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An Indian Debt Market: Some Issues and Policy Recommendations

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Abstract

The deep and liquid government securities market plays a vital role in the financial development of a country. Over the years, the Indian debt market has gained depth, liquidity and vibrancy; amidst uncertainty has been able to withstand periods of financial stress and crises including the recent pandemic. Some of the focus areas to facilitate the growth of the market inter alia includes: enhancing liquidity in the yield curves of the sovereign and corporate bond markets, participation of different categories of investors and creating new instruments in the derivatives market, promoting foreign investment for the development of local currency bonds and relaxation in restrictions on investment mandates. Continuing vulnerability in financial markets across the globe; with negative repercussions in terms of lowering of sovereign bond yields; widening of risk spreads and tightening of financial conditions. Within this context, this article is a modest attempt to examine the recent developments/issues in the Indian debt market (after analysing published reports and surveys of concerned stakeholders in the government securities market) hindering their development and various measures which can be taken to make these markets efficient. The article is structured in three parts namely: issues and possible resolution, policy recommendations, way forward, and conclusion.

Keywords: Corporate debt vulnerability, Illiquidity, Yield

Introduction

The Indian debt market primarily comprises of the corporate bond market and government securities (or the G-Sec markets) issued by central and state governments. The government issues fixed income instruments and also borrows money by issuing G-Secs in order to finance its fiscal deficit. On the other hand, the corporate bond market consists of financial institutions bonds, public sector units bonds, and corporate bonds/debentures. The G-secs form a major share of the market (in terms of the number of outstanding issues, number of trades and market capitalization); and hence it is the most dominant category of debt markets. It serves as a yardstick for the rest of the market. It is a well-known fact that a developed corporate bond market provides an alternative source of finance for the real sector for their

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long-term investment needs and in risk diversification. Moreover, the path towards making India a $ 5 trillion economy by 2024-25 by and large, will need substantial financial resources to come from the bond market.

As far as G-Sec market is concerned, there has been tremendous development in all the areas which inter alia includes institutional development, improvements in market practices, and building of payment, settlement and legal systems. However, the corporate debt market lag in terms of progress (as compared to G-secs market) mainly due to a large number of issuers and less participation by institutional investors. Factors such as excess total expenditure over revenue receipts (fiscal deficit), the existence of interest, and inflation rate differentials impact the progress of the Indian debt market. The article, in particular, documents the government securities market with 10-year maturity and the corporate bond market recent developments, and suggests some policy recommendations.

Global and Domestic Scenario

A host of factors like geographical and political tensions between the U.S. and Iran, COVID-19 pandemic, trade tensions between U.S. and China, and amicable resolution of Brexit due to U.K. election results have led to increased volatility in global financial markets. With increased uncertainty, financial markets in many advanced and emerging economies have suffered losses more than post the global financial crisis (GFC). Moreover, bond yields fell historically low to less than 1 percent due to rate cuts by Federal Reserve. Indian financial markets are vulnerable to global developments; continuing capital outflows impacting Indian currency negatively have also resulted in slow/negative growth amidst rising concerns from the COVID-19 pandemic. Further, the global volatility has also been increasingly reflected in domestic yields of the bond market. The Indian debt market, over the years, has improved in terms of depth, liquidity, and vibrancy and has exhibited strong financial stability during periods of financial distress, including the present Covid-19 stress. The Indian debt market has also emerged as one the third-largest in the Asia region (Rajaram and Ghose, 2019).

The Country Experience

As compared to its global peers, the Indian corporate bond market rate is around 59.86% as compared to South Korea (42.38%), Malaysia (15.04%), China (11.52%). However, the Indian market lags behind as compared to U.S. (68.56%). The corporate bond issuances in India during FY 2019 amounted to USD 92.43 billion as against USD 86.30 billion in FY 2018, with a growth rate of 7.1%. As reported by RBI, there have been corporate issuances amounting to USD 49.93 billion up to October 2019. Also, the total volume of trade for corporate debt in the secondary market has increased (though at a modest pace). The total traded value (monthly) of corporate bonds was Rs. 1,210 billion in October 2018. However, India

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has a much lower corporate debt to GDP ratio (only 17 percent) as compared to developing economies like Brazil, Turkey Malaysia, and South Korea as reported in Table 1 (RBI Bulletin 2019).

