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Corporate Debt Market in
India: Key Issues and Some
Policy Recommendations

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Corporate Debt market in India: Key Issues and Policy Recommendations

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The views expressed in this paper are those of the authors and do not necessarily reflect those of the Securities and Exchange Board of India. We sincerely thank Shri G. N. Bajpai, Chairman, SEBI for his unlimited support and encouragement in conducting research work. But for him, it would not have been possible to bring out this paper timely. We also thank many of our colleagues for their comments and suggestions.

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Foreword

Financial Markets have several facets and are segregated into Capital and Money markets. Product based classification gives rise to segmentation of market into equity, debt, foreign exchange and futures.

In many countries, debt market (both sovereign and corporate) is larger than equity markets. In fact, in matured economies debt market is three times the size of the equity market. Investment in equity being riskier, certain class of investors choose to invest in debt, based on their risk appetite and liquidity requirements. In fact, most investors like to spread their investments into equity, debt and other classes of assets for reasons of optimal combination of return, liquidity and safety.

A vibrant debt market enables investors to shuffle, reshuffle their portfolio depending upon the expected changes. Debt market, in particular, provides financial resources for the development of infrastructure. Hence, a well-functioning debt market becomes significant for all the market participants.

The robustness of Indian debt market, notwithstanding some of major initiatives taken recently, leaves much to be desired. It was, therefore, felt in line with our regulatory responsibility of developing the market that greater focus should be provided by SEBI on development of debt market. With this underlying thought, the Research Department started working on the project and have produced a fairly comprehensive working paper.

The working paper outlines the significance of debt market in general and its role in accelerating the development of economic growth in particular. It reviews various regulatory and non-regulatory developments, instruments available, investors, issuers and intermediaries in the Indian context. The paper also identifies several weaknesses in the present system along with areas hindering the growth of debt market. Recommendations of the paper include development of corporate debt repo market, institution of debt manager, sound safe and robust infrastructure, regulatory framework, investor profile and comprehensive database.

I congratulate the team of Research Department for the hard work they put in bringing out a quality paper.

July 2004
Mumbai

G.N. Bajpai
Chairman, SEBI

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Securities and Exchange Board of India

The Securities and Exchange Board of India (SEBI) was constituted on 12 April 1988 as a non-statutory body through an Administrative Resolution of the Government for dealing with all matters relating to development and regulation of the securities market and investor protection and to advise the government on all these matters. SEBI was given statutory status and powers through an Ordinance promulgated on January 30 1992. SEBI was established as a statutory body on 21 February 1992. The Ordinance was replaced by an Act of Parliament on 4 April 1992. The preamble of the SEBI Act, 1992 enshrines the objectives of SEBI – to protect the interest of investors in securities market and to promote the development of and to regulate the securities market. The statutory powers and functions of SEBI were strengthened through the promulgation of the Securities Laws (Amendment) Ordinance on 25 January 1995, which was subsequently replaced by an Act of Parliament.

Abstract

This paper presents an overview of the corporate debt market in India. A study of the structure and the status of the corporate debt market along with the current policies initiated by Securities and Exchange Board of India , help to identify the associated structural problems in this segment. Based on a detailed analysis of these identified problems, this paper recommends certain steps, which can help to activate the corporate debt market and to become an important source of finance for the economy.

Objectives of the Study

There are several empirical /theoretical studies conducted out to bring developments and status of Indian Corporate Debt Market and to make suggestions to convert it into vibrant market. This paper has some of the following objectives:-

- Review regulatory and market related developments for the past years in India.
- Identify structural gaps or deficiency in the Indian Debt Market.
- States recent regulatory changes and their impact on the market.
- Make suggestions /recommendations to develop Indian Corporate Debt market as one of most vibrant / liquid transparent and efficient market places.

Motivation for the study

Regulators, policy makers, academicians and practitioners would anytime desire to have complete markets as they provide investors with opportunities to shift their investment across instruments over time depending on expectations and changes. In India for past several years, reforms have been initiated to develop debt market in general and corporate debt market in particular. Despite all this, corporate debt market in India still lacks depth and breadth. Therefore, the present study has been taken up to review the past developments, to identify weakness/gaps and suggest suitable measures to develop the market.

1. Introduction

The role of a healthy corporate debt market as a channel that links society's savings into investment opportunities is of vital importance for several reasons.

For the issuer it provides low cost funds by bypassing the intermediary role of a bank. Although corporations have to go through intermediaries like brokers, underwriters in the debt market too, the intense competition amongst them pushes down intermediation cost. Presence of bond funds gives the corporations an alternative means of raising debt capital and thus ameliorates any potential adverse effect that a bank credit crunch may have on the economy.

For the investor, there exists a yield premium opportunity in comparison to traditional deposits at banking institutions. It also increases the investment opportunities in different type of instruments and tailors risk reward profile according to his/her preferences.

The basic philosophy of developing a diversified financial system with banks and non-banks operating in equity market and debt market is that it enhances risk pooling and risk sharing opportunities for investors and borrowers.

The importance of a well-developed bond market is very well summarised in the following words "co-existence of domestic bond market and banking system helps each to act as a backstop for the other...In a relatively open economy since non- bank intermediation may get located outside the country...the domestic bond market helps in avoiding double mismatches of currency and maturity."¹

It is in the above perspective that we seek an examination of the nature of development of the 'Indian Debt Market'. The paper is divided into six parts. Part II introduces the debt market in India followed by part III that gives a schematic presentation of the microstructure of the corporate debt market in India. Part IV addresses the issues concerning it. Part V deals with the recent initiatives undertaken by SEBI with respect to the debt market. Part VI gives recommendations for developing the corporate debt market in India.

¹ Dr Reddy. Y V (2002) when he quoted Alan Greenspan in a key note address at the Asian Bond Conference on March 11, 2002.

II. *The Indian Debt Market*

The debt market is much more popular than the equity markets in most parts of the world. In India the reverse has been true. This has been due to the dominance of the government securities in the debt market and that too, a market where government was borrowing at pre-announced coupon rates from basically a captive group of investors, such as banks. Thus there existed a passive internal debt management policy. This, coupled with automatic monetisation of fiscal deficit prevented a deep and vibrant government securities market.

The debt market in India comprises broadly two segments, viz., Government Securities Market and Corporate Debt Market. The latter is further classified as Market for PSU Bonds and Private Sector Bonds.

