Brickwork Ratings

Confederation of Indian Industry

MACRO-ECONOMIC, CAPITAL MARKET OUTLOOK AND KEY SECTORAL TRENDS

Foreword

India is re-emerging. Resurgent India is making great stride forward to emerge as a vibrant economic power in global economy. Capital and technology starved market has fast transformed into a vibrant one setting an ideal vantage ground for the foreign capital to be invested in the most efficient way aided by highly skilled professionals and highly productive workforce backed by political will.

Domestic markets with its many limitations are abuzz with activities. The Merger and Acquisition (M&A) activity in India reached record US$ 129.4 billion in 2018 while Private Equity (PE) and Venture Capital (VC) investments reached US$ 20.5 billion. Assets Under Management (AUM) by mutual funds in India reached Rs 23.16 trillion (US$ 334.82 billion) in February 2019 while proceeds through Initial Public Offers (IPO) in India reached US$ 5.5 billion in 2018.

With everchanging global financial market scenario, a constant appraisal, adjustments and re-adjustments of key factors are necessitated. Our business leaders, financial experts, strategists are quite alert and competent to rise to the occasion to change every situation in India's favour. Indian companies have strength in key sectors such as steel, petrochemicals, pharmaceuticals, automobiles, communication etc. at the macro level. Financial markets have also been calibrated to suit the global demands.

The Union Budget 2019-20 has come up with many announcements like merging of NRI portfolio route with FPI, allowing FIIs & FPIs investment in debt securities issued by NBFCs, deepening of corporate tri-party repo market in corporate debt securities, planning to enable stock exchanges to allow AA rated bonds as collateral, setting up of Credit Guarantee Enhancement Corporation with specific focus on infra sector and Social Stock Exchange under SEBI for listing social enterprises & voluntary organisations. With a major paradigm shift in the financial market wherein the household sector is increasingly investing more into the secondary market, it is very important for the market to embrace the Emerging Trends.

In this context, CII organized the 8th edition of Financial Market Conclave to deliberate on the recent developments in the Financial Market. CII-Brickwork Report on "Macro Economic & Capital Market Outlook and Key Sectoral Trends" released at the conclave devoted considerable time and energy in identifying the key factors and upcoming trends – both external and internal – impacting the capital market outlook in India. Not only has the CII-Brickwork team shared a set of business models and emerging trends which would be suitable in the current scenario, it has also analysed how the stakeholders can go about it in the changing market dynamics.

We hope that the readers would find this report useful.

Mr Chandra Shekhar Ghosh

Chairman, CII Eastern Region &
MD & CEO, Bandhan Bank Ltd
Kolkata, 03 August 2019

Introduction

India's growth story is largely driven by strong economic and flourishing fundamental indicators. The rapid economic growth and developmental strides of India in the last five years have been transformational and the country is all set to emerge as a USD 5 trillion economy in the next five years.

However, the liquidity crisis at the NBFCs, escalating trade war fears, higher crude prices- and several macro-economic factors led to volatility in equities that kept the primary market dull during 2018-19. Despite these challenges Indian equity markets fared reasonably well during the year 2018-19. Sensex registered a growth of 17.3%, Nifty 50 recorded a growth of 14.9% in 2018- 19 on easing of concerns over liquidity tightness, waning inflation pressures and improvement in India's ranking in the World Bank's ease of doing business index were some of the highlights.

For 2019-20, the country's growth prospects backed by a stronger rupee, lower yields in the bond market and improving bank credit. The Indian bond market has been witnessing positive outlook backed by favourable domestic macro conditions directing the lower cost of borrowing which shall likely encourage offshore flows in the economy.

As announced in the Union Budget this year, the Government of India will work with the Reserve bank of India (RBI) and Securities and Exchange board of India (SEBI) to deepen the corporate debt market giving special attention to enabling infrastructure. Also, a Credit Guarantee Enhancement Corporation will be set up in the current fiscal year as part of the measures to deepen the bond market even as enabling stock exchanges to allow AA rated corporate bonds to be treated as collateral.

The 10-year government bond yield which was quoting around 7.4% in April 2019 fell to 6.9% by the end of June. It declined further to 6.7% post the Union Budget announcement in which the Government kept its fiscal deficit target at 3.3% of GDP and proposed to tap the global markets through Dollar denominated bonds. In the last 5 years, improvement in the overall macro situation by controlling inflation, keeping fiscal deficit under check and ensuring that real interest rates remain positive is a pathway to the stage of vibrant and developed economy as a whole. These are three main things desired by global investors while investing into Indian rupee denominated government bond. However, instead of raising money overseas, the government could have also displayed more confidence by increasing the limits for foreign investors under the FPI route into the Indian Government Bond market and encourage global investors to invest in India and help develop the local bond market.

Another crucial aspect for country's development, is a liquidity boost for Banks, Non-Banking Finance Companies which had been under stress for quite some time. The government has extended a guarantee to PSU banks to absorb up to 10% of loss from the pooled assets of up to Rs 1 lakh crore purchased from 'healthy NBFCs'. This seems like a good step to bridge the trust deficit and it may revive the credit markets. However, we have to wait to see its actual impact on the bond markets as one can't offset the brutal fact that Indian debt market is less developed compared to other developed nations. The government securities and corporate bonds still remain highly illiquid.

Currently, macro backdrop remains largely supportive for the bonds. The CPI inflation, despite a near term raise, will remain well within the RBI's threshold of 4%. The RBI is likely to reduce the policy Repo rates by at least 50bps in rest of 2019.

This positivity must be well utilised as there is a huge room to be developed and to deepen the corporate bond market. This conclave focuses on the quality of financial securities which India needs to adopt and promote to prepare itself for the markets of tomorrow.

We are thankful to the members of CII and other stakeholders for their guidance in development of the reform agenda.

I would like to express my gratitude to Rajat Bahl, Anita Shetty, Ria Matwani, Praveen Pardeshi and Sukumar Bhat for their contribution in bringing out the knowledge paper for the conclave.

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An important vacuum in the Indian financial architecture is the absence of a viable institution to meet the long term financing needs of industry. In the initial years, Development Financial Institutions served this to some extent. However, the transformation of these into universal banks curtailed the supply of long term finance to industry. With corporate bond market still in a preliminary stage of development, the industry had to rely excessively on banks for long term finance. This has resulted in severe mismatch between the assets and liabilities of the banking system as they have only short term liabilities in the form of demand and time deposits, and this has caused stress in their balance sheets. The future long term financing needs of the industry, particularly those in the infrastructure sector with long gestation periods in their projects will have to be met by developing a vibrant corporate bond market.

There have been a number of initiatives taken to develop the corporate bond market. The SEBI, for example has helped to create information repository to improve transparency in the private placement market, facilitated tri-party repo trading on exchanges for improving liquidity and price discovery and promoted secondary market to improve liquidity. The government has enhanced the investment limit in Corporate Bonds for the Foreign Portfolio Investors and has reduced the tax withholding. Despite these measures, the corporate bond market in India measures a meagre 17% of GDP as compared to 74% in South Korea, 143% in Brazil, 44.5% in Malaysia 143% in Turkey and 123% in the United States. The retail investors constitute a mere 3% of outstanding issuances. The poor penetration is due to low investor base – mostly confined to institutional investors. Even the institutional investors spend more on Central and State government securities. In 2016-17, the LIC alone contributed about a half of investments in bonds, and investment by general, health and re-insurance companies was 36%. Their investment in other securities in 2016-17 was less than 5%.

The reasons for the sluggish development of the bond market in India are due to a number of factors. High cost of debt instruments vis-à-vis other forms of raising funds, liquidity problems due to the absence of a vibrant secondary market, lesser scope to tap cheaper overseas market even after hedging for exchange rate risks, non-uniformity of stamp duties across States are some of the supply side factors. On the demand side, banks continue to be a primary source of financing with 85% of the loans dispensed against on collateral assets. The market based debt instruments are accessed only by large corporates. The smaller firms may not have the required credit rating nor do they have the economies of scale enjoyed by large well established corporates in private placement. In fact, the primary debt market is dominated by finance and infrastructure companies – they together accounted for over 90% of the cumulative value of debt outstanding during 2018-19. The pattern is similar in the secondary market as well. The mutual funds have been playing an important role in widening and deepening the market by catalysing innovations and price discovery, facilitating liquidity and transparent bond valuation in the secondary market, but the overall impact has not been significant.

The enactment of Insolvency and Bankruptcy Code replacing the other resolution frameworks is expected to strengthen the investors' confidence. The announcement of Credit Enhancement Fund in the 2016-17 Budget to help the infrastructure companies to access corporate bond market is likely to help in facilitating the growth of the bond market. More recently, the 2018-19 Budget has mandated large corporates to raise 25% of their financing needs from the bond market and effective implementation of this is expected to help in deepening the market. In the budget 2019-20, government proposed to allow AA rated bonds to be used as collateral in tri-party repo market and to make trading platforms for corporate bonds user friendly.

