Indian Corporate Bond Markets: Challenges and the way forward: Review of Literature

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Abstract: *The objective of this paper is to review the existing literature on corporate bonds- both from a global and Indian perspective and to highlight the issues which have hampered the development of the corporate bond market and to discuss the reforms suggested by researchers and authorities alike to overcome these issues. Corporate bond markets are essential to balance the financial system, they provide a hedge against systemic risk by reducing reliance on banks, and they are ideal for long term infrastructural projects and result in better allocation of scarce resources. The Indian corporate bond market is beset with issues on different fronts- supply side, demand side, market structure and regulation among others. Issuers, investors, dealers and other market players are reluctant to participate in the market due to lack of transparency, illiquidity, lack of diversity in instruments, difficulty in price discovery, lack of trading and many other imperfections in the market. The recommendations suggested span several different areas such as bankruptcy laws, taxation, legal and regulatory provisions, market mechanisms and banking regulations. Since the suggested reforms are spread across various segments and are inter-linked, a concerted effort by the different regulatory authorities, market makers and corporates would be needed to bring about some meaningful change in the market*

Key Words: *Corporate Bonds, Illiquidity, Transparency, Bankruptcy Laws, Debt markets*

1. INTRODUCTION:

A well developed and an active Corporate Bond market is the hallmark of a healthy and balanced financial system. Researchers and academicians around the world are nearly unanimous in their opinion about the role which the corporate bond markets play in relieving the stress on the banking system and thereby reducing the systemic risk in the economy.

These markets by their very nature are in a better position to provide long-term infrastructure funding in contrast with banks which may not be able to do so due to their asset-liability mismatches. Many authors are also of the view that corporate bond markets help in mitigating financial crises, it is believed that the Asian Financial Crisis of the late 90s would have been less severe had these economies had well-functioning bond markets and consequentially were not so much dependent on their banking system to keep them afloat.

Contessi et al (2013) argue that bank lending is markedly pro-cyclical, i.e. it contracts during recession and expands during periods of economic boom, and on the other hand liquidity in corporate bonds remains relatively stable during business cycles.

Another distinct attribute that these markets bring to the table is Market Discipline. Bond investors, who have a direct stake in the outcome, are found to be better at assessing risk than bankers Hakansson (1999). Mishkin (2003) claims that bond financing can be lower than obtaining funds from banks which may have to arrange a syndicate.

Rajan (1992) opines that bonds reduce the information monopoly that banks have over their borrowers which help to keep the interest rates competitive and reduce firm's borrowing costs. Investors (both retail and institutional) stand to benefit from bond markets as it provides them with diverse and relatively safer instruments to park their funds.

Despite the many merits, it is perhaps surprising to discover that only a handful of countries have a vibrant and mature corporate bond market. The US corporate bond market is the largest, both in terms of turnover and the outstanding volume; it is followed by the European Market (Mukherjee, 2012)

The size of India's corporate bond market in relation to the equity market and the banking system is insignificant. Banerji et al (2012) state that the Indian Debt market is malformed and the forward risk assessment very weak. In 2010-11 only 3.9% of the corporate funding was met by bond issues as against 13.8% by equity and 17.8% by banks. The authors further claim that the market lacks both pre-trade and post-trade transparency the primary reasons for this being systemic flaws in the CRAs and private placements. There is a lack of benchmark yield curve due to the absence of diverse securities which has a direct impact on pricing and hence liquidity

The market is dominated by private placements and as of 2014-15 they account for about 95% of the total issues. Secondary market illiquidity, regulatory overlaps, lack of credit protection instruments and outdated bankruptcy laws round up some of the major issues which plague the Indian Corporate Bond market.

In order to improve the present situation of the Indian corporate bond market, the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI) have commissioned a committee under the chairmanship of Shri Harun Rashid Khan (ex-deputy Governor, RBI). In August 2016 the committee came out with a number of issues that plague the market and recommendations to various authorities and institutions on how to overcome these. The report is titled **"**Report of the Working Group on Development of Corporate Bond Market in India**"** (afterwards referred to as the HR Khan Committee Report)**.**

Recently RBI acting on some of the committee's suggestions announced in a report of the increase in limit of partial credit enhancement by banks to 50% (from 20%), allowing direct trading by FPIs (in consultation with SEBI) and its intention to accept corporate bonds under LAF. At the same time the central bank stated that it would exercise caution while opening up the market and would be careful about broadening retail access in markets which require the understanding of complex derivative instruments (Dr R Rajan, August 2016)