The market for government securities is the oldest and has the most outstanding securities, trading volume and number of participants. Over the years, there have been new products introduced by the RBI like zero coupon bonds, floating rate bonds, inflation indexed bonds, etc. The trading platforms for government securities are the “Negotiated Dealing System” and the Wholesale Debt Market (WDM) segment of National Stock Exchange (NSE) and Bombay Stock Exchange (BSE).

The PSU bonds were generally treated as surrogates of sovereign paper, sometimes due to explicit guarantee of government, and often due to the comfort of government ownership. The perception and reality are two different aspects. The listed PSU bonds are traded on the Wholesale Debt Market of NSE.

The corporate bond market, in the sense of private corporate sector raising debt through public issuance in capital market, is only an insignificant part of the Indian Debt Market. A large part of the issuance in the non-Government debt market is currently on private placement basis. Tables 1, 2 and 3 provide details of amount raised by financial institutions and non-financial institutions by way of public issue and private placement. From the tables, it is clear that, on an average private placement accounts for little over one-third of the debt issuance. Unofficial estimates indicate that about 90 per cent of the private corporate sector debt has been raised through private placement in the recent past. The amount raised through private placement has been continuously rising for the past five years which increased by more than 300 per cent over the five year period. The growth rate in the public

issue processes is only about 80 per cent over the period, increasing from Rs. 20896 crore to Rs. 36466 crore. The listed corporate bonds also trade on the Wholesale Debt Segment of NSE. But the percentage of the bonds trading on the exchange is small. The secondary market for corporate bonds till now has been over the counter market. With the recent guidelines issued by SEBI the scenario is expected to change.

Table 1: Resource Mobilization in the Private Placement Market

(Rs. crore)

Year	Private Placement		Total
	FI	Non - FI**	
97-98	4323.7	4878.5	9202.2
98-99	12174.2	4823.5	16997.7
99-00	10875.2	8528.3	19403.5
00-01	13262.3	9843.3	23105.6
01-02 P**	15801.7	12681.6	28483.3

Table 2: Resource Mobilization through Public Issue

(Rs crore)

Year	Public Issue		Total
	FI	Non - FI**	
97-98	9659.7	11236.7	20896.4
98-99	20382.4	12298.9	32681.3
99-00	17981.3	23874.2	41855.5
00-01	26201.2	18529.6	44730.8
01-02 P**	17391.7	19074.5	36466.2

Table 3: Resources Mobilized by FI and Non- FI

(per cent)

Year	FI		Non- FI		Total	
	PP*	PI**	PP	PI	PP	PI
97-98	30.93	69.07	30.27	69.73	30.6	69.4
98-99	37.39	62.61	29.91	70.09	34.2	65.8
99-0	37.69	62.31	26.31	73.69	31.67	68.33
00-01	33.61	66.39	34.69	65.31	34.06	65.94
01-02	47.6	52.4	39.93	60.07	43.85	56.15

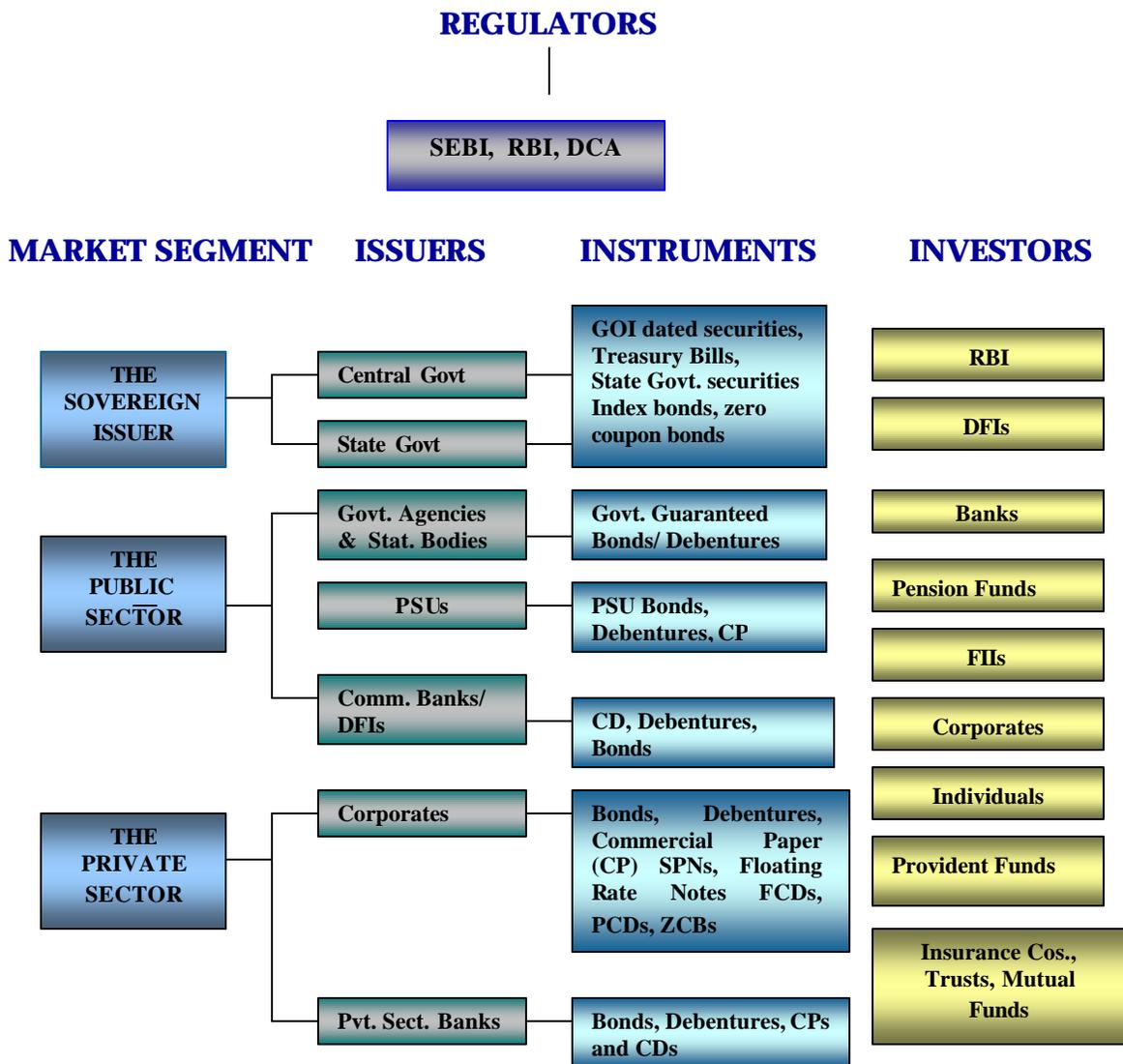
*PP- Private Placement, ** PI – Public Issue