Table 1: Countries' Corporate Debt Market (as percentage of GDP)

Countries	Corporate Bonds to GDP Ratio
U. S.	123.47
China	18.86
Japan	14.57
South Korea	74.3
Singapore	34.02
Malaysia	44.5
India	17.16
Brazil	99.05
Turkey	142.06

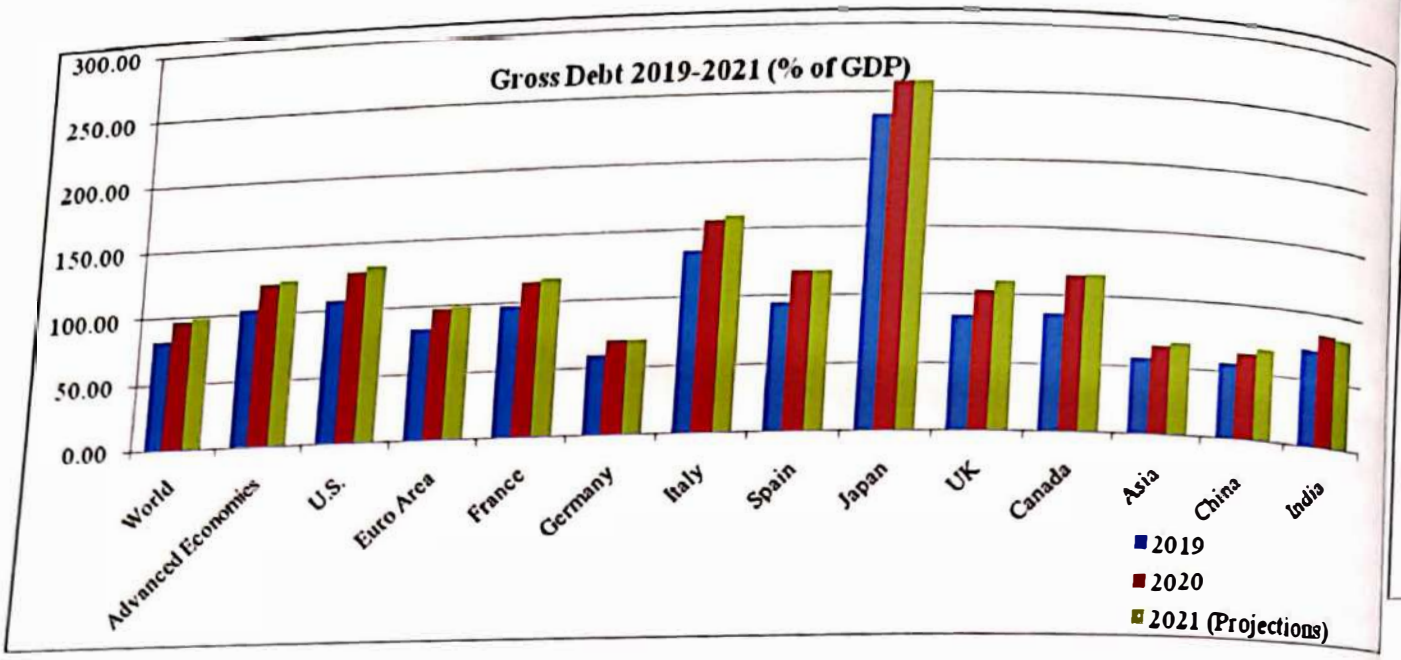
Source: RBI Bulletin (2019)

$75 trillion Global Corporate Debt-A Bubble

The global stock of non-financial corporate bonds was at an all-time high of $13.5 trillion at the end of 2019; it was twice as compared to what non-financial corporations owed in 2008 (Global Financial Crisis). There has been an increase in corporate bond issuance amounting to $2 trillion in the first half of 2020 (with an increase of 49 percent for the same period in 2019). There is a fear that most corporate issuances/borrowing are sub-standard which might lead to another global financial crisis. Corporate bond markets have grown substantially in some larger developing countries growing from $380 billion in 2007 to $3.2 trillion in 2017 (UNCTAD Trade and Development Report, 2020). Further, at the end of 2019, the global outstanding stock of non-financial corporate bonds stood at a record high of USD 13.5 trillion (OECD Report, 2020). It is also reported that by and large, emerging market and middle-income countries would emerge from the covid-19 pandemic with rising debt vulnerabilities. Also, the average general government debt as a percentage share of GDP is expected to rise to more than 62 percent in 2020 (as compared to 53 percent in 2019), due to fiscal measures as well as economic contraction as evident in Figure 1(IMF Fiscal Monitor January, 2021). India's government debt position has been raised at 83 percent of GDP with the need for effective medium-term fiscal framework to boost confidence, anchored on attainable fiscal objectives and revenue mobilization.

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Figure 1: Gross Debt 2019-21(% of GDP)



Source: *IMF* Fiscal Monitor (January, 2021)

Problem and Objective

Investors are actively looking for safer alternatives due to vulnerabilities in debt market. The regulators have been actively engaged in correcting and regulating the debt market; being also the major provider as a primary source of fund. With a broad picture of accelerating global debt vulnerability, and recognizing the importance of the debt market, the article aims at addressing some of the key problems in the Indian debt market and suggests some policy recommendations.