The CRISIL (2016) report claims that the future looks promising for the corporate debt markets in the light of the stressed banking system, low and stable inflation rates, new bankruptcy code, technological innovations and the improving fiscal position of the Government (which reduces crowding out). At the same time the report suggests the creation of a more enabling environment and improvement of the infrastructure to provide the much needed support to the market

This Literature Review is divided into six sections, the first section discusses the supply side of the market i.e. issuers, the second section reviews the literature related to the demand side of the market i.e. investors, the third section talks about the market structure and institutional issues, the fourth section deals with the legal, regulatory and political issues and the fifth section lists some recommendations and the sixth section concludes.

2. RESEARCH METHODOLOGY:

This paper is based on exploratory research. It aims to gain familiarity and acquire new insights on corporate bond markets in India and abroad by reviewing the existing Indian and international literature on this topic. The research design employed for the study is descriptive in nature Different national and international journals, government reports, books and websites which focused on various aspects of corporate bond markets were used for the study.

3. OBJECTIVES OF THE STUDY:

Following are the objectives of the study:

- To study the functioning of Corporate Bond markets in India and abroad and understand the reasons for their underdevelopment by reviewing the existing literature.
- To draw recommendations for India from the experience of other countries and reports of government and international agencies.

4. SUPPLY SIDE OF CORPORATE BOND MARKET AND ITS CHALLENGES:

It is a widely held belief among researchers and regulators alike that liquid and deep corporate debt markets would allow for better allocation of funds among borrowers. The reason being that markets work on the basis of free market forces and are thus better at assessing risk and return.

Luengnaruemitchai and Ong (2005) argue that in terms of risk management, deep and liquid corporate debt markets can provide a natural hedge for local companies. It allows them to obtain long term debt at competitive rates without exposing themselves to foreign currency exposures and asset-liability mismatches.

Greenspan (1999) stressed the importance of having alternative sources of financial intermediation in an economy, this greatly assisted the United States during the credit crunch of 1980s in which bond financing substituted bank lending which had dried up.

4.1 Why the Indian Economy and its borrowers urgently need a corporate bond market?

The Indian corporate bond market lacks depth; the size of the market is only 15% of the GDP (2013-14) while the corresponding figures for US and Singapore are 126% and 47% respectively. CRISIL and ADB (BGFI Market Assessment) report (2014) claims that over a period of 10 years there is a projected gap INR 55 lakh crores in infrastructure and 35 lakh crores in non-infrastructure. According to Nath (2012) commercial banks have limited ability in financing infrastructure projects as these projects by their very nature are long term, require large amounts of funds are having lengthy gestation periods. At the same time, it is risky to raise funds for such projects through external commercial borrowings as it exposes the firms to foreign currency movements and makes them vulnerable in the event of a crisis (as it happened in the Asian Financial Crisis). Hence such funding has to be met through local bond markets.

Mitra (2009) states that a liquid corporate bond market would reduce the cost of capital for the issuers. He further argues that a vibrant market would shift large borrowers to the bond financing and hence SMEs and small

borrowers would have better access to bank lending. These small borrowers are squeezed out by large companies who compete with them for bank lending.

Hakansson (1999) opines that some of the basic investment needs of a nation may be delayed in the absence of a proper balance between alternative sources of financing. Conversely funds that could be productively utilised in the bond markets end up being invested in foreign securities or US treasuries. He further argues that liquid bond markets have a positive spill over effect on the banking system and helps to keep the interest rates competitive, which ultimately reduces the overall cost of capital.

4.2 Supply Side Challenges

4.2.1 Unbalanced Composition of issuers

There is concentration among the composition of issuers, both in terms of type and the ratings of issuers. The issuer side is highly concentrated with the financial sector accounting for majority of the issuances, most of them being through the private placement route. (ADB and CRISIL Report, 2014)..

The ADB-CRISIL report (2014) further informs that the concentration issues are also prevalent in the ratings of the issuers; the market is mostly restricted to ratings of AA or above. There is a huge pool of low rated borrowers that are dependent only on bank lending to meet their financing requirements; this group is likely to much better-off if the corporate bond markets open to them provided that some efficient credit enhancement system is put in place..