*Source-Handbook of Statistics on the Indian Economy, RBI ** P-Provisional, FI- Financial Institution,

III. Market Micro Structure

It is necessary to understand microstructure of any market to identify processes, products and issues governing its structure and development. In this section a schematic presentation is attempted on the micro-structure of Indian corporate debt market so that the issues are placed in a proper perspective. Figure 1 gives a bird's eye view of the Indian debt market structure.

Figure 1- The Structure of the Indian Debt Market



The microstructure of the Indian Debt Market can be explained under two broad sub sections:

a) Primary Corporate Debt Market

1) Market structure consists of issuers, instruments, processes, investors, rating agencies and regulatory environment.

i) Issuers

Indian Debt Market has almost all possible variety of issuers as is the case in many developed markets. It has large private sector corporate, public sector undertakings (union as well as state), financial institutions, banks and medium and small companies: Thus the spectrum appears to be complete. Figure 1, delineates details on various classes of issuers. Two main classes include private sector corporates and banks.

ii) Instruments

Figure 1 provides names of some of the more popular instruments that have been issued. Till recently Indian debt market was predominantly dominated by plain vanilla bonds. Over a period of time, many other instruments have been issued. They include partly convertible debentures (PCDs), fully convertible debentures (FCDs), deep discount bonds (DDBs), zero coupon bonds (ZCBs), bonds with warrants, floating rate notes (FRNs) / bonds and secured premium notes (SPNs). The coupon rates mostly depend on tenure and credit rating. However, these may not be strictly correlated in all cases. The maturities of bonds generally vary between one year to ten years. However, the median could be around four to five years. The maturity period by and large depends on outlook on interest rates. In expectation of falling interest rates environment, corporate, it is observed, mostly go to shorter term instruments while the opposite is true in case of possible hike in interest rates. For the past few years interest rates have been falling and short end issues are on the rise. This is one of the reasons that many corporate are reluctant to go for public issue route and listing of their securities.

iii) Processes

There are several processes that are in vogue in India as well as in other markets. The more popular ones are public issue and private placement routes. Both these have their own pros and cons. In a mature and developed market where large

number of institutional investor /sophisticated investors are available and a highly developed mutual fund industry is in operation, the private placement route may be acceptable to issuers, investors and regulators. In a less developed market / small market it is a catch 22 position. Private placement is not suitable because this market do not have adequate number of informed investors and the public issue route may create regulatory arbitrage, higher compliance costs resulting sometimes in migration of markets. In India private placement route is highly popular owing to various reasons (These are given in the following **Box 1**).

Box 1- Reasons for Dominance of Private Placement

The dominance of private placement in total issuances is attributable to the following factors

- Under private placement, the deals can be tailor made to suit requirements of both the issuer and the investor.
- The mandatory lengthy issuance procedure for public issues, in particular, the information disclosure requirements, was not applicable to private placement and this provided a strong incentive for eligible entities to opt for private placement. Also listing of bonds on stock exchange was not required.
- It is observed that private placement route generally involves lower issuance costs.

iv) Intermediaries

Two classes of intermediaries required for the proper development of debt market are broker and investment banker/ merchant banker. Most of the brokers as well as merchant bankers in India are inadequately capitalized and their professional knowledge also needs further improvement. In some markets, it is observed that there are dedicated “**Debt Managers**” who facilitate subscription or sometimes subscribe to the issue and later on even facilitate trading in bonds. India needs a dedicated “**Bond Manager**” concept.

v) Investors

For the development of Corporate Debt Market / Fixed Income Securities Market, it is necessary and sufficient to have a large as well as diverse number of sophisticated / institutional investors. Figure 1 lists some of the classes of investors that have been investing in the debt market. Institutional Investors in India are few in number and the variety also is limited. We have only 37 mutual

funds, hardly five insurance companies till recently and there are no pension funds. Banks and financial institutions, by and large, do not take active interest in Corporate Debt Market. Investors with diverse expectations are a precondition for the development of corporate debt market. Diversity could be in terms of maturity needs as well as expectations on interest rates. The most important structural weakness in India is lack of large and diverse institutional investors.

India has large number of retail investors; however, their expectations are quite contrary to market principles - risk and return. Most investors think and perceive that investments in bonds should provide them guarantee, repayment of principal and regular payment of coupons. Any delay/default causes worries in their minds. And sometimes these investors complain to regulators or to the government for non receipt of coupons or non-repayment of principal. This type of behaviour implies lack of understanding of the principles of the capital market on the part of the investors.

vi) Rating agencies

India has a well developed Credit Rating Agency system and rating agencies are well experienced and regarded. By and large, their ratings do carry confidence in the market.

2) Some of the Structural Weaknesses identified in the Primary Market are :

- (i)** Lack of large and diverse investors
- (ii)** Lack of dedicated intermediaries (Bond Manager)
- (iii)** Heavy tilt towards private placement

b) Secondary Corporate Debt Market

1) Appropriate 'micro-structure' of secondary market is vital for trading, clearing and settlement. The present infrastructure has its own merits and demerits. Some of the micro structure features are discussed below:

i) Trading Platform

Corporate debt instruments are traded either as bilateral agreements between two counterparties or on a stock exchange through brokers. Worldwide, the majority of transactions in corporate bonds is conducted in the over-the-counter

(OTC) market by bilateral agreements. In India corporate bonds are traded, mostly, on WDM segment of NSE.

The National Stock Exchange (NSE) introduced a transparent screen- based trading system in the whole sale debt market, including government securities in June 1994. The wholesale debt market (WDM) segment of NSE has been providing a platform for trading / reporting of a wide range of debt securities.