Issues

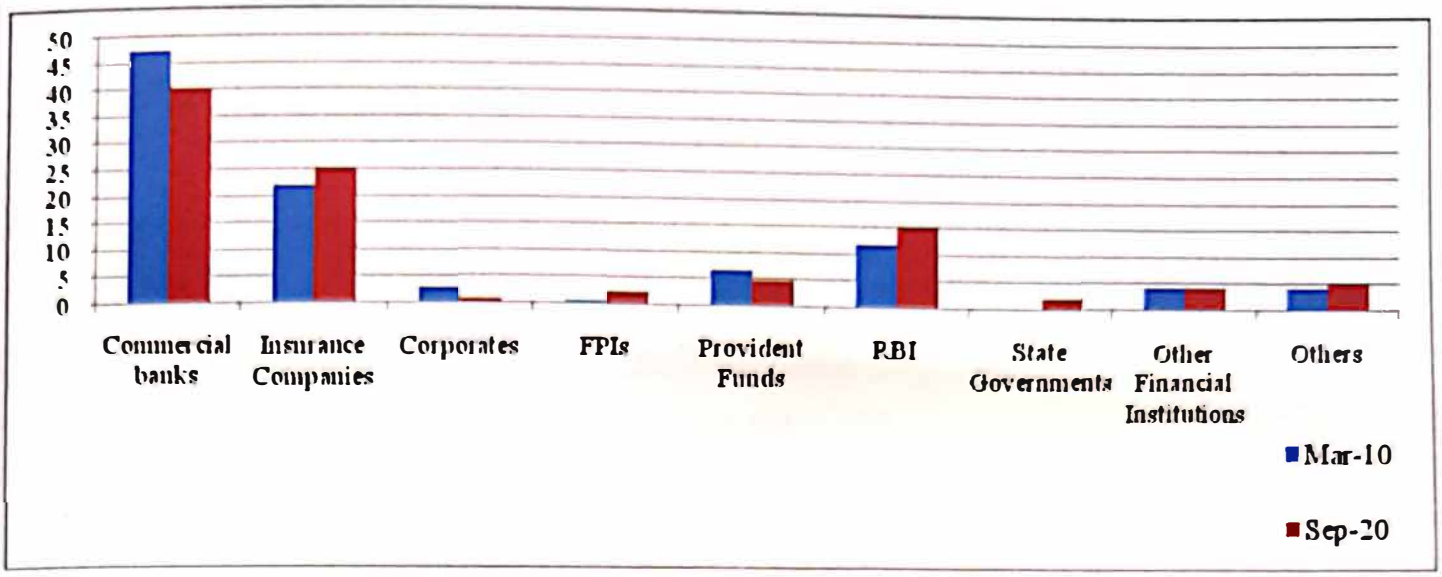
G-secs Market (10 Year Maturity)

Holding of G-secs (percentage share in outstanding stock):

There has been an increase in the investor base for government securities over the period of time. The dominant investors in government securities have been the banks. With time, it is observed that there has been a decline in portion of the share of total holdings of banks; and an increase of share of insurance companies and non-resident investors (Figure 2). Measures have been taken for seamless flow of funds in G-secs market to promote direct retail investment.

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Figure 2: Government Securities Holding (percentage share in outstanding stock)



Source: RBI Bulletin (November, 2020)

Maturity Profile of Dated Government Securities

Table 2 depicts that there has been an increase of 17 percent (at end-September 2020) from 13 percent (at end-March 2012) in the share of securities with residual maturity of more than 20 years. Issue sizes have also increased. At the same time, the number of securities has remained by and large, unchanged over the last decade. This has lead to a reduction in the interest rate and refinancing risks. However, the flip side to it is that it appears that Government wants to pass on the burden of debt to younger generations leading to serious financial stability implications. Also, a rise in government debt will lead to shifting of the target of combined debt to GDP (%) by FY23 by seven years in FY30 as mentioned by Fiscal Responsibility and Budget Management (FRBM). An increase in debt has also financial stability implications on sovereign debt ratings thereby impacting financial stability.

Table 2: Dated Government Securities-Maturity Pattern

Maturity (Years)	As of March 31, 2012		As of September 30, 2020	
	No of Securities	Total Outstanding (Rs. Cr)	No of Securities	Total Outstanding (Rs. Cr)
0-5 yrs	39	7,82,017	34	19,39,139
5-7yrs	12	4,22,251	10	8,74,072
7-10 yrs	14	4,77,846	13	11,25,350

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10-15 yrs	11	3,61,451	16	13,52,702
15-20 yrs	6	2,09,367	4	2,27,151
20-25 yrs	7	2,37,307	6	5,06,002
25-30 yrs	3	1,03,000	3	2,77,798
>30 yrs			5	3,54,468
Total	**92**	**25,93,328**	**91**	**66,56,682**

Source: RBI Bulletin (November, 2020)

Government Borrowings-Gsecs

The government has been increasingly meeting its fund requirements through market borrowings in the current financial year. There has been a significant increase in borrowings by the Centre and State due to the fiscal implications of the pandemic and economic lockdown (Table 3). Recently, the state borrowing limit, that is, Gross State Domestic Product (GSDP) has also been increased in FY21 to 5 percent from 3 percent. In fact, huge borrowing from the market could crowd out private investment.