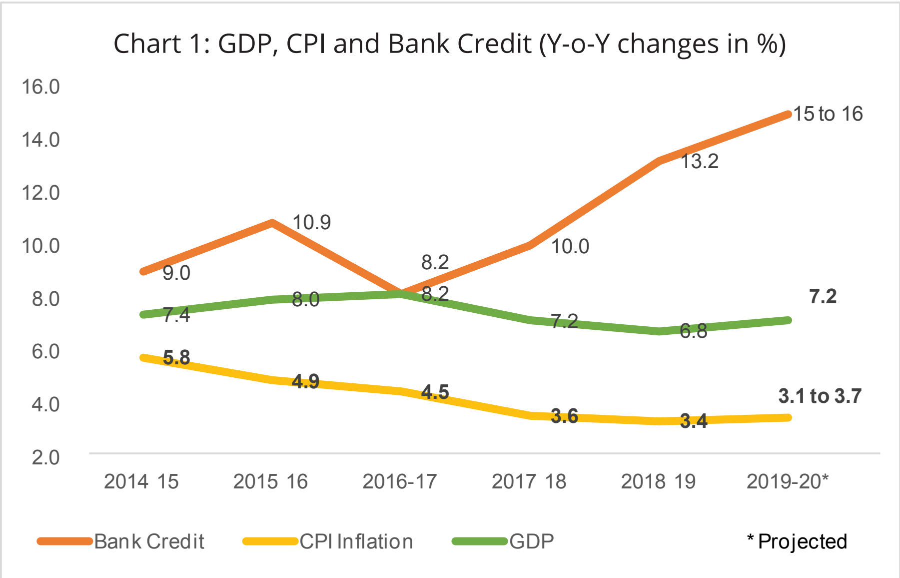
The development of a vibrant bond market is imperative to meet the financing needs and this must be an important reform agenda for all stakeholders. The immediate policy measures that are needed to enhance the bandwidth of the bond market include rationalisation of stamp duties on capital transfers across States, liquid market for credit –deposit swaps, facilitate and incentivise public issues and undertake measures to expand the investor base. In this context, CRAs perform a valuable role in the development of credit markets through objective rating process and dissemination of information and disclosures through the press releases and rationales as mandated by SEBI.

Economic Scenario

The ambitious target of the present government to expand the Indian economy to USD 5 trillion by 2024-25, necessitates India's GDP to grow at a pace of ~8% annually. However, there are challenges faced by the economy in the form of liquidity crisis, slowdown in bank credit amid deteriorating asset quality of banks and fall in exports during 2018-19. The geo-political tensions like rising protectionism, trade conflict between United States and China, Brexit, US sanctions on Russia, Iran and Venezuela also impacted economic activities to a great extent. All these domestic and global factors brought down the economic growth to a 5-year low at 6.8% during 2018-19.

Despite a moderation in real GDP growth in 2018-19 by 40 basis points over 2017-18, Indian economy remained one of the fastest growing in the world displaying better growth prospects. The economy is expected to emerge fundamentally and financially strong in the coming years with the acceleration in growth through new policy initiatives and continued economic reforms. Moderate levels of Inflation and improvement in bank lending amid easy monetary policy improved the economic prospectus recently and as per RBI projections, the GDP is expected to grow at a rate of 7.0% during 2019-20 (Chart 1).

Capital markets play a crucial role in the economic development of a country. They provide financial resources required for the long-term sustainable development of the economy. Development of viable capital markets is therefore considered an important element in the macro-financial policy toolkit, including for objectives such as financial stability and the transmission of monetary policy.



Source: RBI, MOSPI, BWR Research

Easy Monetary Policy Stance Cushioned by Moderate levels of Inflation

High levels of inflation make holdings of financial assets economically unattractive relative to non-financial assets such as housing and gold. Thus, one of the major preconditions of macroeconomic stability, i.e., maintaining low level of inflation is necessary for the financialisation of savings and capital market development.

Adoption of flexible inflation target at 4% (+/-2%) by Monetary Policy Committee (MPC) since 2016 provided an effective monitoring of inflation and accountability mechanisms. The flexible inflation targeting, helped by low oil prices and food supply management, has kept the headline inflation under control in the recent years, within the MPC's mandated target (Chart 1). This helped the MPC to change its monetary stance from neutral to accommodative, and reduce the interest rate by 75 basis points in the year 2019 (Jan to June). However, the main concern is transmission of interest rates. With banks and NBFCs facing huge liquidity crunch, the interest rates continue to remain high reflected in the median Marginal Cost of Lending Rates (MCLR) of scheduled commercial banks which remained high in the range of 8.75% in 2018-19 as compared to 8.40% in 2017-18.

Liquidity Management by RBI

During 2018-19, banking systemic liquidity experienced significant shift owing to two autonomous factors, i.e., frequent forex intervention (sale of dollars) by RBI and huge expansion of currency in circulation. To manage liquidity needs of the system efficiently, the Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR) has been increased with effect from October 1, 2018, which supplemented the ability of individual banks to avail liquidity from the repo market against high-quality collateral. Furthermore, RBI decided to reduce the statutory liquidity ratio (SLR) by 25 bps every calendar quarter until it reaches 18% of Net Demand and Time Liabilities (NDTL) to align the SLR with the LCR requirement. Furthermore, RBI infused durable liquidity of INR 2,99,250 crore through open market operations (OMOs) and continued to inject funds though repo and term repo under Liquidity adjustment facility (LAF) window. In addition to this, the RBI introduced a new liquidity management tool in the form of dollar-rupee swap on March 2019. RBI has conducted two sets of FX swap auctions (March 26 and April 23, 2019), with a fixed tenure of three years and has infused a total of Rs 69,435 crore (USD 10.2 billion) liquidity into the domestic markets.

Despite these measures, banks continued with liquidity shortage. Nevertheless, these measures helped the banks to increase their lending to productive sectors of the economy. Outstanding bank credit growth which remained within 8 to 10% levels in the last two fiscals improved noticeably and crossed 13% during 2018-19. However, NBFCs continued to face liquidity shortage and unable to lend. To address the liquidity needs of NBFCs, the RBI issued guidelines on 2 November 2018, allowing partial credit enhancement (PCE) to bond issuances by NBFCs and Housing Finance Companies (HFCs), to improve funding access. The purpose of PCE bonds issued is to refinance any existing debts of NBFCs/HFCs. The contours of this guideline needs to be relooked so as to get more acceptance among borrowers as well as guarantee providers because in current form it hasn't took off yet.

Government and RBI has initiated certain steps in order to improve the liquidity position and keep the funds flowing into NBFCs –

- The relaxation of asset securitisation norms by RBI in November 2018 has helped ease the liquidity issues to some extent. The total securitisation volumes have almost doubled reaching close to Rs 2 trillion in FY19 most of which was raised by NBFCs and HFCs through sell-down of their retail and SME loan portfolio to various investors.

- Proposal to remove Debenture Redemption Reserve (DRR) and special reserve currently applicable for public issues in the Budget 2019-20, provide further fillip to NBFCs to access the retail market to meet their borrowing requirement, a move that was necessitated after a pullback from MFs investing in NBFCs.

- For purchase of high-rated pooled assets of financially sound NBFCs, amounting to a total of Rs 1,00,000 crore during the current financial year, Government will provide one time six months' partial credit guarantee to Public Sector Banks for first loss of up to 10%. The efficiency of this measure needs to be seen in the coming period.

Box 1: Bank credit still remains the preferred mode of financing

The mounting pressure of non-performing assets (NPAs) which limits bank lending and shortage of liquidity in NBFCs makes development of the corporate bond market in India all the more critical for meeting the financing requirement of industry and infrastructure sector. An active corporate bond market also helps in the diversification of risks in the financial system.

Below chart explains the dependability of corporates on bank loans (47% of total) and other alternative sources. It has been also observed that when bank's get vary of lending to corporates, they access debt markets. The inverse relationship between these two funding sources are captured in the trends in the outstanding debt and bank credit growth in the chart below.

Between FY12 to FY19, bond outstanding has grown at a CAGR of 17%, while bank credit registered a CAGR of 11% during the same period.

Higher growth in bonds as compared to bank credit have resulted in an increase in the ratio of corporate bonds to overall debt.