4.2.2 Dominance of Private Placements

As per the HR Khan Committee report the corporate bond issuance is dominated by private placements as these accounts for a very high percentage of the total issuances in the market (2014-15). Under private placements the bonds can be issued to a maximum of 49 investors. The reasons for going for private placements are ease of issuance, minimum disclosures, low cost and promptness. At the same time the private placements contribute to opaqueness and illiquidity in the secondary markets.

Table 1.1 depicts the amount of public and private issues over the past 7 years. Except 2001-12 and 2013-14 private placements accounted for about 95% of the total amount raised in the market.

Table 1.1- Amount of Public and Private Issues

Year	Public Issues		Private Placements		Total
	Amount (in Rs Crores)	As % of total amount	Amount (in Rs Crores)	As % of total amount	
2010-11	9451.17	4.14	218785.41	95.86	228236.58
2011-12	35610.71	11.99	261282.65	88.01	296893.36
2012-13	16982.05	4.49	361462.00	95.51	378444.05
2013-14	42382.97	13.31	276054.18	86.69	318437.15
2014-15	9713.43	2.35	404163.50	97.65	413876.93
2015-16	33811.92	6.87	458073.48	93.13	491885.4
2016-17 (up to 22-01-17)	26964.93	5.33	478974.26	94.67	505939.19

Source: SEBI

Table 1.2 –Number of Issues: Public and Private

Year	Public Issues		Private Placements		Total number of Issues
	Number of Issues	As % of total issues	Number of Issues	As % of total issues	
2010-11	10	0.71	1404	99.29	1414
2011-12	20	1.01	1953	98.99	1973
2012-13	20	0.80	2489	99.20	2509
2013-14	35	1.79	1924	98.21	1959
2014-15	25	0.95	2611	99.05	2636
2015-16	20	0.67	2975	99.33	2995
2016-17 (up to 22-01-17)	11	0.41	2662	99.59	2673

Source: SEBI

Table 1.2 shows the number of public and private issues in the market for the past 7 years. Public issues account only for about 1% of the total number of issues. Thus private placements dominate not just in the volume of funds raised but also the number of issues in the corporate bond market.
Mitra (2009) claims that preponderance of private placements is not unique to India, but what is unique here that even the highly rated corporates choose to go via the placement route even though the lower cost of capital in a public issuance can overcome the high cost of issuance.

Chaudhari, Raje and Singh (2014) attribute the dominance of private placement on the narrow investor base; they state that considering the limited investor base the investors have no incentive to publicly issue securities, this in turn leads to non-transparency and illiquidity in the market which discourages investors from entering the market. Thus a vicious cycle is established.

Banerji et al (2012) state that with most of the bond issuances being private placements availability of bonds for trading in secondary market is pre-empted by a handful of investors and the price discovery in the secondary market is also limited. It also prevents investors with better offers from stepping in.
SEBI has introduced an Electronic Book Mechanism (EBM) on private placements above 500 crores to ensure some transparency in private placements. The HR Khan committee has suggested that EBM be extended to all issuances.

4.2.3 Lack of incentives for the borrowers

The HR Khan Committee report states that there are inherent structural incentives for the borrowers to prefer bank financing e.g., cash credit systems so that the burden of the cash management falls on the banks and no disincentive for enjoying unutilised working capital limits. The committee believes that this facility impedes the development of corporate bond markets. The committee has suggested that large corporates with bank lending above a cut-off level should be required to tap the markets to meet their working capital and long term requirements.
Nagpal (2005) is of the view that in India most of the companies are still family dominated and are hesitant to issue debt and equity as it represents dilution of control, and in addition to that the disclosure requirements, legal and accounting costs make bank finance a much more attractive alternative.

4.2.4 Dominance of Government owned companies

Nath (2012) is of the opinion that the most important supply side issue in the corporate debt market is the dominance of government owned companies; the debt market is dominated by huge issuances by the Government. Luengnaruemitchai & Ong (2005) opine that government borrowings crowd out the private sector to some extent.
However, Dittmar and Yuan (2008) have a different opinion, they found in their study of emerging market economies that Government bonds promote a vibrant corporate bond market. They attribute the positive effect to three factors-spanning, liquidity enhancement and price discovery.

5. INVESTORS IN THE CORPORATE BOND MARKET AND THEIR CHALLENGES

The primary investors in the Indian corporate bond markets are banks, institutions such as insurance companies and mutual funds also participate albeit to a much smaller extent, in addition to these FIIs also participate in the bond market. Retail investors are almost absent or play a very insignificant role in the market. Recently, large corporates have also started investing in corporate bonds.