Table 3: Government Borrowings-Gsecs

Month/Year	Amount (Rs Crore)
Apr-20	83,000
May-20	1,31,000
Jun-20	1.32,000
Jul-20	1,72,000
Aug-20	1,30,000
Sep-20	1,20,000
Oct-20	1,10,000
Nov-20	79,000
Dec-20	94,975

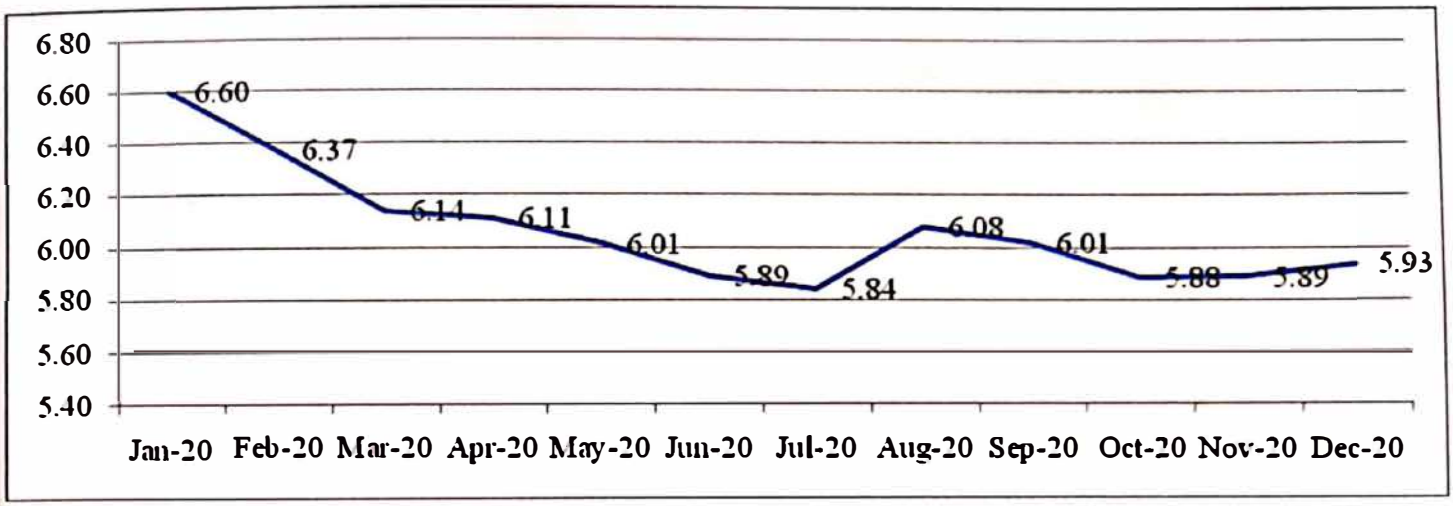
Source: CARERatings Debt Market Update

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Trend of Gsec-10 Yr Yield

The decline in GSec yields was aided by the RBI's measures announced in the monetary policy (Oct'20) to boost demand for government securities viz. increase in OMO purchases, liquidity infusions through TLTRO, and increased time limit for keeping government bonds in HTM category (till Mar'22).

Figure 3: Gsec-10 Yr Yield



Source: CCIL & CARE Ratings

At the same time, the sustained high level of inflation and the increase in central government borrowings to compensate the states for the GST shortfalls capped the fall in yields (Figure 3).