Chart 2 (a): Sources of Debt for Corporates (March 2018)

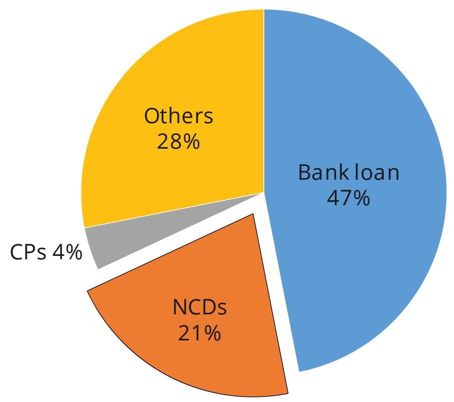
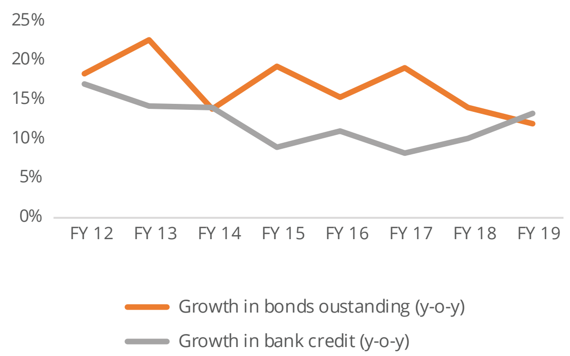


Chart 2 (b): Trends in Outstanding Bank Credit and Corporate Debt

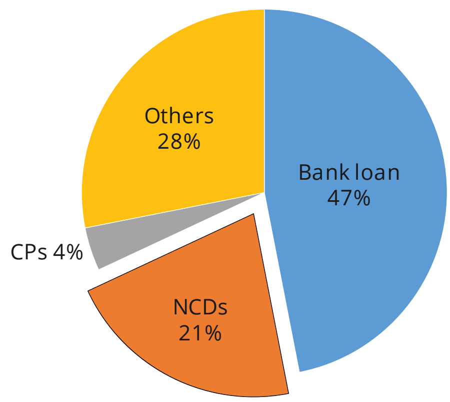


Source: Ace Equity, SEBI, RBI, BWR Research

Corporate Bond Market - Snapshot

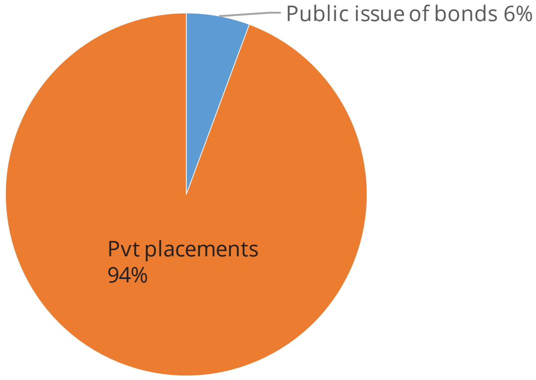
Heavy dependency on bank borrowing

Sources of Debt for Corporates (2018)



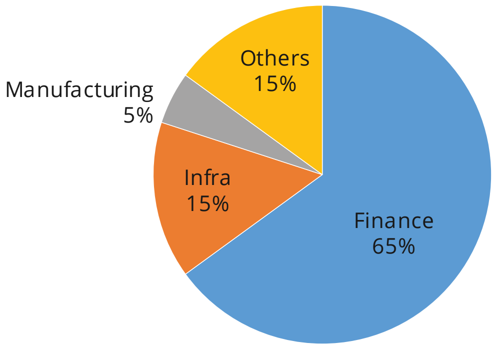
Private placements preferred

Public issue vs Pvt placements (2019)



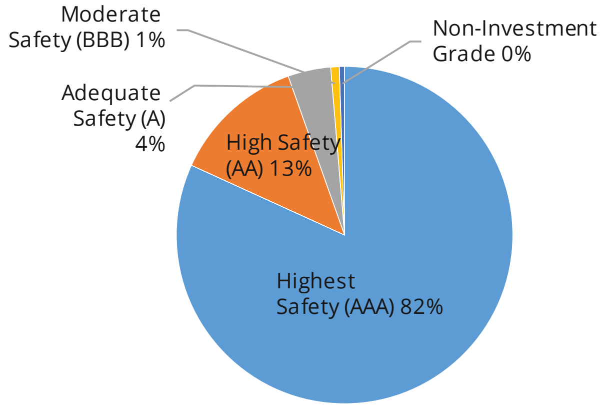
Financial services sector enjoys major share

Sectoral share in secondary market for corporate debt (2019)



Dominance of high rated bonds

Corporate Debt by Ratings (2019)



Source: Ace Equity, SEBI and BWR Research

Corporate Bond Market - A viable institution to meet the long-term financing needs

A developed bond market significantly increases the depth of the financial markets by serving the needs of both the private and public spheres better. This assumes a role of even greater significance given the asset quality of banks, liquidity crisis faced by NBFCs etc. RBI and SEBI along with government have undertaken several initiatives to strengthen the regulatory and supervisory frameworks to increase the resilience of the corporate debt market. Yet, India's bond market remains small compared with other major economies. Moreover, bank credit still remains a preferred mode of financing for a majority of firms particularly SMEs. (refer Box 1).

The Union budget 2019-20, stressed on the required investments for India (which may average Rs 20 lakh crore annually or USD 300 billion) on the back of proposed target of achieving 8% GDP growth every year. Budget has also estimated that Railway Infrastructure would need an investment of Rs 50 lakh crore between 2018 and 2030. On the above background, proposed a number of measures to enhance the sources of capital for infrastructure financing. Hence, the Corporate Debt markets are crucial for the infrastructure sector, the budget also proposed a few measures to further deepen bond markets namely, to allow AA rated bonds to be used as collateral in tri-party repo market and to make trading platforms for corporate bonds user friendly.

Overview of the Capital Markets in India

All the major segments of the capital market, viz., Central Government securities (G-Sec) market, market for State Development Loans (SDL), corporate bond market and equity market have experienced consistent growth during the past few years in terms of primary issuance, market capitalisation (for equity market) and trading volumes in the secondary market.

In the cash segment, equity market remains the largest segment, even as G-Sec, SDL and corporate bond markets have grown steadily. Though the growth in corporate bond market is at par with the equity market, but the secondary market turnover in corporate bond market is much lower compared other segments of the capital market.

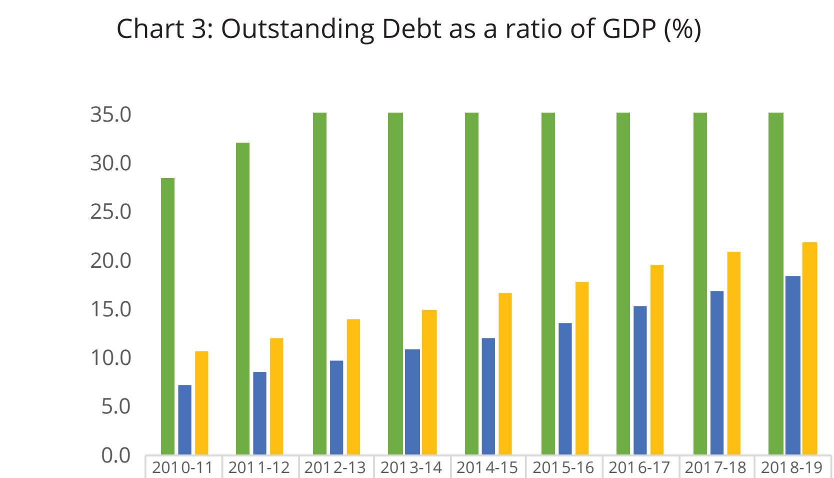
Table 1: Secondary Market Turnover in Financial Markets (Amount in Rs crore)

	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Government Securities Market	2,552,181	3,099,108	5,920,929	7,968,661	9,149,608	8,557,672	15,198,472	9,830,117	7,907,618
	(33.4)	*(35.5)*	*(59.5)*	*(70.9)*	*(73.4)*	*(62.1)*	*(98.9)*	*(57.5)*	*(41.6)*
Forex Market Turnover	2,311,739	2,624,112	3,316,787	4,225,846	5,114,340	5,512,112	7,008,460	6,035,678	6,511,074
	(30.3)	*(30.0)*	*(33.4)*	*(37.6)*	*(41.0)*	*(40.0)*	*(45.6)*	*(35.3)*	*(34.3)*
Equity Market Turnover	4,682,437	3,478,391	3,257,053	3,330,152	5,184,500	4,977,072	6,054,422	8,317,987	8,724,625
	(61.3)	*(39.8)*	*(32.8)*	*(29.6)*	*(41.6)*	*(36.1)*	*(39.4)*	*(48.7)*	*(45.9)*
Corporate Debt Market	**195,532**	**243,277**	**293,728**	**378,729**	**1,091,293**	**1,022,408**	**1,470,662**	**1,798,098**	**1,799,660**
	(2.6)	*(2.8)*	*(3.0)*	*(3.4)*	*(8.8)*	*(7.4)*	*(9.6)*	*(10.5)*	*(9.5)*
GDP at market prices	**7,634,472**	**8,736,329**	**9,944,013**	**11,233,522**	**12,467,959**	**13,771,874**	**15,362,386**	**17,095,005**	**19,010,164**

Note 1: Secondary market turnover includes only for Spot markets, **Note 2:** Figures in brackets represent percent to GDP at current market prices.
Source: RBI, CCIL, SEBI, CSO, BWR Research

Liquidity in the secondary market for government securities has noticeably improved over the past decade which constitute around 41% of GDP during 2018-19. Equity and forex markets also exhibit similar trends in their trading volume in the secondary market whereas, corporate bond markets represent meagre trading volume. Even though, the corporate bond market turnover has grown over the years (with the secondary market turnover to GDP ratio grown from 2.0% in 2010-11 to 9.5% in 2018-19) is still far behind compared to other cash market segments of the capital markets.