The **WDM trading system**, known as NEAT (National Exchange for Automated Trading), is a fully automated screen based trading system, which enables members across the country to trade simultaneously with enormous ease and efficiency. The trading system is an order driven system, which matches best buy and sell orders on a price/time priority.

Trading system provides two market sub-types:

➤ **Continuous Automated Market:** In continuous market, the buyer and seller do not know each other and they put their best buy/ sell orders, which are stored in order book with price/time priority. If orders match, it results into a trade. The trades in WDM segment are settled directly between the participants, who take an exposure to the settlement risk attached to any unknown counter-party. In the NEAT-WDM system, all participants can set up their counter-party exposure limits against all probable counter-parties. This enables the trading member/participant to reduce/minimize the counter-party risk associated with the counter-party to trade. A trade does not take place if both the buy/sell participants do not invoke the counter-party exposure limit in the trading system.

➤ **Negotiated Market:** In the negotiated market, the trades are normally decided by the seller and the buyer, and reported to the exchange through the broker. Thus, deals negotiated or structured outside the exchange are disclosed to the market through NEAT-WDM system. In negotiated market, as buyers and sellers know each other and have agreed to trade, no counter-party exposure limit needs to be invoked.

ii) Clearing and Settlement Mechanism

Primary responsibility of settling trades concluded in the WDM segment rests directly with the participants and the exchange monitors the settlement. Mostly these trades are settled in Mumbai. Trades are settled gross, i.e. on trade for trade

basis directly between the constituents / participants to the trade and not through any clearing house mechanism. Thus, each transaction is settled individually and netting of transactions is not allowed.

Settlement is on a rolling basis, i.e. there is no account period settlement. Each order has a unique settlement date specified upfront at the time of order entry and used as a matching parameter. It is mandatory for trades to be settled on the predefined settlement date. The Exchange currently allows settlement periods ranging from same day (T+0) settlement to a maximum of two business days from the date of trade (T+2).

iii) Instruments traded on WDM:

The WDM provides trading facilities for a variety of debt instruments including government securities, Treasury Bills and bonds issued by Public Sector Undertakings(PSU)/ corporate/ banks like Floating Rate Bonds, Zero Coupon Bonds, Commercial Paper, Certificate of Deposit, corporate debentures, State Government loans, SLR and Non-SLR bonds issued by financial institutions, units of mutual Funds and securitized debt by banks, financial institutions, corporate bodies, trusts and others.

From Table 4, a highly skewed pattern can be observed in trading of debt instruments. In 1994-95 government securities used to account for less than 50 per cent of the total trades reported, in 2002-03 the same went up to about 94 percent which is more than double. All other segments account for a little over six percent

iv) Investors in WDM

Large investors and a high average trade value characterize this segment. Till recently, the market was purely an informal market with most of the trades directly negotiated and struck between various participants. The commencement of this segment by NSE has brought about transparency and efficiency to the debt market, along with effective monitoring and surveillance to the market.

Table 4: Security wise Distribution of trades on WDM in percentage terms

<i>Year</i>	<i>Govt. securities</i>	<i>Treasury Bills</i>	<i>PSU/ Institutional Bonds</i>	<i>Others</i>
94-95	44.63	38.84	11.17	5.36
95-96	65.12	19.04	8.39	7.45
96-97	64.7	25.92	4.66	4.73
97-98	76.14	16.96	2.27	4.63
98-99	80.19	10.15	4.75	4.91
99-00	92.99	3.62	.5	2.89
00-01	91.22	5.4	1.84	1.54
01-02	95.24	2.7	1.16	.91
02-03	93.62	3.02	1.87	1.49

v) Regulatory Environment:

The listed corporate debt is under the regulations of SEBI. SEBI is involved whenever there is any entity raising money from Indian individual investors through public issues/ private placement. It regulates the manner in which such moneys are raised and tries to ensure a fair play for the retail investor. It forces the issuer to make the retail investor aware of the risks inherent in the investment. SEBI has in fact laid down guidelines known as Disclosure and Investor Protection (DIP) Guidelines, 2000 guidelines to maintain transparency in the market and make it efficient.

2) Some of the Structural Weaknesses identified in Secondary Market

- (i)** Absence of Clearing Corporation and CCPS.
- (ii)** Dedicated trading platform.
- (iii)** Exclusive, well capitalized and professional intermediaries.
- (iv)** Lack of reliable and up to date information.

IV. Issues of Concern

After reviewing functioning of debt market in some other markets and in India, the following issues have been identified as some of the major aspects affecting the market.

a) Poor Quality Paper

Quality of paper refers to regular payment of coupon and repayment of principal at the right time. Companies that do not default on these two counts are said to be issuing high quality paper. High quality paper issued in the market does not create problems / issues for investors, regulators and issuers. The question of private placement vs. public issue and institutional investors vs. retail investor are of less significance and almost no consequence in the market, if the quality of the paper is good.

It is the poor quality paper with a possibility of non-payment of coupon and principal that poses threat to the development of the market and hence stringent regulatory norms are warranted.

Imposition of additional regulatory provisions, though has its opportunity cost, therefore, it is essential to strike a balance between regulatory protection and disclosure based regulation.

Further, in an emerging market / developing market the incidence of industrial sickness is relatively high. This high industrial sickness generally translates into default of companies and their obligations. The bond paper issued by companies turns worthless and creates problems in the minds of investors. Since most retail investors, who invest in bonds, hold for maturity and also hold their investment in a fewer number of companies, any default will wipe out their savings and security for the post retirement / old age requirements. Therefore, defaults in fixed income securities market attract more attention of the public and the regulators.

b) Inadequate liquidity

Secondary Market for Corporate Debt lacks liquidity in India. Hardly few trades take place, that too, in a limited number of issues. There is a chicken and egg problem. Poor liquidity is attributable to inadequate number of good papers and

lack of sufficient investor base in terms of quantity as well as diversity. We can address the liquidity issue in the following ways:

- 1) By developing 'bond manager';
- 2) By enlarging number of investors;
- 3) By introducing good quality paper.

The third factor is exogenous and the second will take long time. Therefore, what is feasible and achievable in the near term is the development of 'bond manager' so that liquidity issue can be addressed and to some extent the quality of paper also.