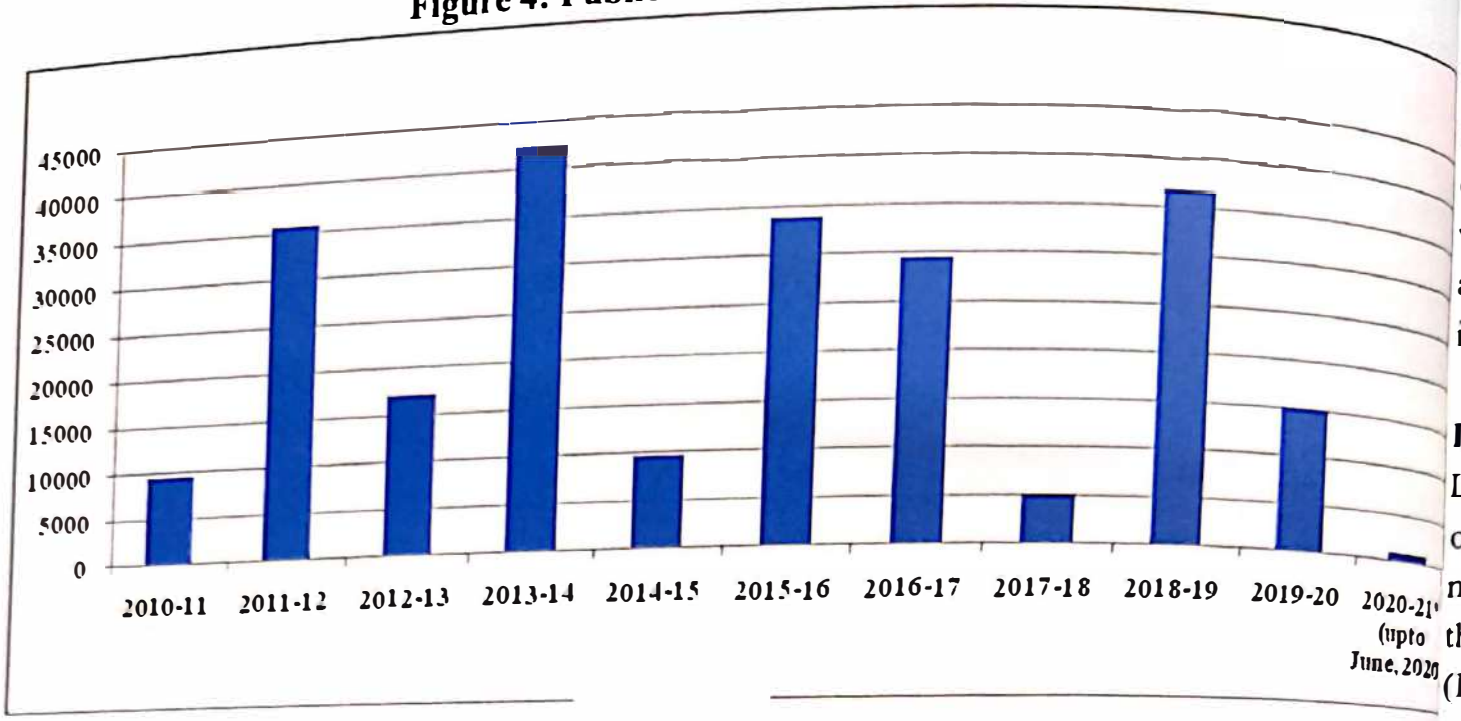
Corporate Bond Market

Public Issue of Non-Convertible Debt

Factors like high liquidity and low interest rates have lead to an increase in issuance of corporate bonds. There have been large swings in corporate debt issuances; however, the growth rate is much lower as compared to other countries. Corporate bond issuances have lead to diversification in the sources of corporate financing. There is a need to allow private sector to procure financial resources from different sources without exposing them to vulnerability (Figure 4).

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Figure 4: Public Issue of Non-Convertible Debt

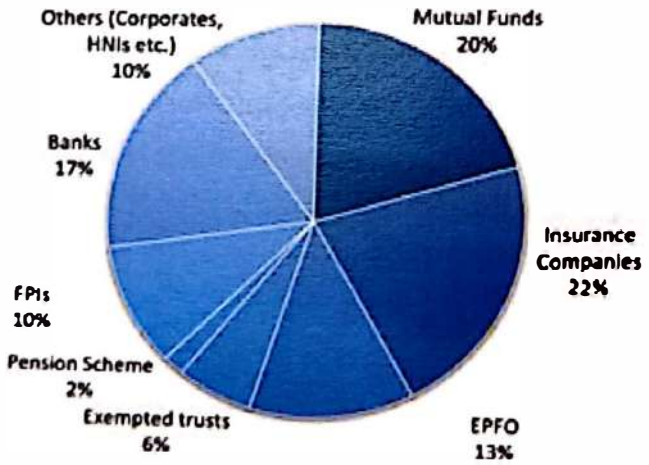


Source: SEBI

Less Investor Base

Despite of the reforms undertaken, the bond market has remained thin. There has been dominance of finance and infrastructure companies with AAA rated bonds accounting for more than half of total amount outstanding in the primary segment if the market (Figure 4). Majority of investors belong to insurance and mutual funds companies which accounts for approximately 42% of the total investments followed by banks (17 per cent), employee provident funds and national pension savings schemes (15 per cent) and FPIs and other categories of investors (26 per cent) as depicted below in Figure 4 (CRISIL Yearbook on Indian Debt Market).