Total outstanding debt in India during 2010-11 was around 50% of GDP with Central government dated securities accounting for 31% of GDP as compared to 7.9% of the State development Loans and 11.7% of Corporate bonds. In a span of 9 years, total outstanding debt increased to 60% of GDP and G-sec market still holds the major portion. However, the interesting part is consistent rise in the share of outstanding corporate debt compared to miniscule change in the share of G-sec debt over the years (Chart below).



	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
G-sec	28.5	32.0	35.5	38.0	39.5	40.2	39.9	40.4	40.8
SDLs	7.3	8.5	9.7	10.8	12.1	13.5	15.3	16.9	18.3
Corporate Debt	10.7	12.0	14.0	15.0	16.6	17.8	19.6	20.8	21.8

Source: RBI, MOSPI, SEBI, BWR Research

India's bond market remains small compared with other major economies

In terms of size, Indian corporate bond market is not only small compared with other domestic capital market segments, but also significantly lower compared to some developing countries such as Malaysia, South Korea, Brazil and Turkey (Table 2). The corporate debt to GDP ratio in India is at a meagre 17% of GDP as compared to 74% in South Korea, 143% in Brazil, 44.5% in Malaysia 143% in Turkey and 123% in the United States. The absence of retail investors in the Indian debt markets is one of the major reasons, which is evident from a mere 3% of outstanding issuances by retail investors.

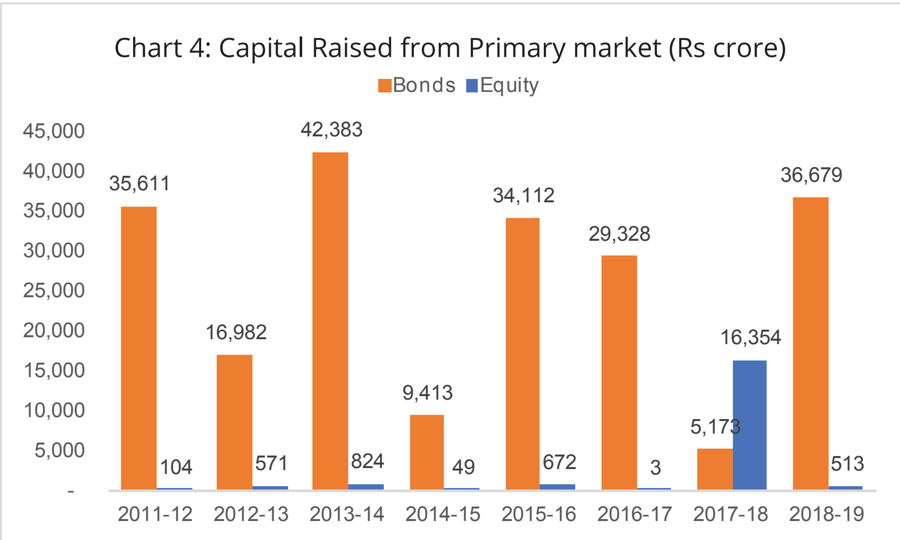
Compared to other countries, the proportion of firms using banks as the primary source of working capital and the proportion of loans requiring collaterals as well as the value of collateral (as proportion of loan) is higher in India. This indicates the prevalence of asset-backed lending in India, which is essentially a feature of a relatively less developed financial system with limited expertise to gauge the credit risk of unsecured lending.

Table 2: Corporate Debt Market Penetration (as% of GDP)-June 2018

Countries	Corporate Bonds to GDP Ratio
US	123.47
China	18.86
Japan	14.57
South Korea	74.30
Singapore	34.02
Malaysia	44.50
India	17.16
Brazil*	99.05
Turkey**	142.06
*: Data pertains to 2014; **: Data pertains to 2015.	
Source: RBI Bulletin, Jan 2019, BWR Research	

Primary Market: Debt dominates in terms of financing options

The total resource mobilisation by Indian corporates through public/private/rights issues is dominated by debt.

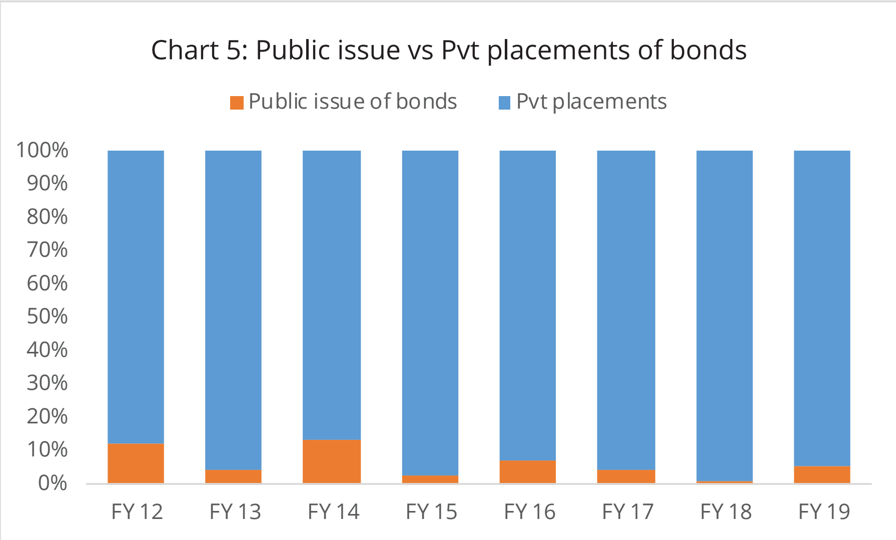


Source: SEBI, BWR Research

The most notable feature of the debt market is that bulk of the debt (close to 99%) is placed privately, which has not changed despite various measures taken by the regulators in the past.

Private placement constitutes 95% of Primary Debt market

Private placements dominate the primary corporate debt market with 95% of total issuances amounting to Rs 6,103 billion in 2018-19 as against Rs 366 billion of public issues, as ease and timeliness makes private placements the most preferred way of raising debt. Within private placement market, insurance companies are the major players as they find such investment attractive due to long-term and fixed nature of their liabilities.



Source: SEBI, BWR Research

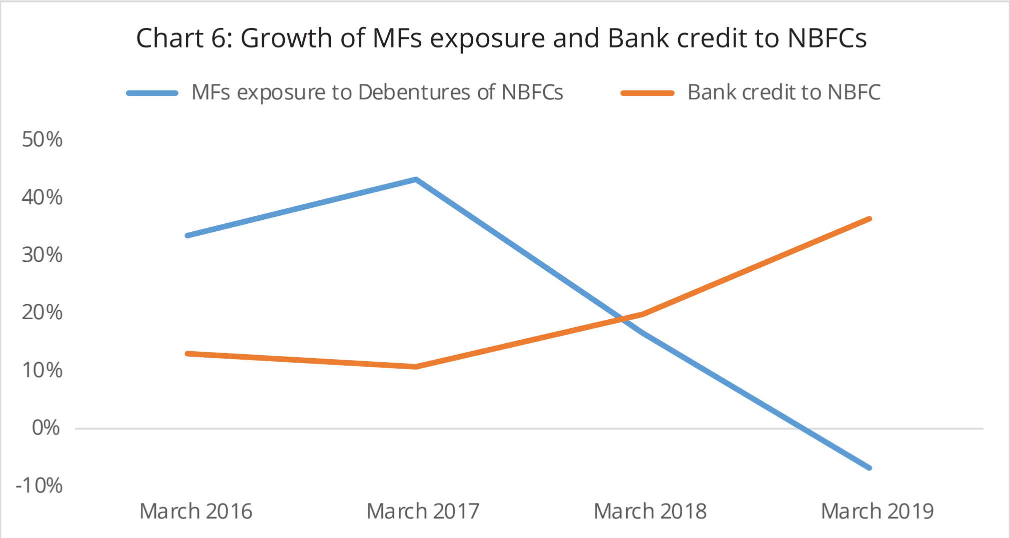
Primary market issuance processes and costs are important factors in the decision of a corporates to access the corporate bond market. Most of the bond issuance in India has moved to the private placement market, because it allows corporates quick access to funds at fairly low cost.