5.1 Demand Side Challenges

5.1.1 Restrictions on institutional investors

The primary investors of the bond markets, banks, pension funds, insurance companies and MFs are all restricted by their respective regulatory bodies in the securities in which they are allowed to invest

Banks are the largest group of investors in the market but they are greatly restricted in the securities in which they can invest due to the risky nature of the instrument. RBI has issued several guidelines which restricts the debt securities in which the banks may invest. (Mukherjee 2012) The Deepak Parekh report committee (2012) on infrastructure financing has stated there is a regulatory asymmetry in treatment of loans and bonds as a result of which banks are more willing to advance loans to accompany than to subscribe to bonds of the same company.

Mitra (2009) claims that due to such restrictions banks prefer to hold government securities as they require less regulatory capital, moreover, banks also prefer loans over bonds as loans can be made to different categories of borrowers while banks can only subscribe to bonds of investment grade.

In most of the developed markets insurance companies and pension funds are one of the biggest investors in corporate bond segment. For example, insurance companies in US hold 46% of the portfolio while for LIC the figure is barely 13% (Chaudhari, Raje and Singh)

Just like banks, restrictions are imposed here too, insurance companies can only invest in securities listed AA or above. The HR Khan committee states that these institutions are provided limited space for going down the credit curve as they hold funds in fiduciary capacity to protect the interest of the subscribers.

5.1.2 Limited FII Participation

The widespread participation of FIIs in the equity market in India has made it one of the biggest markets globally but the same is not true for India's debt market and especially in the corporate debt segment the FII participation has been very insignificant. The participation by foreign investors in the market has been needs to be encouraged if corporate bond market has to break out of the low level equilibrium in which it is presently trapped.
Nath (2012) claims that the large government borrowing program and the SEBI law on the restrictions of rollover of limits is limiting FII participation. He further adds that tax issues between the FIIs and the government and a weak rupee also discourage FIIs from investing in the domestic corporate bond market. While Mukherjee (2012) believes that the several sub-limits on investments imposed on FIIs by the regulators serves as a major deterrent.

The CRISIL report on Indian Debt Markets (2016) suggests establishing a mechanism to manage foreign exchange risk, a policy to settle disputes, increasing FII access to derivatives market, favourable tax laws and inclusion in emerging market bond indices as the possible solutions.

5.1.3 Leveraged position of large non-financial corporates

Another demand side issue of the corporate bond market highlighted in the HR Khan Committee report is that large non-financial corporates who would normally be the preferred issuers of the corporate bond market cannot easily access funds from the market mechanism due to their already levered position.

6. THE MARKET STRUCTURE, ITS IMPERFECTIONS AND INSTITUTIONAL ISSUES:

Presently, the benefit of India's comprehensive financial architecture is enjoyed only by the equity and gilt-edged markets. The corporate bond markets still languish behind and are fraught with imperfections:

6.1 Lack of Market Depth

Bose and Condoo (2003) compute the n-bond concentration ratio to estimate the market depth. They identify the 'n' most frequently traded bonds and find out their share in the total market trading. If the ratio is high for a small value of 'n'; then it can be presumed that market lacks depth. While Bose and Condoo (2003) computed this ratio for 1997-98 to 1999-00, Chaudhari, Raje and Singh compute the same almost a decade later ,2008-09 to 2011-12. The results are given in Table 3.1 below:

Table 3.1: 'n' bond concentration ratio

	Share of Total WDM Turnover (in %)	
Number of top securities	**5**	**10**
1997-98	**47.45**	**60.86**
1998-99	**50.44**	**65.57**
1999-00	**49.59**	**67.01**
2000-01	**84.89**	**92.24**
2008-09	**31.30**	**43.10**
2009-10	**24.20**	**35.10**
2010-11	**26.70**	**38.60**
2011-12	**36.40**	**44.20**

Source: Bose and Condoo (2003) & Chaudhari, Raje and Singh (2014)

The more recent figures show a slightly improved market, with the average 5- bond concentration averaging at around 30% which is a lot lesser than the previous figures, but the concentration still remains on the higher side with the 10 bond concentration jumping to 44% in 2011-12 from 38.6 % in 2010-11. The authors claim that this is a sign that the markets consist of participants with similar outlooks.
Bose and Condoo (2003) further report that shallowness has distortionary effects of the market, in their study on the Indian Corporate Bond Market they find that bonds with lower ratings suffer more severely from volatility in their YTMs as compared to bonds with higher credit ratings.