Figure 4: Market Share of various classes of investors



Source: CRISIL Year Book on Indian Debt Market

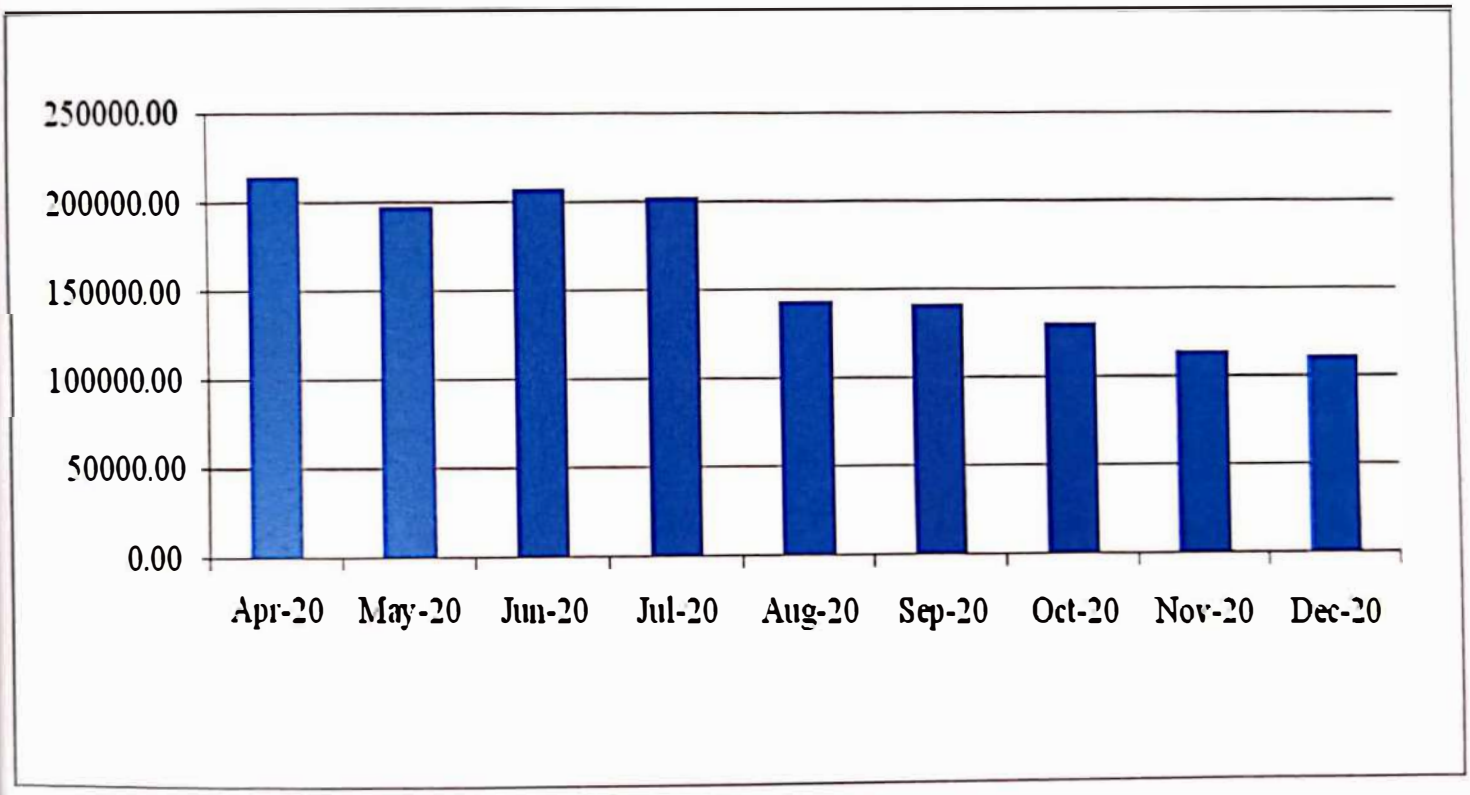
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There is a high probability of heightened volatility and exposure of the market to sector-specific risks due to a lack of investor diversity. Increased investment limits wherein RBI has allowed FPIs to invest in corporate bonds and the limit has been increased from 9 percent to 15 percent. The government is working on the inclusion of Indian sovereign bonds in global bond indices from next year which would attract more foreign investments foreign as it is mandatory for many overseas funds to track global indices (IIMA Report, 2020).

Illiquidity

Liquidity in the bond market depends on the volume of bonds in the primary market offered by issuers' on-going basis as well as the circulation of bonds with active investor participation in the secondary market. Despite, measures undertaken by RBI's to promote and foster government securities trading in the secondary market, the Indian corporate bond market needs a significant change to boost liquidity (Figure 5).

Figure 5: Trading in Corporate Bonds



Source: SEBI

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Increasing heterogeneity of investors, diversification in investment horizons, risk tolerance etc. can help in increasing liquidity in bond markets. Further, SEBI has proposed that bonds should be traded on exchange platforms the same way like stocks and g-secs are traded which would boost demand for a wider set of such securities.