To encourage public issue of bonds and to make the existing process of issuance of such securities simpler and cost effective, SEBI in August 2018 cut the timeline for listing of debt securities to six days from 12 days. Also, SEBI has made ASBA (Application Supported by Blocked Amount) mandatory for all the investors for making payment while applying in a public issue of debt securities. This facility would reduce the time taken for collecting banks to commence clearing of payment instruments, forwarding application forms along with bank schedules to registrar and undertaking of technical rejection test.

The Self Certified Syndicate Banks (SCSBs) or intermediaries will have to provide guidance to their investors on making applications in public issues. Recently, regulators have tried to improve transparency and disclosures in the private placement market through requiring listing of privately placed securities on the exchanges in order for these to be eligible securities for the institutional investors. However, this has resulted in taking away the advantages of private placement avenues for issuers as these securities have now to be listed. Further problems remain in streamlining the disclosure requirements for private placements to the needs of fixed income instruments - making it burdensome for first-time issuers and unlisted firms.

Financial services are the major issuers, though NBFCs facing issues raising money lately

Financial services especially NBFCs are the major issuer of debt instruments in the market. These players are facing a liquidity crisis post the IL&FS default as mutual funds which are the major subscribers of debentures issued by NBFCs have turned wary of investing in NBFCs, which has seen a decline of 7% y-o-y as on March 2019. (Chart 6).



Source: SEBI, RBI, BWR Research

While on the other hand, bank credit to NBFCs has been steadily increasing. In the last couple of years i.e. FY18 and FY19, bank credit to NBFCs has grown by 20% and 37% respectively, which is much faster than 10% and 13% growth seen in FY16 and FY17, when market borrowings were still on the rise.

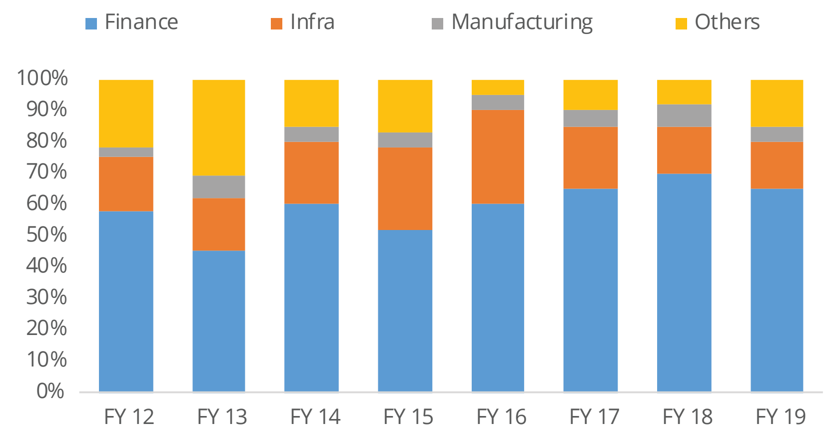
Hence, NBFCs are getting more dependent on the banks to fulfill their funding requirements, but banks have other restrictions. The credit-deposit ratio of banks has reached around 78% from a low of around 73% seen 2 years back, which means banks are lending more out of their deposits. Banks are running out of space to continue lending, unless they can shore up their own deposits.

If the lending growth continues to outpace deposit growth, the banks will be under pressure to raise more deposits. This leads to inability to transmit the effect of rate cut by RBI, on the contrary, banks might be forced to increase their deposit rates and thereby increase their lending rates as well.

Secondary market lacks liquidity due to limited retail participants

In terms of trading volumes in the secondary market, corporate debt market lacks liquidity compared to equity markets. Retail participants prefer to invest in equities and investor interest in trading in the secondary market also reflects the easy accessibility of the market. On the other hand, corporate debt market is dominated by Finance and Infrastructure sector (accounts for almost 80% of the overall corporate debt traded in the secondary market) while manufacturing companies have a very low share.

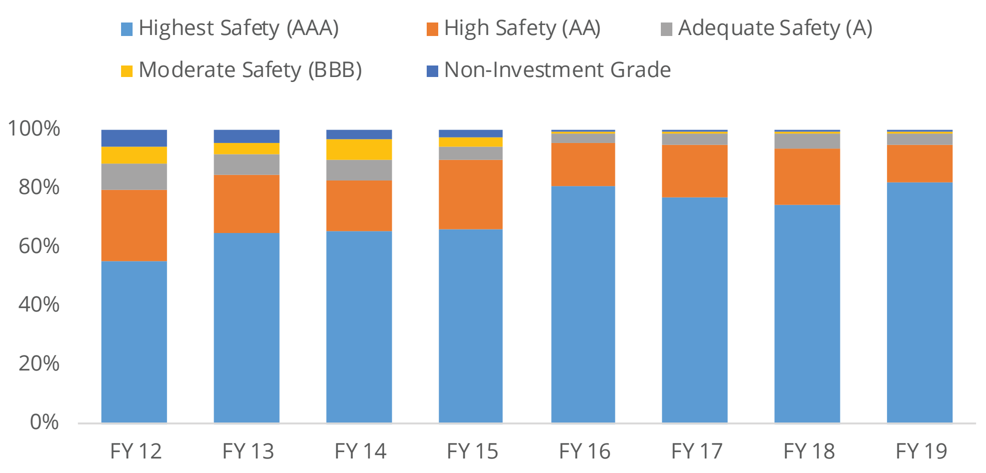
Chart 7: Sectoral share in secondary market for corporate debt



Source: RBI Bulletin, BWR Research

High rated bonds dominate the corporate bond market accounting more than 80% of the total corporate debt in the market. The higher concentration of high-rated bonds in the corporate debt market could be attributed to low market bandwidth and limited investors' appetite for bonds with high risk-return combinations.

Chart 8: Corporate Debt by Ratings (Maturity >=1 year)



Source: SEBI, BWR Research

The Indian corporate debt market has historically been characterised by the issuance and trading activity restricted to debt securities rated in the 'BWR AAA'/'BWR AA' category (or equivalent by other CRAs) on the national rating scale. Prior to 2008, over 90% (by value) of bonds issued were rated at 'AA' or above (or equivalent). This ratio has fallen post 2008 to below 85% and then again reversed in favor of high rated bonds in the last 3-4 years (Chart 8).

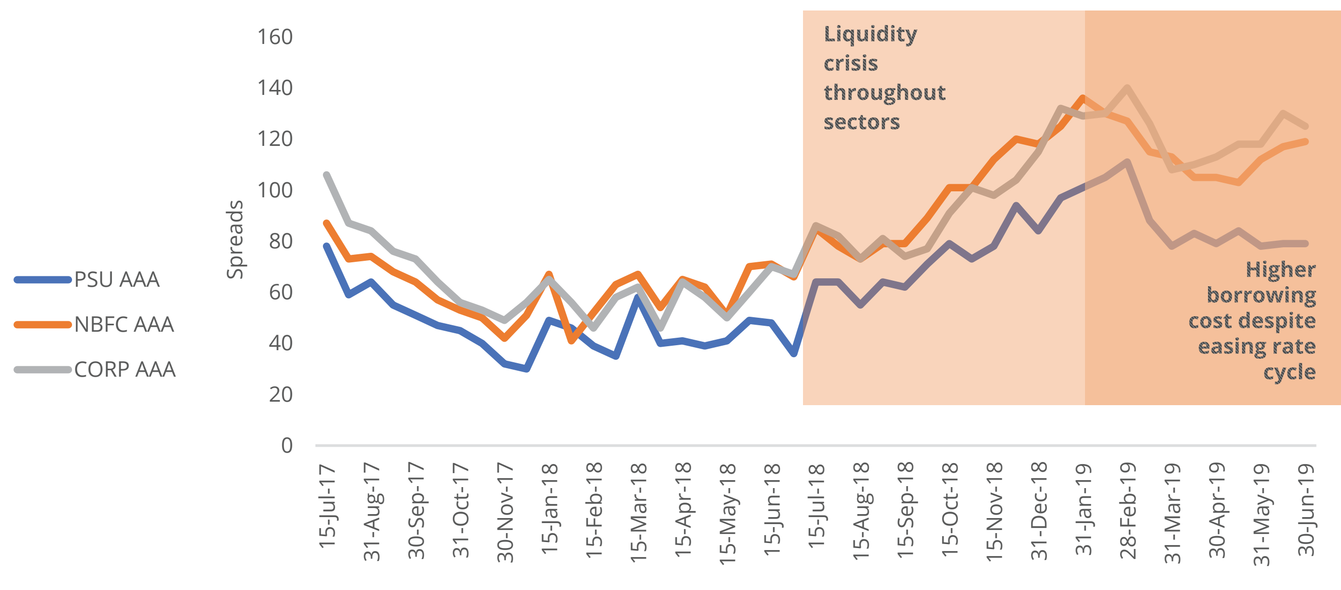
Rising Cost of Borrowings

As mentioned earlier, corporate bond markets play a critical role for companies in accessing the long-term financing needs. Today, companies wanting to borrow long term in local currency to finance expensive investments are faced with a dearth of adequate institutional sources. The absence of a deep and liquid corporate bond market at the longer end of the maturity spectrum causes corporations either to go for rolling shorter maturity borrowings, which tend to be more expensive, or to go for foreign borrowings, which pose exchange-rate risks. The rising cost of borrowing is also one of the major reasons behind this.