6.2 Non-Standardisation

The market lacks standardisation on more than one front. The HR Khan Committee report states that the stock exchanges and the market in general do not follow uniform standards, and have different conventions for day count, holidays and multiple basis of yield calculation.

Khanna and Varottil (2012) claim that non-standardisation adds uncertainty and makes bonds less attractive to investors. On the other hand, Nath (2012) claims that the foreign investors have to follow a different set of guidelines as compared to their domestic counterparts.

Luengnaruemitchai and Ong (2005) talk about the standardisation of bond contracts, they claim that standardisation makes it easier to assess credit risk, different features associated with the bond contract like reference rates, embedded options, collateral etc which makes it difficult to assess credit risk especially in emerging economies. Roldos (2004a.) has a different opinion, he argues that standardisation and homogeneity in bond contracts reduces the issuer's financial flexibility. Standardisation is considered as a pre-requisite to liquidity in the market.

6.3 Absence of benchmark yield curve across maturities:

A vibrant and liquid government bond market across maturities enables the pricing of corporate bonds; it is especially useful for a country like India where a large proportion of the bonds are seldom traded.

The government bonds set a floor limit for corporate lending, so that the issuers only need to concentrate on their credit spreads. The government bonds in India generally have a 10-year maturity period with a few issues stretching to 25-30 years, thus the benchmark yield curve is not present across all maturities. This behaviour is reflected in corporate bond markets as well with most issues ranging from 5-10 years in maturity.

Banerji et al (2012) believe that this has a first order impact on liquidity. Pricing in the secondary market is not visible. The authors further state that determining credit spread for corporates, SMEs and PSUs becomes difficult in such a scenario. The suggestion that they offer is that trusted issuers like banks and FIs should issue bonds across maturities.

6.4 Illiquid CDS Market:

Risk protection instruments such as Credit Default Swaps are an essential part of the corporate bond market. According to a Biais, B. (2006) CDS help in overcoming the lack of liquidity in the corporate bond market by allowing the traders to take long and short position relative to the default risk of an issuer.

The HR Khan report is of the view that the lack of activity in the market is attributable to the restrictions placed by RBI on netting of Mark-to-Market (MTM) position against the same counterparty for capital adequacy and exposure norms. It suggests that legal provisions that permit netting should be explored expeditiously and for the long run the RBI Act should be amended so as to remove the legal impediments that constrain netting.

6.5 lack of liquidity in the secondary market:

Liquidity of a corporate bond and of the market in general has serious implications for pricing and yield spreads. Bao, Pan and Wang (2011) found out that variation in aggregate liquidity is the primary factor which explains time variation in bond indices, they report an R^2 exceeding 20% which is greater than the credit risk for all bonds rated 'A' and above. The R^2 goes up to 50% during times of crises

Table 3.2: Secondary Market Liquidity Comparisons

Country	Trading Ratio	
	G-Secs	Corporate Bonds
US	3.3%	0.9%
China	0.7%	0.3%
Japan	2.0%	0.1%
South Korea	0.9%	0.2%
Hong Kong	1.3%	0.2%
Singapore	0.4%	NA
Malaysia	0.4%	0.1%
India	0.8%	0.2%

Source: CRISIL Yearbook on Indian Debt Market (2016)

Table 3.2 shows that liquidity in the secondary markets for corporate bonds is on lower side, it's a lot lesser than USA which has the most active corporate bond market globally. The G-Sec market fares far better in terms of liquidity. Bose and Condoo (2003) list dominance of private placements, lack of market makers, security fragmentation and the buy and hold strategy of the institutional investors as the primary reasons of illiquidity in the secondary market.

As per the HR Khan report one of the most important reasons for lack of trading and illiquidity in the secondary market is that issuers come out with fresh issues rather than going for reissuance of bonds. They suggest that issuers should be encouraged to go for reissuance of an existing type of security rather than coming out with a new issue.

6.6 Absence of pre-trade and post-trade transparency

Bessembinder and Maxwell (2008) define transparency as the amount and the timeliness of information provided to the investing public. They classify transparency as being pre-trade and post-trade, the former refers to the

dissemination of quotes or other indications of trading interest while the latter means dissemination of information related to completed trades i.e. price and volume data.