Table 5: The Amount of Securities Available for Trading on WDM Segment (as on March 31) (Rs crore)

<i>Year Securities</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>
Govt. Secs	329682	381323	416834	512279	605459
T Bills	11881	16120	18480	24489	35753
PSU Bonds	35177	37779	35262	38755	37101
Institutional Bonds	27729	27119	27171	25366	21475
Bank Bonds	2699	4383	3911	6506	7056
Corporate Bonds	11400	13247	14790	17656	16269
Others	21638	27684	31489	31187	13388
Total	440207	507655	547937	656238	736502

c) Investor base

In many markets the number of investors in fixed income securities market runs into thousands and their variety include mutual funds, insurance companies, pension funds, endowments, private banking institutions, banks and retail investors. In India, we have primarily mutual funds investing in bond funds and their investment requirements are one sided, if money starts coming in all mutual funds will get in large quantities and if it starts going out it will go in huge quantities thus creating storms in the market. Insurance funds and pension funds are the long term investors. Any short term shocks can be absorbed by these long term players. Insurance companies in India till recently were limited in number and they were investing to hold till maturity. Individual investors generally hold for maturity. Now that we have more private sector and joint

sector players, their presence in the primary as well as in the secondary market can be felt in the time to come. Pension funds are not there today. Banks do invest in the primary market and their activity in the secondary market is almost nil.

d) Regulatory arbitrage (additional costs on listed companies)

Companies operating in India can be broadly divided into two categories on the basis of regulatory jurisdiction: Listed and Unlisted. All companies are, by and large, administered by the Companies Act, 1956 and the regulatory administration is carried out by DCA, Ministry of Finance.

Listed companies are overseen by SEBI through Listing Agreement of exchanges. Listed companies are required to follow elaborate corporate governance principles, accounting and disclosure standards, continuous disclosure standards and hence incur additional costs. Unlisted companies, thus, enjoy regulatory arbitrage over listed companies. There is a perception that listed companies seek delisting owing to perceived regulatory arbitrage.

e) Debt Versus equity : Cost and risks

By design and necessity debt has finite life sometimes, very short whereas equity is said to have perpetual life. Therefore, debt paper is offered and reoffered quite frequently by companies. In falling interest rate scenario, as has been the case in India for the past few years, corporates tend to borrow for shortest possible period thus restoring to repeated issue costs and interest rate risks. High regulatory and compliance costs add to cost of resources. Therefore, corporates might innovate new methods of raising capital. Either way, the corporate debt market will be affected adversely.

f) Incomplete access to information

One of the most important issues is lack of sufficient, timely and reliable information on bonds and on bond markets to the investors. Information on bond issue, size, coupon, latest credit rating, trade statistics are sparsely available. If the investors have access to the relevant information more frequently then it may be possible for them to assess the quality of the paper and take decisions.

In addition, there is no one place in India where one can have all the data pertaining to corporate debt issues. No one knows exactly how much debt is

outstanding on any given date and different agencies have incoherent estimates for the same. Tables 1 and 2 amply demonstrate this point. Annual public issue amount averages around Rs. 40,000 crore for the past 3 years. If the entire 5 year period is considered roughly Rs. 170,000 crore was raised through public issue. However, the amount of debt outstanding for trading at NSE excluding government securities and treasury bills comes to roughly Rs. 100,000 crore. There is a wide gap between publicly issued amount and that which is admitted for trading even if one considers average maturity period of five years. Generally bonds have longer maturity. Hence, any regulatory action either becomes ineffective or misdirected leading to unintended results target. Therefore, there is an urgent need to launch a survey and prepare a comprehensive database and bring in transparency. Transparency ensures confidence which in turn ensures liquidity. Sudden shocks can be mitigated.

g) Interest rate structure

Very skewed interest rate structure exists in India. Corporates with “AAA” rating offer lower coupon than sovereign rate offered on certain instruments such as public provident fund, National Saving Certificates. Individual investors, therefore, have almost nil or no interest in coupon debt market, both primary as well as in secondary, unless they are accompanied by some fiscal concessions resulting in net higher return compared to above cited instruments.

V. Recent Initiatives by SEBI and their Impact

In the past few months SEBI had initiated a slew of measures in order to properly promote primary and secondary corporate debt market in India.

a) Primary Market :

Any constituent of the corporate debt market can issue bonds/debentures through **public issues** and **private placements**. To be able to make a public issue the issuer has to meet the statutory requirements prescribed in the Disclosure and Investor Protection Guidelines. These are given in Box 2.

Box 2: Statutory requirements for public issues as specified in DIP guidelines

In case of a debenture issue, the company has to give undertakings to the following effect in the offer document as well:

- i.** The company has to forward the details of utilization of the funds raised through the debentures duly certified by the statutory auditors of the company, to the debenture trustees at the end of each half-year.
- ii.** The company has to disclose the complete names and addresses of the debenture trustees in the annual report.
- iii.** The company has to provide a compliance certificate to the debenture holders (on yearly basis) in respect of compliance with the terms and conditions of issue of debentures as contained in the offer document, duly certified by the debenture trustees.
- iv.** The company has to furnish a confirmation certificate that the security created by the company in favour of the debenture holders is properly maintained and is adequate enough to meet the payment obligations towards the debenture holders in the event of default.
- v.** Credit rating of not less than investment grade is obtained from not less than two credit rating agencies registered with SEBI and disclosed in the offer document.
- vi.** The company is not in the list of wilful defaulters of RBI.

vii. The company is not in default of payment of interest or repayment of principal in respect of debentures issued to the public, if any, for a period of more than 6 months.

viii. An issuer company can not make an allotment of non-convertible debt instrument pursuant to a public issue if the proposed allottees are less than fifty (50) in number. In such a case the company shall forthwith refund the entire subscription amount received. If there is a delay beyond 8 days after the company becomes liable to pay the amount, the company shall pay interest @15% p.a to the investors.

ix. Where credit ratings are obtained from more than two credit rating agencies, all the credit rating/s, including the unaccepted credit ratings, have to be disclosed.

x. All the credit ratings obtained during the three (3) years preceding the public or rights issue of debt instrument (including convertible instruments) for any listed security of the issuer company shall be disclosed in the offer document.

The public issue can come as an **open offer** to public at large or involve a **book building** process. Book building is a process by which demand for the securities proposed to be issued by a corporate is elicited, built up and the price determined on the basis of the interplay between demand and the quantum of the securities to be issued.

