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EXECUTIVE BRIEFINGS
BUSINESS AND ECONOMY: BOND MARKETS

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August 2016

The name is Bond

James Carville, an advisor during the Clinton Presidency, was once said to have remarked, "I want to be reincarnated as the bond market because it is more important than the Pope and I can then intimidate everyone." Over the decades, bond markets have indeed become threatening and, in more open economies, tempered politicians from taking extreme and populist measures. However, they are a critical ingredient for long term funding, specifically in infrastructure, and therefore a vital contributor to national output. In India, bond markets have historically held a distant second place where the greater supply of funding has been through traditional banking channels. This has been detrimental and needs to change.

Perhaps in keeping with this sentiment, the Reserve Bank of India (RBI), on the 25th August, announced measures that will foster increased participation by banks, publicly listed companies and foreign money managers in fixed income securities. Over time, these will impart much needed depth and liquidity to India's languid bond markets.

In the first instance, the reforms have raised the limit under the partial credit enhancement (PCE) mechanism from 20% to 50%. When a business enterprise say, in the infrastructure sector, issues long term bonds seeking subscription from insurance or pension funds, it often suffers on account of a low credit rating it may receive due to the intrinsic risks in the initial stages of project implementation. Through the PCE mechanism, a bank provides a contingent line of credit to the issuer, which can be drawn upon in case of a shortfall in cash flows for servicing the bond. In this manner, the bond issue is able to improve its credit rating and obtain higher subscriptions at lower costs. Previously, banks could provide enhancement up to 20% of the total bond issuance by a company – this limit has now been increased to 50%. This development would benefit large infrastructure projects that have often suffered on account of their inability to place long term debt.

A second reform would allow the use of corporate bonds under the RBI's Liquidity Adjustment Facility (LAF), the process through which the central bank manages liquidity and controls the cost of money in the banking system. This would require an amendment to the Reserve Bank of India Act, 1934. Currently, only treasury bills, Government securities and certain other SLR-denominated instruments can be used in the LAF mechanism. When notified, the amendment would increase the demand for corporate bonds thereby increasing liquidity and improving price discovery. Further, listed companies that were previously permitted to lend through repos in Government securities only to banks and primary dealers and for a minimum tenor of 7 days, will now be able to do so without restrictions on tenor or counter party.

With a view to creating a long term market for offshore-listed rupee-denominated debt instruments, a third measure seeks to encourage Indian banks to issue *masala bonds* to raise tier I and tier II capital. This essentially provides another channel for them to enhance capital cushions and strengthen their balance sheets.

Fourth, the RBI has allowed brokers that are authorised as market makers to participate in corporate bond repos. Previously, only banks and institutions such as mutual funds and insurers were allowed in

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this segment. The measure would help brokers manage funding requirements arising from their market making activities and should therefore, increase their participation in fixed income instruments.

In the longer term, the bond markets must go retail, rather like what happened to equities in the 1990s through the creation of the National Stock Exchange (NSE) and electronic securities depositories. Effectively, trading moved out of Bombay and the markets expanded both in terms of width and depth. A similar initiative that can rejuvenate the public trading platform to encourage retail investment would go a long way in creating a vibrant structure. Currently, bond investments are the monopoly of large institutions transacting behind closed doors and not always subject to the scrutiny of public markets.

In the fullness of time, it is likely that India's bond markets will acquire sufficient depth and therefore, influence. They will act as a restraining force upon politicians tempted to take recourse to populist measures, spending sprees and high taxation. The RBI will do well to continue with such reforms as they are not only in the interest of greater financial depth but also better governance and sensible policies.

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