Bessembinder and Maxwell (2008) found that transparency is a double edged sword; the investors have benefitted from the increased transparency by way of reduction in bid-ask spreads that they pay to the dealers, at the same time bond dealers experienced reduction in compensation and employment.

Banerji et al (2012) state that the Indian corporate bond market lacks both pre-trade as well as post-trade transparency. They argue that issues related to Credit Rating Agencies (CRAs) and the dominance of private placement are the primary reasons that result in lack of transparency in the market...

6.7 Tax and Stamp duty related issues

Khanna and Varottil (2012) are of the opinion that availing tax benefits is one of the key motivational factors for bond investors. Wells and Schou-Zibell (2008) also believe that tax reforms, particularly stamp duties can help develop the corporate bond market. They claim that stamp duties, which are not payable on bank loans, make bonds less attractive to the tax sensitive borrower.

Stamp Duty forms paid by issuers is an important determinant of the cost of issue of bonds. Mitra (2009) strongly argues for the elimination of stamp duty, claiming that it acts a major barrier to the development of securitisation and liquidity. The HR Khan report takes a more moderate position; the report argues for rationalisation of stamp duty across states so that there is no inter-state variation in the amount of stamp duty. Chaudhary, Raje and Singh (2014) offer a number of tax reforms suggestions, these include opening a separate window of exemption for investment in corporate bonds for the benefit of retail investors, exemption of withholding tax for FIIs.

6.8 Absence of Bond Indices

Indices play an important role in the development of the bond market, or any other securities market in general. They can be used a tool to measure the performance of the market as a whole, investors may also invest directly in the index and lastly the index acts as a benchmark against which the performance of an individual portfolio may be compared. (Goltz and Campani 2004).

Unfortunately, indices are absent in the Indian corporate bond market, the HR Khan committee opines that constructing bond indices has proved to be difficult as the market lacks in both breadth and depth. SEBI is in dialogue with stock exchanges to design a suitable bond market index. .

6.9 Lack of innovative debt instruments

Globally various kinds of bonds are available to meet investor needs, some of these include reverse floating bonds, deep discount bonds, step up bonds, step down bonds and index based bonds among others. On the other hand, in India majority of the bonds are fixed rate bonds.

According to Mitra (2009) there is a lack of diversity in the types and maturity of bonds which are available in the bond market. In India mostly fixed rate coupon bonds are prevalent and the average maturity of the bonds of the Indian corporations is 5-7 years.

The CRISIL Yearbook report (2016) suggests that fixed-income exchange-traded-bonds (ETFs) can also be popularised as they have emerged as the preferred mode of investment globally.

6.10 Small Issue Size

The size of individual issues in the bond market is quite small. This has a material impact on liquidity in the market. Wells and Schou-Zibell (2008) opine that many Asian economies have discovered that small issue size hampers liquidity. An empirical study by FitchRatings Report (2015) supports this view. In their sample study of the underlying holdings of five major U.S. corporate bond ETFs they found that smaller bond issues (under $500 million) traded significantly less frequently than larger issue bonds. For example, issues sizes of over $3 billion traded 98% of the days over the examination period, whereas issue sizes of $250 million to $499 million only traded on 28% of the days over the same period. They conclude that issue size has a significant influence on liquidity.

6.11 Ineffective credit enhancement mechanism

Bond investors generally desire credit ratings of AA or above, moreover many institutional investors are prohibited by their respective regulations to hold securities below investment grade. As a result, many issuers especially infrastructure related and SMEs who have lower ratings find it very difficult to raise funds from the bond market and are thus forced to rely solely on bank funding as a source of external debt.

On the recommendation of the HR Khan committee RBI has increased the partial credit enhancement limit provided by banks from 20% to 50% with no single bank having exposure of more than 20%.

The HR Khan committee has further suggested the capital required to be maintained by the banks should be lowered if the base rating of the project improves.

6.12 Flaws in the credit rating process of CRAs

All bond issues whether public or private are required to be rated. Banerji et al (2012) argue that there are systemic flaws in the credit rating process of Credit Rating Agencies. They are of the opinion that such flaws increase the risk and hamper transparency in the bond market.

The HR Khan Committee report states that the Indian ratings industry is following global best practices and is IOSCO compliant. SEBI's regulatory framework requires CRAs to make disclosures about credit rating procedure, rating history and defaults on their website and also to the stock exchanges in case of listed securities. The CRAs are also required to inform the Exchanges about any changes in ratings, including default, assigned to securities of a client through Press Releases uploaded on their website. However, the report informs that the market participants are of the view that CRAs compliance level in adhering to these regulatory requirements is not high.