The public issues market has over the years been dominated by financial institutions, which is exemplified by the fact that ICICI and IDBI accounted for the entire debt offerings in 1998-99 and all but one issue in 1999-2000. Another interesting fact is that in spite of dominating the public issues market even financial institutions have raised significantly larger amounts through the private placement route.

Total resource mobilisation from the private placement market increased sharply by over 3-fold between 1997-98 and 2001-02, The share of private placement issues in total mobilisation from the primary capital market (public issues and private placements) for non financial institutions increased from about 30 percent in 1997-98 to around 85 per cent by 2000-2001.

On September 30, 2003, SEBI, in order to provide greater transparency to privately placed issues and to protect the interest of investors in such securities, issued a circular stating guidelines that any listed company making issue of debt securities on a private placement basis and listed on a stock exchange has to comply. SEBI has in the meanwhile granted a transition period up to March 31, 2004 to those issuer companies who had issued privately placed debt securities but did not list those securities prior to September 30, 2003 (the date of the Circular) to enable them to comply with the provisions of the Circular.

1) Objectives

Primary market guidelines issued by SEBI and changes made by exchanges are supposed to have been aimed to enforce:

- i)** Increased disclosures;
- ii)** Increased frequency of disclosure;
- iii)** Provision of reliable information;
- iv)** More public issues / wide distribution;
- v)** Improvement in quality of paper.

2) The Fallout of SEBI Guidelines

It is possible that highly rated companies might have attraction to explore alternative sources of finance which are cheap, easily available and have less stringent covenants. Companies with low credit rating or companies without better alternative sources might use public issue of debt paper and seek listing on stock exchange. In fact, this could be a counterproductive outcome that will produce poor quality paper leading to possible defaults. If these defaults are more in number then there are chances that the market development will get hampered. Some of the likely fallouts are discussed below:

i) Increased reliance on credit markets

More and more companies particularly highly rated ones would go to banks and raise loans with flexible covenants. Coupon tenor and rescheduling are the main factors that weigh in favour of loans. Only companies that do not have access to bank credit on favourable terms are likely to use capital market route.

ii) Migration to Overseas Market

Since funds are generally available cheaply in the overseas market, many companies try to access ECB, Yankee bond market or they can use ADR/ GDR route also.

iii) Reliance on equity

One of the typical attitudes, on the basis of past behaviour of Indian corporate, is to go for equity financing, whenever markets are on rise. Though, theoretically and practically equity is considered to be costlier than the debt it is observed that the equity is preferred way of financing projects with or without heavy premium. It suits corporate many ways.

V. Recommendations

a) Debt Manager

The concept of debt manager: The concept of 'debt manager' appears to be quintessential for the development of corporate debt market. This group of intermediary should be an exclusive one and they should be committed and sufficiently capitalized. All the public / private issues will be placed through this debt manager. In order to provide competitive market environment sufficient number can be licensed, provided they meet entry norms. Entry and exit should be free.

Debt manager can subscribe, hold and trade in debt. They would not be allowed to operate in other markets till the debt market attains certain critical mass. This process is expected to provide supply of quality paper, increased confidence, increased liquidity etc. They can create liquidity in the market by providing two-way quotes in all market conditions.

Introduction of this concept requires work in certain following areas

- **Factors that determine distribution capacity of debt manager:** As debt managers will be responsible for distribution of bonds, it is important to have a set of criteria that would help in assessing their capacity to reach maximum number of investors.
- **Operational and risk management capacity of debt manager:** Factors need to be identified in order to evaluate debt manager's ability to manage their primary and secondary market obligation. For risk management, minimum capital requirements should be set up according to the degree of risk undertaken by debt manager.
- **Entry and exit criteria:** Entry barriers should be low in order to have large number of debt managers. In fact both entry and exit should be free as long as debt managers satisfy the minimum conditions. They should be allowed to lend and borrow securities amongst themselves in order to provide liquidity in various instruments.
- **Monitoring of trade:** To monitor the trading activity of debt manager, electronic database of trading practice should be established. Monitoring is essential to ensure that they carry out their responsibilities properly. Its

dissemination to investors should be facilitated at an affordable rate. This dissemination of information could be done in form of a “Bulletin Board” maintained by the exchanges/clearing corporation. This dissemination need not be on real time basis. Even ex post facto reporting at the end of the day will put significant pressure on the dealers to be honest and fair to the investors. The price reporting and trading practice surveillance may be linked to the centralised clearance, settlement and depository systems.

- **Punishment on default:** In case debt managers do not carry out their obligations, proper penalising framework should be put in place. In order to ensure that debt managers take their responsibilities seriously, a system as mentioned above should be developed for monitoring and enforcing of their obligations. Their performance should be evaluated on a quarterly basis. When a system is fully automated, breach of the market-making obligation should lead to suspension of these intermediaries and other penalties as per the applicable regulations as and when framed.

b) Trading Platform

Single vis-à-vis Multiple: It has been observed that multiple agencies competing for market share in a small market mostly fragment the market thereby reducing liquidity. In case of India, liquidity in the debt market is very poor. Moreover, NSE and BSE have been promoting trading in corporate debt. If one goes by the above argument it seems that liquidity is getting bifurcated here. If other exchanges also join this competition in future, it would lead to further reduction in liquidity as well as increase in costs. One of the solutions to the above problem can be in the form of ‘Single Trading Platform’. To initiate this, exchanges can put joint effort for the development of the single trading platform.

However, the other side to the above solution is that a single trading platform can create monopoly. Availability of alternatives provides a comfort zone and helps in encouraging competition amongst the players

In such a scenario, the obvious alternative is to have multiple trading mechanisms. One option is to allow multiple trading mechanisms to co-exist but requires a central collection and dissemination of prices. Such an approach is adopted in USA where all trades in the G Sec market are reported to the so-called Gov PX systems. The Gov PX system makes information available to

subscribers for a fee. However, in case of India, initially, information needs to be provided freely to create awareness.

Multiple trading mechanisms should come up with following features-

- **No operational arbitrage:** Care should be taken that no operational arbitrage may arise if multiple trading platforms exist.