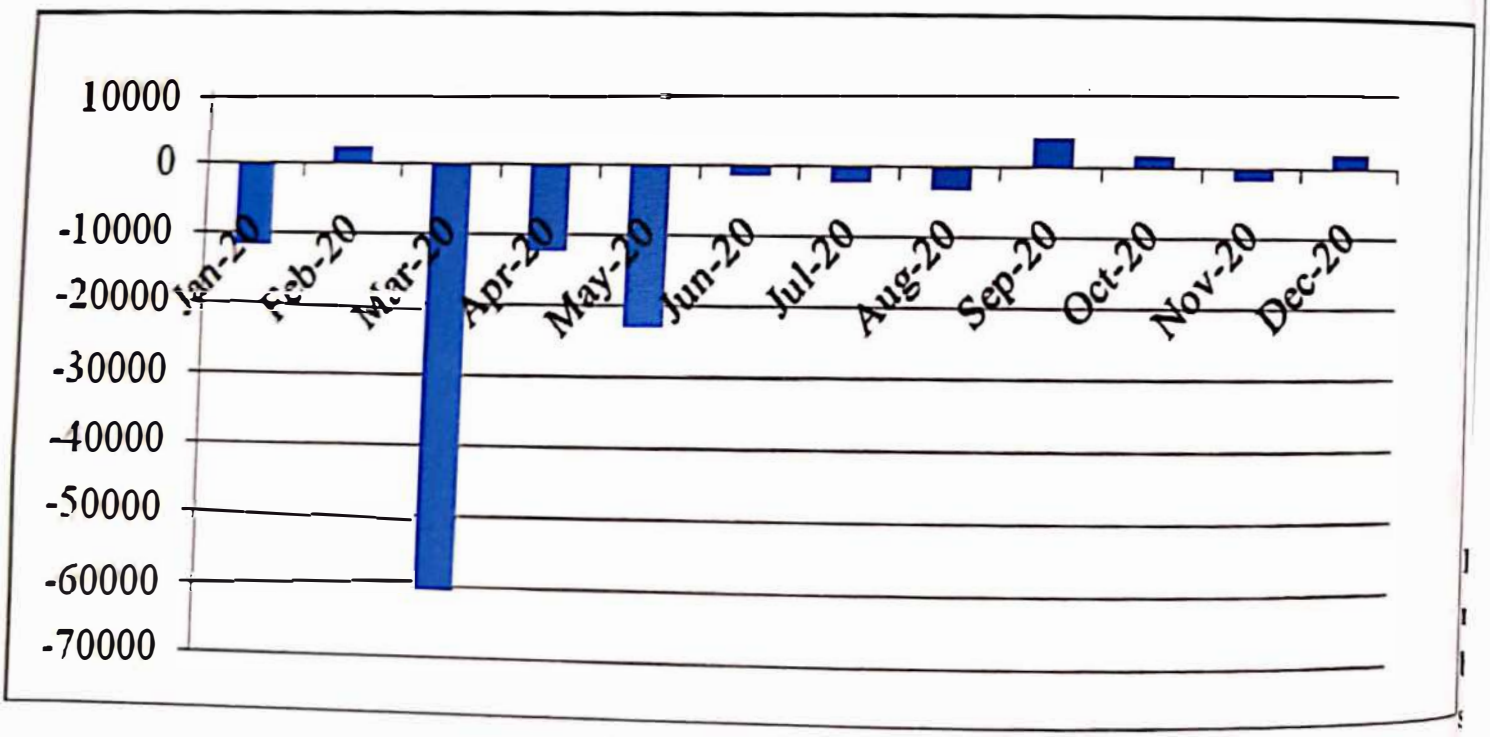
Global funds are leaving Indian bonds

Global funds own about 1.5% of the local debt as compared to about 30% in Indonesia. As India plans to sell around Rs 12 trillion ($160 billion) of bonds this financial year, foreigners could be an important source of demand for sovereign debt. There has been sale of Indian corporate and government bonds this year of around $14.6 billion by overseas fund, the most among emerging-asian economies. The flow (inflow and outflow) of debt funds is evident from Figure: 6

Some of the factors which can be attributed to foreign investors leaving the Indian debt market inter alia include:

a)Negative real rates: India has one of the lowest real returns on debt. Even mature economies like Japan, EU region, and Australia are now offering real rates of returns that are better than India. As a result, most of the risk-off flows into debt are moving away from India into a developed market, which offers better real yields on the debt.

Figure 6: Net Flows in Debt Funds (January 2020-December 2020) in INR Crores



Source CDSL

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b) Sovereign rating a major issue: It may be recollected that Moody's had recently downgraded India's sovereign debt to Baa3 in Jun-20. Global investors fear huge losses on their debt portfolio. Also, with fiscal deficit likely to cross 8% in FY21, most of these FIIs see a distinct possibility that India could see another downgrade.