7. REGULATORY, LEGAL AND POLITICAL IMPEDIMENTS

The market suffers from widespread and interlinked issues related to regulation, legal statutes and government policies. There is a lack of a single regulatory authority for corporate bonds, as a result the existing regulation is fragmented and often at cross purposes.

Khanna and Varottil (2012) present an interesting argument, they suggest that all weaknesses in the structure of the market are actually legal impediments which inhibit smooth market functioning.

The issues prevalent in the corporate bond market cannot be solved without some bold action on the part of the policymakers.

7.1 Weak Bankruptcy Laws

Strong bankruptcy laws safeguard the rights of creditors and investors in case of a corporate insolvency or corporate restructuring. A robust and comprehensive system to deals with corporate bankruptcies augments the bond markets in an economy.

Luengnaruemitchai and Ong (2005) state that many emerging Asian economies such as Thailand, Malaysia and Korea have revamped their bankruptcy laws with the aim of strengthening creditors' rights and facilitating the process of corporate debt restructuring.

Using cross-country regressions La Porta et al. (1998) show that there is a positive correlation between the index of creditor rights and the size of the credit market. Strong creditor rights are associated with lower cost of credit as it helps them to enforce their contracts. However, some researchers also suggest an opposing view and believe that creditor's right may become excessive and contribute to ex-post inefficiencies in the form of a liquidation bias. (Vig, 2013) (See Aghion, Hart, and Moore (1992), Hart et al. (1997))

Vig (2013) studied the effect of the passage of the SARFAESI Act on the corporate debt structure. He found that an increase in the rights of the secured creditors led to a 5.2% decrease in the use of secured debt by the firms. To support his findings, he suggests that stronger creditor rights impose an extra cost on the borrowers which gets translated into less use of secured debt.

The Indian bankruptcy system has historically been time consuming and inefficient. Wells and Schou-Zibell (2008) suggest that political pressure against declaring enterprises insolvent and long delays in the judicial process are the factors responsible for the inefficiencies in the bankruptcy system.

Khanna and Varottil (2012) believe that India needs a comprehensive bankruptcy law urgently to replace the existing system which is fragmented and covers different pieces of legislation.

7.2 Regulatory Overlaps

Wells and Schou-Zibell (2008) argue that regulation in the market is fragmented and as believed by some market participants, at cross-purposes. Different market participants are responsible to different regulators so that there is a lack of unity of purpose or direction. Corporate bonds and brokers come under the purview of SEBI, banks and primary dealers are regulated by RBI, insurance companies by the IRDA and so on. These regulatory overlaps hamper market participation. Chaudhary, Raje and Singh (2014) have a similar view. They opine that due to multiple regulators; jurisdiction becomes blurred and ambiguous which gives rise to inefficiencies and regulatory arbitrage.

Mukherjee (2012) claims if there is lack of coordination amongst the regulators then any policy initiative taken up by any one of them may not be able to produce the desired results. The author cites the case of repo in corporate bonds in support of his argument. The repo in corporate bonds was permitted by RBI back in 2010 but such permission was not granted by SEBI and IRDA to their respective entities.

7.3 Delay in Contract Enforcement

A bond is essentially a contract between the lender and the borrower. Collateral, interest payments and priority at the time of liquidation are contractual obligations of the borrower which form part of the debt contract. Khanna and Varottil (2012) are of the view that whether the lenders are able to obtain expeditious enforcement of the

debt contracts is the first important component of the bond market's legal structure. Unfortunately for India such enforcement is far from expeditious

An overburdened judicial system and the prohibitive costs associated with lengthy civil suits are the primary reasons behind India's poor record in contract enforcement. Such inefficiencies allow borrowers to enjoy undue advantage at the cost of the lenders. This increases the risk perceived by the lenders/investors in debt contracts.

7.4 Political Economy of Corporate Bonds

Khanna and Varotttil (2012) discuss about the political reasons behind the underdevelopment of the corporate bond market. They argue that liberalization of equity markets would likely benefit many incumbents as compared to liberalizing the debt markets. They further argue that liberalising debt market would involve making substantial changes to labour laws and bankruptcy laws, both of which would result in controversies and heated debates. In addition, the authors point out that reform related to equity markets are generally made in the administrative space, while reforms related to debt markets are taken in the legislative space. This difference worked in the favour of equity markets as administrative reforms are implemented by a government agency (which is subject to different pressures than the legislative) and the reforms are primarily enforced internally and not through judicial courts.