- **Closed domain for trading:** As debt is largely a wholesale market, it is preferable to keep trading in this segment closed amongst specified investors. The logic behind having a closed domain for trading lies in the inherent characteristic of this market. This market differs from the equity market, as every transaction has an impact on the yield of other papers unlike the equity market where scrips trade individually without a corresponding impact on the prices of other scrips. Thus if trading is allowed in all sizes, which is a possibility if trading is done at a retail level, the market could be distorted. Hence, it should be closed to a specified set of investors.

Closing the market to few shareholders does not imply that it will be restricted to qualified institutional buyers (QIBs) only. Any investor who is willing to trade above a certain amount would be allowed to operate in the market. Another argument that goes in favour is that for any investor who wants to invest a small amount, there exists no incentive to enter this market because of the presence of small saving schemes which give them similar or better return without equivalent risk (in fact less risk).

c) Bond Market Information and Central Database

The Problem and solutions: One of the major problems in Indian corporate debt market is lack of data in terms of its correctness, quantity and updation. Urgent need exists to create reliable and up-to-date database. There is no single source accessibility in India where data pertaining to corporate debt issue is available. No one knows exactly how much debt is outstanding on any given date and different agencies have incoherent estimates of the data. Hence, any regulatory actions either become ineffective or misdirected leading to unintended results. Therefore, there is an urgent need to launch a survey and prepare comprehensive database on few selected parameters from top companies. In this regard, following steps can be taken-

▪ **Maintain a website for information dissemination:** Leads can be taken from United States of America where the Bond Dealers Association maintains a site called www.investinginbonds.com, which gives detailed information about the available debt securities simultaneously giving details about the risks involved in investing in bonds and guiding them as to the investment strategy. In case of India, there is a portal called debtonnetindia.com - a joint venture of the IL&FS and NSE. It is a virtual book-building portal, which acts as an internet-based book for placing issues. Investors can bid for the issue through the portal, which enables the lead manager to build and close the book for the issue. This portal can be further expanded on similar lines to make it more informative.

In addition, one can emulate the practice of NASD where in all the firms trading in corporate bonds are required to report trade data on secondary market transactions to NASD. NASD then disseminates trade information of these transactions to public through its web site. This gives investors an opportunity to view real trade information.

▪ **Responsibility of market participants in providing data:** Stock Exchanges, brokers, 'debt manager', rating agencies and other concerned should regularly provide information on various parameters. This should be available freely on the websites and trading platforms.

▪ **Depositories as source of information** -Depositories can act as a major source of information as they can disclose the amount of transactions that takes place without disclosing the name of the participants.

▪ **Trade at OTC-** Even trades that take place in the OTC market should be compulsorily reported and information dissemination should be as good as in the others segment of the market. This effort would help to take informed decision.

d) Repo Market in Corporate Debt

The concept and the need: Repo transactions enable dealers to finance long positions and cover short positions allowing them to respond to investor's needs quickly. In the Indian scenario, Government securities are the most preferred instruments for repo transactions. As of now, there are no takers for repo transactions where corporate bonds are used as collaterals. This is so

because the corporate bond markets do not possess some of the basic requirement to get qualified for repo purpose.

Few of the problem areas as identified in the Indian case are as following:

- Shut down period –The market participants feel that shut down period needs to be cut down from fifteen days in the current scenario to three days. This move is justified because dematerialisation is widely prevalent today.
- Net-off period –Net off should be allowed for repos as they can make markets effective.

e) Private Placement of Corporate Debt

The Problem: In 2002-2003, the amount of funds raised by privately placed debt was Rs 48,424 crore as against Rs. 10,035 crore in 1995-96. This rise has been witnessed because this segment requires minimum disclosure.

According to the Companies Act 1956, a corporate entity issuing debt is mandated to make full disclosure as applicable to public issues of equity capital only if the number of subscribers is more than 50. Corporate take advantage of this and make multiple issues in one year to meet their requirement making sure that the number is less than 50.

Thus, steps need to be taken in order to address these issues. Disclosure should be made mandatory irrespective of the number of subscribers. Recently disclosures have been made compulsory for all listed companies coming out with private placement. If an unlisted company wants to come out with a private placement and intends to get it listed, disclosures have been again made mandatory. However, the unlisted companies who do not fall under the jurisdiction of SEBI still are free to make private placement without adequate disclosures. This needs to be plugged with the help of respective regulatory bodies or by expanding the jurisdiction of SEBI.

Private placement of debt should be encouraged subject to the following conditions-

- All privately placed debt will be issued to qualified institutional investors as well as to other institutions but not to the retail investors.
- All private placements will be carried out by debt manager and / or primary dealer.

- All private placements will be compulsorily admitted for listing and regular information should be made available as specified previously.

f) A Sound, Robust and Safe Market Infrastructure

The concept: Safety and standardization in trading and settlement practices should be ensured. Standardized robust trading rules and a safe infrastructure help reduce hidden transaction costs and promote market liquidity. Safety in trading and settlement is a prerequisite for the existence of deep and liquid markets as more investors will be willing to trade in a safe market.

- **Shorten settlement lags:** Settlement lags need to be shortened to T+3 or shorter, and to adopt delivery –versus payment (DVP) practices.
- **Establish a clearing corporation:** This need to be done for the trades that takes place on the WDM segment of NSE. A computerised clearing and settlement system should be set up for the corporate bonds. (Look into the viability of the existing systems to act as one.)

In order to widen the investors' base as well as expand the market, steps should be taken to link it to clearing houses of other countries. This was done in case of Hong Kong where Central Money Market Unit (CMU) was linked to the Euro clear and Cedel. This international link helped in the promotion of the dollar debt securities to the foreign investors. All debt instruments cleared through the CMU are either immobilised or dematerialised, and transfer of title is made in book entry form. The Hong Kong Monetary Authority (HKMA) has been promoting the linkages in order to facilitate cross border trades of securities in Asian times. In December 1997, the HKMA became a member of Reserve Bank Information and Transfer system (RITS) for Australian government securities and Austraclear (for private sector debt securities in Australia). The link enables CMU members to hold and trade securities in RITS and Austraclear through HKMA's membership in both systems. Similar steps were taken in respect of other countries like Korea and Reserve Bank of New Zealand. Initiatives like this would give an international dimension to the corporate debt market.