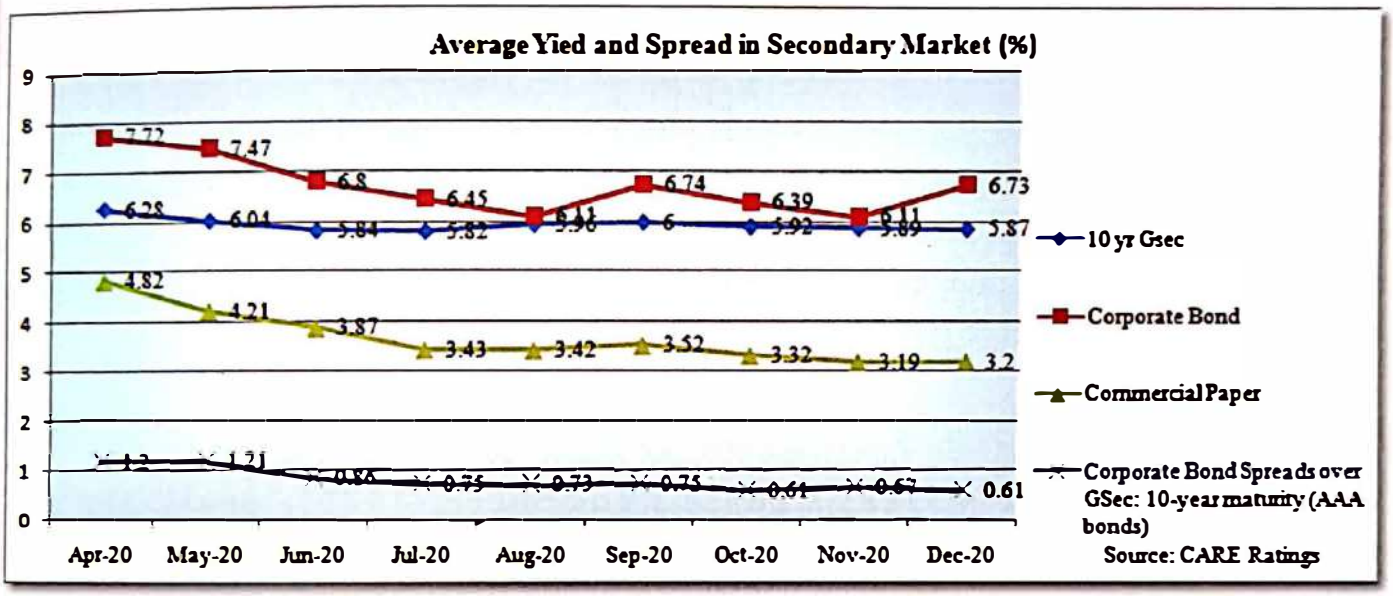
c) Weakness in the rupee: In the last one year, INR is down 8% making it one of the worst-performing EM currencies.

d) Rising NPAs: Bad loans of Indian banks have been moving up from 8.5% to 12.5% by March 2021 if a worst-case scenario played out after the EMI moratorium was lifted (RBI FSR, 2020). This could also be a big setback for the Indian rupee.

Declining yield in Corporate Bond Markets

Globally bond yields have come down and are close to zero or even negative. Driven by higher growth and better corporate fundamentals, perhaps this is an opportunity for credit investors in Asian economies looking for returns in 2021 as U.S. yields collapsed.

Figure 7: Yield and Spread in bond and G-secs market



Source: CARE Ratings

Indian corporate bond yields have performed better with those of government securities by a decent margin in lieu of TLTRO (targeted long-term repo operation) by RBI, as depicted in Figure 7. Corporate bond spreads in India have narrowed to pre-pandemic levels across the term structure. The nearly sustained decline in the yields of corporate debt securities in the last few months has been driven by demand for these securities from banks and mutual funds.

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Policy Recommendations

Tracing the development of the Indian debt market, a few of the suggestions inter alia includes:

4.1 Issuing government securities in Demat form so that the newer investor can also access the risk-free instrument would enhance retail participation. Likewise, corporate bonds can also be traded on exchange platforms like that of shares and government securities which would create demand for a wider set of such securities.

4.2 Easing regulations and giving tax incentives for developing market for foreign investment in local currency bonds.

4.3 For channeling funds and mobilising savings towards the capital market, the mutual fund industry can play a vital role.

4.4 Relaxation in restrictive investment mandates by the Government which limit the participation of financial institutions.

4.5 Encourage Small and Medium Enterprises to issue bonds and raise funds from the debt market.

4.6 As private placements dominate the primary corporate debt market, there is a need to streamline bond issuance process for more participation of investors.

Way Forward

The article discusses some of the issues hindering the smooth functioning of the Indian debt market and suggests some policy recommendations aimed at global integration and international cooperation. Going forward, promoting liquidity in the sovereign yield curve, allowing more participation of investors, and creating innovative instruments in the derivatives market can be the key areas. Implementing such measures would promote the seamless flow of funds for government securities and would also serve the interests of a growing economy like India as a whole.

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