The cost for raising funds for the issuers has been volatile across sectors. Some issuers have been able to take advantage of the falling interest rate trend while some had to borrow funds at a huge cost. The Indian debt market witnessed liquidity crisis during early second half of financial year 2019 due to slew of defaults evoked in the NBFC sector starting from a major government owned entity leading the pathway to negative investor sentiments and thus higher cost for the borrowers.

As per FIMMDA, the spread between PSUs, NBFCs and corporates with 10-year maturity widened significantly in the recent period, despite RBI MPC's easy monetary policy stance (Chart 9).

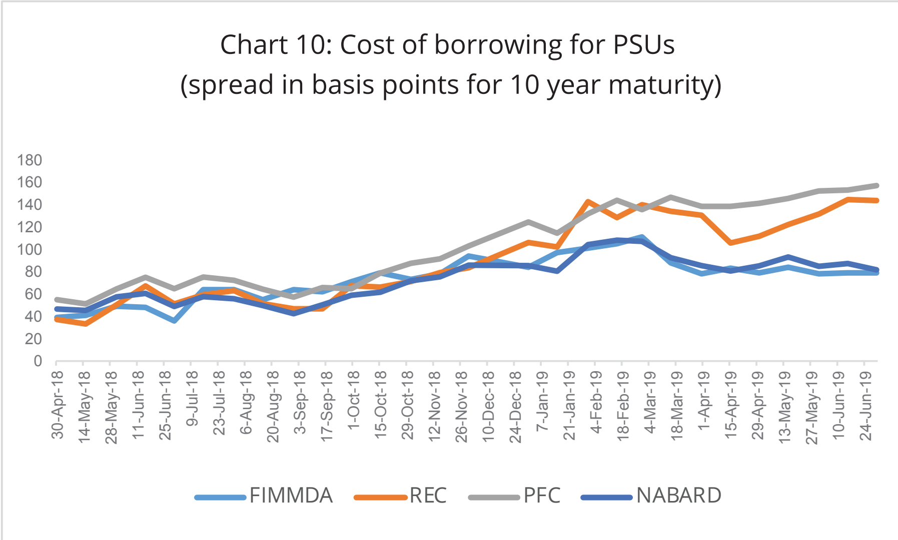
Chart 9: 10-year Corporate Bond Spreads trend in last 3 years



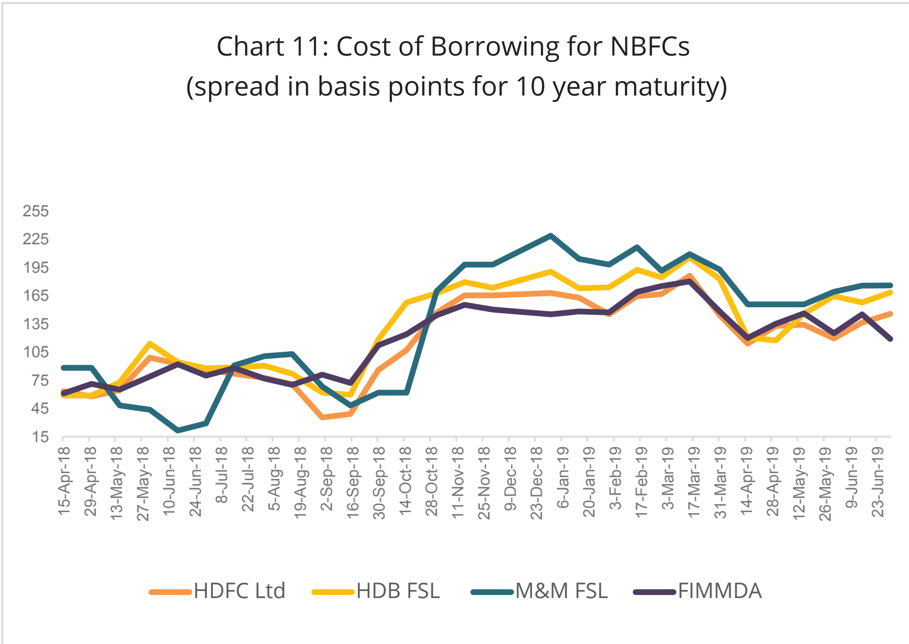
Source: FIMMDA, AIMIN, BWR Research

The poor transmission of rate cuts is evident from higher borrowing costs for the companies witnessed in the past one year period. For instance, FIMMDA gilt curve reported 42 bps increase in yields during the period between April 2018 and April 2019, and PFC witnessed a huge 94 bps jump in yield rates during the same review period (Chart 10).

The cost of borrowing for the Public Sector Units (PSUs) including Financial Institutions and Banks with 10-year maturity has rose around 27-94 basis points on April 15, 2019 compared to a year ago. The benchmark PSU curve has moved by 42 basis points.

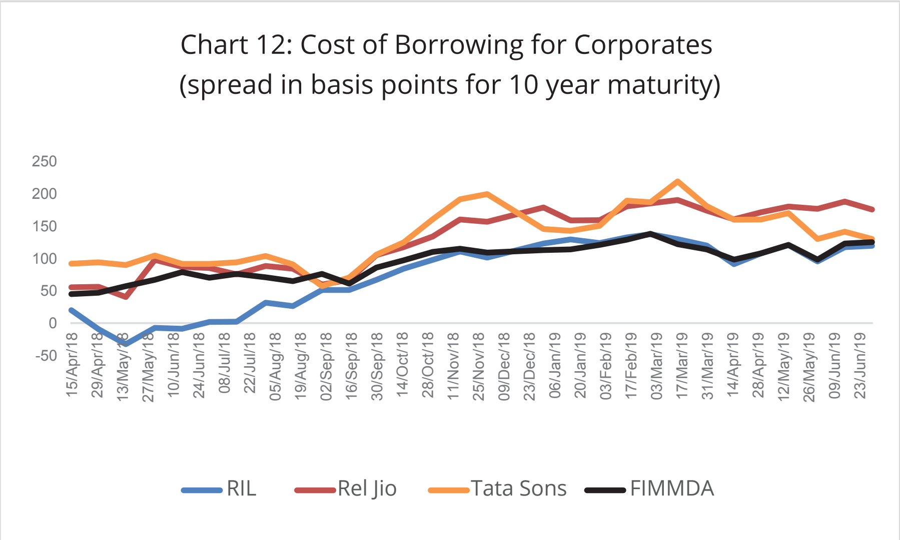


Source: FIMMDA, AIMIN, BWR Research



Source: FIMMDA, AIMIN, BWR Research

The cost of borrowing for the Non-Banking Finance Companies (NBFCs) including Housing Finance Companies (HFCs) with 10-year maturity has rose around 50-67 basis points on April 15, 2019 compared to a year ago. The benchmark NBFC curve has moved by 59 basis points. Negative investor sentiments due to IL&FS default on their various debt papers have caused the inching up of cost for the issuers (Chart 11).