Establishment of trade guarantee fund for the corporate debt needs to be implemented as it can help to improve the health of the market a lot. In the initial stages, it can cause pain but this is necessary to activate the market by increasing its safety level.

g) Regulatory Framework

Disclosure system and information: Fair disclosure of information about an issuer and the securities that it is offering is vital to a functioning of a public market for bonds or equities.

- **Mandatory disclosure:** Adequate disclosure should be made mandatory. Also required is that these disclosures should be enforced effectively so that one can achieve the desired results. One of the areas where disclosures need to be made compulsory is disclosures regarding product feature. Information on products feature should be also clearly specified. As most of the products differ from each other, varying kind of disclosure may be required according to the variety of products. Accurate and comprehensible disclosure of product information of debt issues is necessary to make the investors fully aware of the risk return trade off. Moreover, disclosure should focus on an issuer's creditworthiness rather than its relative prosperity.

- **Securities registration procedure:** It should not be costly or burdensome as it can discourage corporations from going to local bond market. As these are cost-benefit trade-off for the issuers due care needs to be taken. Costs can be relatively more if registration forms are lengthy/complicated, waiting period is long until the field registration statement becomes effective etc.

- **Short Selling:** More liberal attitude needs to be adopted towards short selling. The ability to short sell a security makes a market more complete. In particular, the ability to short sell and borrow a security promotes liquidity.

h) Widen Investors' Base

Steps should be taken to widen the investor base. In order to achieve this Korea gave bank and other guarantees to the bond issuers. However, due to lack of proper regulatory framework this system of guarantee did not succeed. The guarantee insurance scheme far exceeded the ability of the insurance companies. In reality there was no authentic bond guarantee insurance business that is one based on well-established risk management skills with effective database and sufficient statistics. None of the guarantors seemed to realise the enormous risk involved in bond guarantees, and the fees charged were considered more like service rather than insurance premiums based on the past statistics. In other words the scheme appeared to consider the

guarantees as an easy way to increase revenues without exposing themselves to significant risk. In order to avoid such situation proper framework should be put in place.

However, these insurance companies in turn need to follow capital adequacy regulation, corporate governance norms, international auditing standard etc. Regulations should be placed in order to ensure a proper framework for the working of these guarantors. Besides providing guarantees, steps should be taken to instil confidence in the investors.

Bondholders should be also involved in managing post bankruptcy situations. Through active bondholders' interest and protective measures such as bondholder committees, bondholders can serve their purpose as well as the purpose of the market as whole.

Though retail investors should not be allowed directly in the market they can be involved indirectly in the market as has been done in the case of Hong Kong. Here government bonds were made popular amongst the retail investors with the help of placing bank. Initially when efforts were made to make the bonds popular amongst the retail investors, insufficient application channels, obstacles from the stockbrokers and lack of investment knowledge of bonds among the public did not let it take off. However, a new issue mechanism was introduced which offered more offering channels for investors to subscribe for bonds. The use of placing banks largely removed the impediments for tendering method. For the retail issue launched early in October 2001, the corporation appointed 13 placing banks using over 625 branches to place the new issues to retail investors. When retail investors applies for a new issue by the corporation, he can go in person to a placing bank and fill in simple transactions ticket there, or apply through its phone banking and internet facilities. Placing banks keep custody of the debt securities for their customers. The corporation ensures that its retail bond issues have a secondary market. It requires placing banks to enter into an agreement with the corporation to make a market for the note holders until the specific bonds mature. To facilitate market making by the banks, the corporation sets aside a reserve amount of 20-30 percent of the issued amount of the retail bonds to facilitate the placing banks to quote two-way prices in the secondary market. Even if placing bank has no debt securities to offer, it is still require to quote a firm bid price for the specific issue in which it has acted as a placing bank to the customer.

i)The Role of Securitization

The Concept: Securitization refers to the issuance of new bonds collateralized by a pool of assets which can be other bonds, loans, or any receivables with a regular cash flow. This is usually done via a Special Purpose Vehicle (SPV) specifically set up to own and receive the income from the pool of assets, with which to service the bonds it issues in its name. Proceeds from the bond issue are used to pay the original owner or owners to acquire the pool of assets. The original owner or owners of the assets, or by a third party can set up the SPV.

The pooling of assets can provide diversification benefits to potential investors. The asset-backed securities can be issued in several tranches of different maturities and offering different risk-return configurations, and can be rated at different credit levels. Specifically, credit guarantees can be used to enhance the credit worthiness of some of the tranches, making them eligible to a wider range of investors. Credit enhancement can also be achieved through the over-collateralization of the asset-backed securities. The asset-backed securities can be issued in bigger sizes than usually the case in emerging corporate bond markets, and therefore likely to have better liquidity in secondary markets—again desirable characteristics for investors.

Consequently, securitization can contribute to the development of corporate bond markets by overcoming the problems of the small size and low credit quality of most emerging market issuers—problems which have plagued the emerging corporate bond markets. By participating in a securitization program, or by collateralizing their future-receivable cash flows, small and medium corporates are able to tap capital markets. In particular, securitization has been an important tool to clean up banks' balance sheets and improve their capital ratios in a bank restructuring process.

However as securitization is a derivative product, being packaged from existing securities or other debt instruments, for its market to function properly, the market and market infrastructure for the underlying assets have to be already in good working order. On top of that, legal clarity and predictability on things like the true sale of assets, the taking possession of collateral and realizing its market value etc. also needs to be sufficiently assured. Consequently, some analysts doubt if securitization can be used as a means to help develop bond markets, as the cash market has to be relatively developed before a market for securitized instruments can be introduced. In

addition, to be viable, an asset-backed securities market needs to have in place institutions ready and able to provide credit guarantees or to buy the higher-risk “mezzanine” tranches of the securitization program. But in India since bond markets have been in existence for some times, securitization can be useful in identifying gaps and deficiencies in cash market infrastructures and foundations.

This in turn can help stimulate further reforms and developments in cash markets and beyond, in order to accommodate the proper functioning of securitization markets. Research work done by the HKMA is consistent with this line of thinking.

VI. Conclusions

The study is basically explorative in nature. No empirical study has been carried out. However, several practitioners, market participants, academicians and regulators have held threadbare discussions. A few of those recommendations are mentioned in this paper. The paper benefited from the interaction that we had with all these people. Many of the recommendations, if implemented in Indian Corporate Debt Market, are likely to make it more mature.

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