8. RECOMMENDATIONS

On the basis of the Literature Review the following recommendations are offered in order to improve the state of India's corporate bond market.

- To allow low rated issuers to obtain funding from the market a Bond Guarantee Fund may be established. The main aim of such a fund would be to provide partial credit guarantees to low rated issuers to raise their rating to at least AA and hence to enable them to raise funds from the bond market. ADB and CRISIL (Risk and Infrastructure solution) have proposed to set up such a fund.
- Institutional investors should be allowed a little more freedom in terms of the kind of debt securities in which they can invest. This would help the issuers to get access to a wider base of investors and institutional investors such as pension funds and life insurance companies would find it easier to manage asset-liability mismatches by investing in debt securities of such varied durations.
- Active participation by the FIIs can provide a major boost the corporate bond market. Issues as ambiguity in tax laws and regulatory hurdles must be dealt with on a priority basis.
- Establishment of a bond index is expected to have a positive impact on the trading activity in the bond market as it can provide a benchmark against which an investor can readily measure the performance of his own portfolio.
- Laws related to taxation and stamp duty which discriminate against corporate bonds and reduce their attractiveness as a source of investment must be either down away with or modified to reduce their negative impact on the market.
- Besides the plain-vanilla fixed interest rate bonds that dominate the Indian market at present more innovative bonds as index bonds, reverse rate bonds, step up and step down bonds should also be allowed and popularised.
- Norms related to monitoring of Credit Rating Agencies (CRAs) should be made more stringent and the ratings should be revised and published on a more regular basis. Greater transparency and uniformity in the functioning of CRAs would help increase investor confidence in their ratings.
- Historically India's Bankruptcy laws have been very fragmented. The Insolvency and Bankruptcy Code, 2016 has been passed recently to consolidate the existing framework by creating a single law for bankruptcy and insolvency. But in order to have any meaningful positive impact it must better address the concerns of creditors and investors by providing a new time bound recovery and resolution framework
- To avoid regulatory overlaps that hinder any rapid development and enactment of major changes in the corporate bond markets, a new agency may be set up which would help to coordinate the activities of the many different regulators and in the process ensure that the reforms are implemented in a more expeditious manner.
- Small issue sizes have been found to be one of the major causes of illiquidity and lack of trading in the market. To ensure greater liquidity the issuers may be advised not to come out with issues that are smaller than a certain prescribed size.

9. CONCLUSION:

India's corporate bond market is quite underdeveloped in relation to its international counterparts. The literature reviewed in this paper highlight many challenges which the market faces which hinder its growth. The market seems to be caught in a cycle where existing imperfections such as illiquidity, lack of transparency, low levels

of trading, poor price discovery and fragmentation prevents prospective issuers and potential investors from entering the market. The low levels of participation further aggravate these imperfections; thus reinforcing the cycle.

Corporate bonds have historically been a neglected and underdeveloped segment of the Indian securities market. However, in the wake of the increasing stress on the Indian banking system and its vulnerability in the event of a financial crisis; the Indian Policymakers have started to pay attention to this often ignored section of the market. For an emerging economy like India, corporate bond markets hold special significance. The market forces ensure more efficient allocation of scarce financial resources than the banking system which is susceptible to the evils of crony capitalism. Bond markets are also in a better position to fund the infrastructural projects of a growing economy.

There is consensus among researchers that strong political intent is needed to develop the bond market. The reforms needed would have to be bold since many of the problems are interlinked and wide in scope. For the reforms to effectively implemented cooperation between different entities such as SEBI, RBI, the Ministry of Finance, IRDA, PFRDA and stock exchanges would have to be secured. India would do well to learn from its Asian neighbours many of whom have successfully developed their bond markets after recovering from the debacle of the Asian financial crisis. (Wells and Schou-Zibell 2008)

Finally, the reforms must be implemented in such a manner that the growth pains of developing market are minimised. The gradual and steady development of strong institutional and regulatory frameworks is necessary to sustain the momentum of corporate debt markets. The infrastructural facilities should be improved to support the heightened activity in the market. (Chaudhary, Raje and Singh 2014)

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