Source: FIMMDA, AIMIN, BWR Research

The cost of borrowing for the Corporates with 10-year maturity rose around 68-105 basis points on April 15, 2019 compared to a year ago. The benchmark Corporate curve has moved by 53 basis points (Chart 12)

Recent Initiatives to Revive Corporate Bond Markets

As explained earlier, the bond market in India is far behind in terms of liquidity compared to other segments of the capital markets. To further deepen the bond markets the government and regulatory bodies have come out with various measures. Below is the list of recent initiatives taken by Government /SEBI / RBI:

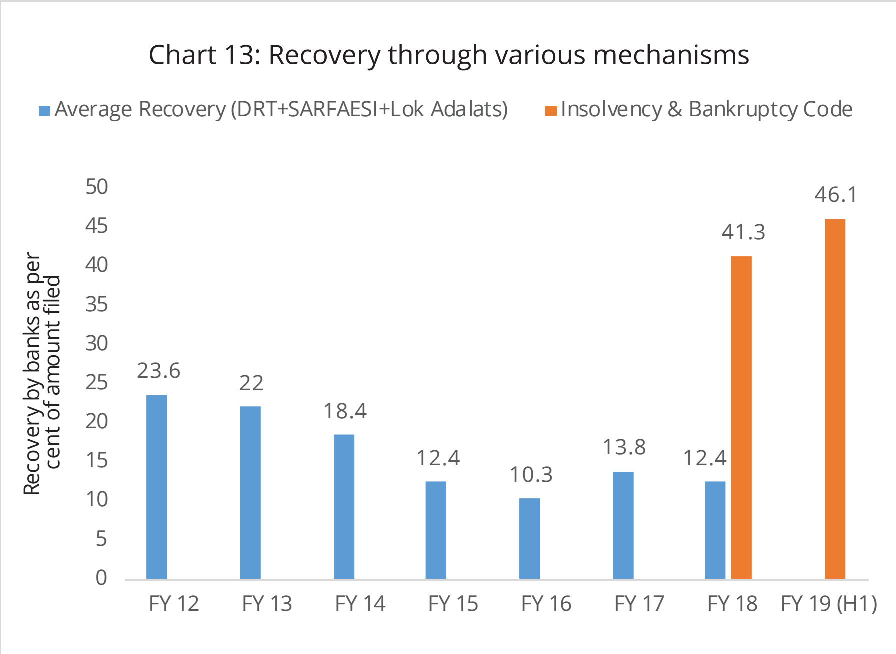
Recent Regulatory initiatives	Rationale / Purpose
VRR for Foreign Portfolio Investors (FPIs) Investment in Debt: The Reserve Bank launched the Voluntary Retention Route (VRR) in debt on March 1, 2019 under which, FPIs can voluntarily commit to remain invested in a Committed Portfolio Size (CPS) for a committed retention period (minimum period of three years or as decided by the Reserve Bank). Investments through this Route will be free of certain regulatory norms applicable to FPI investments under General Investment Limit. Participating FPIs are provided special facilities such as permission to carry out repo/reverse repo transactions for cash management and the use of currency/ interest rate derivatives to hedge currency/ interest rate risks. The first tranche of investment limits (₹400 billion for investment in Government Securities (VRR-Govt.) and ₹350 billion for investments in Corporate debt instruments (VRR-Corp)) were made available for allotment 'on tap'.	To encourage FPIs willing to undertake long-term investments to invest in Indian debt markets.
The requirement of 1 per cent security deposit to be deposited by the issuer with the stock exchange prior to the opening of subscription list has been omitted.	In order to ease the cost and compliance burden on the issuer in case of public issue, it was decided that the requirement of 1 per cent security deposit may be deleted from the regulations.
The RBI constituted a task force on the development of of secondary market for corporate loans. It will suggestrequired policies for facilitating the development of secondary market in corporate loans, including loan transaction platform for stressed assets, creation of a loan contract registry, its ownership structure and related protocols such as the standardisation of loan information, independent validation and data access. The report of the task force is due by the end of August 2019.	Development of secondary market for corporate loans
Government will work with RBI and SEBI to enable stock exchanges to allow AA rated bonds as collateral (Budget Proposal)	To boost the liquidity in corporate bonds
Measures will be announced to deepen the corporate tri party repo market in corporate debt securities (Budget Proposal)	To deepen the bond market
The requirement of creating a Debenture Redemption Reserve (DRR), which is currently applicable for only public issues as private placements are exempt, will be done away with for NBFCs (Budget Propsal)	Removal of Debenture Redemption Reserve (DRR) and special reserve, provide further fillip to NBFCs to access the retail market to meet their borrowing requirement, a move that was necessitated after a pullback from MFs investing in NBFCs
For purchase of high-rated pooled assets of financially sound NBFCs, amounting to a total of Rupees one lakh crore during the current financial year, Government will provide one time six months' partial credit guarantee to Public Sector Banks for first loss of up to 10% (Budget Propsal)	To improve the liquidity position of the NBFCs
The RBI announced in June 2019 its direction on interest rate derivatives. As per RBI, there is now a need to permit flexibility for exchanges and market-makers in the design and innovation of products while ensuring that relatively less informed participants using these derivatives markets are adequately protected.	To boost participation in hedging of interest rate risks
A Credit Guarantee Enhancement Corporation will be set up in the current fiscal year (Budget Proposal)	To deepen the bond market

Source: RBI, SEBI websites, BWR Research, Budget Documents

Improvement in recovery post IBC introduction can boost confidence in the market

In addition to liquidity enhancing measures and easy accessibility of the bond market, the introduction of IBC also helped to improve corporate debt market outlook.

Introduced in May 2016, the Insolvency & Bankruptcy Code (IBC) is a game changer in the resolution of NPAs in India because it provides a framework for time-bound insolvency resolution (180 days extendable by another 90 days) with the objective of promoting entrepreneurship and availability of credit while balancing the interests of all stakeholders. As per RBI's Report on Trend and Progress of Banking in India 2017-18, the average recovery through mechanisms that existed before IBC viz., the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act, Debt Recovery Tribunals (DRTs) and Lok Adalats has been declining over the years (Chart 13). The average recovery through IBC is greater than these mechanisms and is also improving gradually, pointing to the need and efficiency of such a channel.



Note: Data on average recovery (DRT+SARFAESI+Lok Adalats) is not available for 2018-19: H1

Source: RBI, BWR Research

Corporate Insolvency Resolution Process (CIRP)

The experience so far has been encouraging with IBC providing resolutions to some large corporate debtors. Raw data suggests that the number of cases ending with liquidation is about four times higher than those ending with a resolution plan. Liquidation could be an efficient mode of resolution for debtors in default for long time wherein the scope for revival of the enterprise is low and liquidation value exceeded resolution value. As such, the number of liquidation orders should be seen as a natural step towards efficient reallocation of resources rather than an adverse consequence of IBC itself (Table 3). Further, the government has proposed eight amendments in the Insolvency and Bankruptcy Code. One of the amendments will enforce a strict 330-day timeline for the insolvency resolution process, including any legal challenges. These amendments are aimed at speeding up the bankruptcy resolution process and fill critical gaps in the law.

Table 3: Corporate Insolvency Resolution Process (CIRP)

Quarter	No. of CIRPs at the beginning of the Quarter	Admitted	Closure by			No. of Corporates undergoing Resolution at the end of the Quarter
			Appeal / Review	Approval of Resolution Plan	Commencement of Liquidation	
Jan-Mar, 2017	-	37	1	-	-	36
Apr-Jun, 2017	36	129	8	-	-	157
July-Sept, 2017	157	232	18	2	8	361
Oct-Dec, 2017	361	147	38	7	24	439
Jan-Mar, 2018	439	195	20	11	59	544
Apr-Jun, 2018	544	246	20	14	51	704
Jul-Sept, 2018	704	238	29	32	86	768
Oct-Dec, 2018	768	275	7	14	77	909
Jan-Mar 2019	909	359	11	14	73	1,143
Total		**1,858**	**152**	**94**	**378**	**1,143**

Source: Insolvency, Bankruptcy Board of India and BWR Research

Recommendations

Brickwork Ratings had a look into the past recommendation of various committees and groups to help deepen the capital market, especially the secondary markets. In this regard below is an illustration of various recommendation and their current status:

Key Recommendations of earlier Committees/Reports

	List of key recommendations of earlier Committees/Reports	Status
Issuers	1. There should be a guideline limiting the number of fresh issuances that would include re-issuance of the existing bonds by a corporate in a given time period (say over a quarter). Any new issue should preferably be a reissue so that there are large stocks in any given issue, thereby helping to create secondary market liquidity.	Fully Implemented
	2. The issuers coming out with frequent debt issues with the same tenor during a quarter may club them under the same umbrella ISIN which in turn would increase the float in the market, thus enhancing its liquidity.	Fully Implemented
	3. Re-issuances may not be treated as fresh issuances for the purpose of Stamp duty.	Not Implemented
	4. The corporate governance norms applicable to companies which have listed only debt securities and not equity may be reviewed to make them less onerous.	Under Process
	5. As suggested by market participants, SEBI may have a re-look at the guidelines issued in October 2013 so as to clarify on day count convention, shut period, basis for yield calculation, calculation of coupon interest and redemption with intervening holidays with illustrations	Fully Implemented
Investors	1. Systematic Disclosure of Debt Servicing Performance Information: Banks, NBFCs and all institutional investors may be mandatorily required to report for listed entities to the exchanges a non-payment of debt by a listed borrower within 15 days.	Fully Implemented
	2. Restriction on FPIs to invest in bonds with maturities of up to 3 years (a segment largely confined to lower rated issuers), constrains investment by FPIs in bonds rated below AAA	Fully Implemented
	3. FPIs are currently not permitted to invest in securitisation PTCs which may be allowed.	Fully Implemented
	4. Necessary amendments may be made in FEMA regulations to allow investment by FPIs in unlisted debt securities and pass through securities issued by securitizations SPVs / Special Purpose Distinct Entity (SPDE). Amendments may also be carried out in both FEMA notification and SEBI guidelines to facilitate direct trading in corporate bonds by FPIs in the OTC segment and on an electronic platform of a recognized stock exchange, subject to certain safeguards, without involving brokers.	Not Implemented
Intermediaries	1. Encourage growth of professional Debenture Trustees (DTs)	Fully Implemented
	2. The role of debenture trustees to be strengthened.	Fully Implemented
	3. Stock exchanges may operationalize market making scheme in corporate bonds	Under Process
	4. Regulated entities like banks, PDs, in addition to brokers, may be encouraged by the regulators to act as market makers in corporate bond market subject to appropriate risk management framework.	Under Process

