in 2007, Committee on Financial Sector Reforms in 2008, and most recently the HR Khan Committee in 2016, recommended measures to augment bond market liquidity. Many of these measures involved market-driven initiatives, such as setting up trade repositories and allowing exchanges to offer dedicated debt segments for corporate bonds so as to enable trading based on a transparent order-matching mechanism.

While similar measures in the government securities market helped generate liquidity to some extent, they failed to create a meaningful impact on the corporate debt market. Most corporate bond issuances today take place through private placements, where there are fewer disclosure requirements, lower issuance costs, and faster processes compared to public issuance on exchanges. A more fundamental reason, however, why both issuers and investors prefer private placements over public issues can be better explained by studying the microstructure of security markets, an essential principle of which is that liquidity attracts liquidity.

Once trading becomes sufficiently liquid at a specific venue, it is very difficult to move to a new venue. This is because most traders prefer to trade at the venue where there is greatest liquidity. **In their 2007 paper**, economists Bruno Biais and Richard Green discussed the case of the New York Stock Exchange (NYSE), where the corporate bond market was more liquid prior to 1940s than today’s over-the-counter (OTC) market. This is because the OTC markets are characterized by large information asymmetries—institutional investors have more information and greater bargaining power with dealers, enabling them to get better prices. A diverse investor base is conducive to liquidity, which explains why bonds were actively traded on the NYSE prior to the 1940s. But what caused liquidity in the NYSE bond market to diminish after 1940s?

One explanation Biais and Green proffer is that unlike bond markets, stock markets offered higher margins, which attracted “specialists” or market makers who in turn supplied liquidity in that market. And because liquidity attracts liquidity, the presence of market makers in stock markets drew retail investors away from the exchange-traded bond market. OTC markets continued to attract large institutions but the trading has remained relatively illiquid till date. Recent

crackIAS.com

developments such as the Dodd-Frank Act and higher capital requirements under Basel III norms, however, have reduced dealer profits and **lowered transaction costs**, thereby gradually contributing more liquidity to the exchange-traded bond market.

Israel’s Tel Aviv Stock Exchange (TASE) has a similar story. Established in 1953, TASE boasts of a corporate bond market that is even more liquid than the US’ OTC market despite the former being much smaller in size than the latter. This can be traced back to the early days of the exchange, when securities were sold through daily auctions. The initial liquidity created through these auctions attracted more trading and even greater liquidity, leading to lower trading costs.

What does this mean for the Indian corporate bond market? One, policymakers must grapple with the fact that even though exchange-based bond trading employing a limit order book mechanism contributes to liquidity—through facilitating pre-trade and post-trade transparency—it would be difficult to shift bond trading from the OTC market to electronic exchanges at this stage. Building liquidity from scratch takes considerable time, especially given the fact that the microstructure of India’s corporate bond market has historically favoured institutional investors over retail ones.

Two, reforms such as allowing brokers to act as market makers in the corporate bond repo market, consolidating existing bond issues in order to reduce maturity fragmentation, or allowing insurance companies to invest more in lower-rated bonds may help. The government must, however, also stick to fiscal rectitude so as not to crowd out funds for corporates.

Harsh Vora is an entrepreneur, investor and trader.

END

Downloaded from **crackIAS.com**

© **Zuccess App** by crackIAS.com

crackIAS.com