	List of key recommendations of earlier Committees/Reports	Status
Infrastructure	1. Creation of a centralized database of all bonds issued by corporates. It should also track rating migration. Database should be made available free of cost to all the investors.	Fully Implemented
	2. The introduction of a DVP3 mechanism, where funds and securities are settled on a net basis, will give a significant boost to the domestic corporate bond market, and make it easier for domestic and foreign institutional investors to trade in rupee corporate bonds.	Fully Implemented
	3. The Electronic Book Mechanism for private placement of debt securities, currently mandatory for issuances over Rs.500 crore, may be extended to all primary market issuances.	Fully Implemented
	4. A uniform valuation methodology available on a daily basis may be followed by all the regulated entities for valuation of their holdings of corporate bonds.	Fully Implemented
	5. CRAs may be mandated to strictly adhere to the regulatory norms with regard to timely disclosure of defaults on the stock exchanges and their own website. They may also publish the credit rating transition matrix more frequently. CRAs may take up membership of credit information companies to access relevant credit information.	Fully Implemented
	6. Banks may be encouraged to submit loan overdue information to CICs on a weekly basis to start with. RBI may consider whether CRAs may be allowed access to Central Repository of Information on Large Credits (CRILC) database based on legal feasibility and other relevant factors.	Not Implemented
	7. A centralized database for corporate bonds covering both primary and secondary market segments may be established expeditiously in two phases, for secondary market trades by end August 2016 and for both primary and secondary market by end October 2016.	Fully Implemented
Instruments	1. Municipal bonds may be given some fiscal support with such support taking the form of bond insurance or providing credit enhancement so that municipalities are encouraged to issue such bonds for development of urban infrastructure either on stand alone or on pooled basis. A plan should be drawn for developing this market in India.	Not Implemented
	2. Launch of corporate bond index products by exchanges.	Fully Implemented
	3. Restrictions on participation in repo markets may be relaxed.	Partially implemented
	4. An electronic dealing platform with CCP facility with appropriate risk management framework similar to the CROMS platform for G-sec may be introduced.	Not Implemented
	5. FIMMDA may consult market participants to develop a commonly acceptable market repo agreement for execution among the market participants by end September 2016	Partially Implemented
	6. Guidelines on Tripartite repo on corporate bonds may also be introduced by depositories/other entities in consultation with SEBI by end September 2016	Fully Implemented
	7. Entities authorized as market makers in corporate bond market, including the brokers, may be allowed to participate in the repo market executed on electronic platform linked to guaranteed settlement.	Not Implemented
	8. Insurance companies and EPFO may be allowed to invest in AT-1 bonds of banks subject to prudential limits with credit rating upto investment grade	Not Implemented
	9. The maximum investment ceiling of 2% of the total portfolio of the funds in AT-1 instruments stipulated for non-Government PFs may be reviewed for relaxation	Under Process
	10. Corporate bond index may be introduced by the Stock Exchanges/other entities	Fully Implemented

	List of key recommendations of earlier Committees/Reports	Status
Incentives	1. The stamp duty on partly secured, and unsecured debentures should be made uniform across states and be linked to the tenor of securities, within an overall cap.	Under Process
	2. To promote healthy growth of securitization market, the central government should consider establishing an appropriate institutional process to evolve a consensus across States on the affordable rates and levels of stamp duty on debt assignment, PTCs, security receipts (SRs).	Not Implemented
	3. Create 'credit event infrastructure' on all multiple debt holder obligations, whether in the form of bonds or loans – reporting and dissemination of a credit event across all creditors.	Under Process
	4. To create a more attractive environment for investments, the credit rating industry must adhere to international best practices. By doing so, investors can take advantage of an international standardized rating, which will in turn make the market more transparent and reliable which will attract both domestic and foreign investors.	Fully Implemented
	5. If pension funds/other institutions were to use CDS to hedge their exposures to individual issuers, credit risk should be counted as an exposure to the hedge counterparty rather than the issuer.	Under Process
	6. Smoothing out tax discrepancies between equities taxed at 0 % compared to bonds taxed at 10 / 20 % may help retail investors get involved in the bond markets.	Under Process
	7. Guidance be developed to provide clarity that GAAR rules do not apply to FII capital market transactions where the main purpose of these transactions are to provide investment products to international investors rather than the derive a tax benefit.	Under Process
	8. During the initial phase the upper limit for PCE by the banking system as a whole may be enhanced to a higher limit with no single bank having exposure of more than 20 per cent of the bond issue size by end August 2016.	Under Process
	9. It may be clarified that the capital required to be maintained by banks on account of PCE would be reduced if the base rating of the project improves during the credit enhancement period. Guidelines in this regard may be issued by end August, 2016	Under Process
	10. A separate regulatory framework may be formulated for providing credit enhancement of corporate bonds by NBFCs engaged in such activities. Necessary guidelines, in this regard, may be issued by end August, 2016	Under Process
	11. It may be clarified that the capital required to be maintained by banks on account of PCE would be reduced if the base rating of the project improves during the credit enhancement period. Guidelines in this regard may be issued by end August, 2016	Fully Implemented
Market makers	1. A market-making scheme for corporate bonds should be evolved by the market participant(s) willing to do so, including large intermediaries – such as banks, primary dealers and investment banks.	Not Implemented
	2. A clear change to Indian law is required to recognize close-out netting, an established practice in all advanced financial markets, and to establish an efficient recovery mechanism.	Not Implemented

Source: Report of the Working Group on Development of Corporate Bond Market in India, SEBI, RBI, BWR Research

In view of the above status, Brickwork Ratings is proposing following recommendations to deepen the capital markets in India. Brickwork has also consolidated views of few market participants in this regard.

Recommendations for development of Corporate Bond Market

From Brickwork Ratings	From other market Participants
• Creating a credit guarantee entity (credible and strongly backed, may be govt.) for mortgages and retail loan portfolio better mechanism structure of debt market and reducing or avoiding defaults.	• Bring credit discipline among the market players as such robust and accepted process for evaluation.
• Free participation of trade in corporate bond repo market by all sort of lenders and holders.	• Better and stricter surveillance for lending especially for NBFCs to its clients so as money is responsibly monitored for end use.
• Allow Banks to provide partial credit enhancement to issuers in the 'A' rated category	• Removal of sectoral caps for investment by MFs/Insurance or Banks and allowing them for free investment spirit than rating restrictions.
• Allow NBFCs to access repo market for overnight liquidity access	• Promoting investor education on a larger scale specially to HNI, Retail & corporates for broader participation.
• Simplify NCD issuance and listing norms for issuers to cut down on time taken to comply regulations	• Removal of rating restriction which is at AA for retirement funds to investment grade as it was earlier so as investors can decide and take own call based on assessment and comfort so as can enhance yields and broad-base portfolio plus have market for all categories, anyways assuring returns on portfolio is company's responsibility and can choose to have own policy than driven by rating directed
• Explore a loan market syndication platform for creating a tradeable exchange to facilitate single and multi-borrower loan sell downs	• Banks has been desisted from taking investment calls in bonds and prefer loans, some portion must be kind of compulsory so as investors base gets widen • Banks should be encouraged to invest in corporate debt securities in order to widen the investor base
• Setup an alternate bond exchange to facilitate trading of bonds in the speculative grade	

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About Brickwork Ratings

Brickwork Ratings (BWR) is India's home grown credit rating agency built with superior analytical prowess from industry's most experienced credit analysts, bankers and regulators.

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CII is a non-government, not-for-profit, industry-led and industry-managed organization, playing a proactive role in India's development process. Founded in 1895, India's premier business association has around 9000 members, from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 300,000 enterprises from around 276 national and regional sectoral industry bodies.

CII charts change by working closely with Government on policy issues, interfacing with thought leaders, and enhancing efficiency, competitiveness and business opportunities for industry through a range of specialized services and strategic global linkages. It also provides a platform for consensus-building and networking on key issues.

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With 66 offices, including 9 Centres of Excellence, in India, and 10 overseas offices in Australia, China, Egypt, France, Germany, Singapore, South Africa, UAE, UK, and USA, as well as institutional partnerships with 355 counterpart organizations in 126 countries, CII serves as a reference point for Indian industry and the international business community.

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