Characteristics and features of capital markets finance essay

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Capital market in any country consists of equity and the debt markets. Within the debt market there are govt securities and the corporate bond market. For developing countries, a liquid corporate bond market can play a critical role in supporting economic development as

It supplements the banking system to meet corporate sector' requirements for long-term capital investment and asset creation.

It provides a stable source of finance when the equity market is volatile.

A well structures corporate bond market can have implications on monetary policy of a country as bond markets can provide relevant information about risks to price stability

Despite rapidly transforming financial sector and a fast growing economy India's corporate bond market remains underdeveloped. It is still dominated by the plain vanilla bank loans and govt securities. The dominance of equities and banking system can be gauged from the fact that since 1996, India's stock market capitalisation as a percentage of GDP has increased to 108% from 32. 1%, while the banking sector's ratio to GDP has risen from 46. 3% to 78. 2% in 2008. In contrast, the bond markets grew to a modest

43. 4 percent of GDP from 21. 3 percent. Of this corporate bonds account for around 3. 2% of GDP and government bond market accounts for 38. 3% of GDP. (Graph1)

Graph1

Source: RBI

India's government bond market stands ahead of most East-Asian emerging markets but most of it is used as a source of financing the deficit. The size of the Indian corporate debt market is very small in comparison with not only developed markets, but also some of the emerging market economies in Asia such as Malaysia, Thailand and China (Graph 2)

Graph 2

Source: RBI

Characteristics and features

Innovation and a Plethora of options:

Over time great innovations have been witnessed in the corporate bond issuances, like floating rate instruments, convertible bonds, callable (put-able) bonds, zero coupon bonds and step-redemption bonds. This has brought a variety that caters to a wider customer base and helps them maintain strike a risk-return balance.

Preference for private placement:

In India, issuers tend to prefer Private Placement over public issue as against USA where majority of corporate bonds are publically issued.

In India while private placement grew 6. 23 times to Rs. 62461. 80 crores in 2000-01 since 1995-96, the corresponding increase in public issues of debt has been merely 40. 95 percent from the 1995-96 levels. (graph 3). This leads to a crunch in market liquidity. A number of factors are responsible for such preference. First, the companies can avoid the lengthy issuance procedure for public issues. Second is the low cost of private placement. Third, the amounts that can be raised through private placements are typically larger. Fourth, the structure of debt can be negotiated according to the needs of the issuer. Finally, a corporate can expect to raise debt from the market at finer rates than the PLR of banks and financial institutions only with an AAA rated paper. This limits the number of entities that would find it profitable to enter the market directly. Even though the listing of privately placed bonds has been made mandatory, a proper screening mechanism is missing to take care of the quality and transparency issues of private placement deals.

Graph 3: Resource mobilization through debt

Source: Equity and corporate debt report: RBI

Graph 4

Source: RBI

Dominance of financial institutions:

The public issues market has over the years been dominated by financial institutions. The issuers who are the main participants in other corporate bond markets (that is, private sector, non-financial), represent only a small proportion of the corporate debt issues in the Indian market. Most of the privately placed bonds (which are about 90% of the total issue of corporate bonds) are issued by the financial and the public sector. (Graph 4)

Inefficient secondary market:

Further the secondary market for non-sovereign debt, especially corporate paper still remains plagued by inefficiencies. The primary problem is the total lack of market making in these securities, which consequently leads to poor liquidity. The biggest investors in this segment of the market, namely LIC, UTI prefer to hold these instruments to maturity, thereby holding the supply of paper in the market.

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. Number of trades in debt compared to equity on average for August 2007 is just 0. 003%.

Graph 5

Figures are turnover on the wholesale debt market segment of NSE.

Source: NSE

Challenges and issues

Dominance of private placements

Dominance of large corporations. The credit rating system encourages only the large corporations with an AAA rating. (Table 1)

Non-existent repo market for corporate bonds unlike the government bonds where there is an active repo market.

Complicated and slow issuance procedure.

Regulators in India are reactive rather than proactive.

Illiquid secondary market- part of it is due to the fact that the number of issuers is low and part of it is due to the fact that the large investors prefer to hold these securities till maturity.

Lack of formal market makers

Limited demand for bond financing. The corporate debt market in India continues to be dominated by banks

Limited investor base. A successful corporate bond market requires non banking investors which are limited and restricted in case of India.

Inadequate credit assessment skills coupled with lack of transparency in trades

There is a lot of confusion in the market regarding both regulations and the trading floors.

To sum up, corporate bond the market in India suffers from deficiencies of participants, products and a comprehensive institutional framework.

Table 1: Distribution of corporate bond issues by credit ratings

Recent developments

Given the importance of a well developed corporate bond market, the government, the RBI and SEBI have initiated measure to develop the corporate bond market in India. Most measures were aimed at improving the disclosure norms. The corporate bond market got its due attention by the government in the Union Budget of 2004-05where in the High

Level Expert Committee on Corporate Bonds and

Securitisation, chaired by Dr. R. H. Patil, was set up to look into the regulatory, legal, tax and mortgage design issues for the development of the corporate bond markets. The suggestions made by the committee were to develop the market infrastructure. Some of the suggestions made in the report include the removing the stamp duty, simplifying the issuance and disclosure norms, to bring the cost of corporate bonds at par with those of government securities by having similar TDS norms, enhance the investor base by encouraging participation of mutual funds, pension funds, insurance companies and gratuity funds and also retail participation through better primary and secondary markets. It also suggested a regulatory framework for a transparent and efficient secondary market for corporate bonds should be put in place by SEBI in a phased manner. It also recommended having a trade reporting system, introduction of repo in corporate bonds and better clearing and settlement system.

Both RBI and SEBI have fundamentally agreed to these recommendations and steps are being taken to implement the same. Some of the steps include:

Dematerialization of holdings, as required by SEBI since 2002; increased trading transparency from compulsory reporting of trades, linking local rating agencies to international rating agencies. In January 2007 SEBI was declared as the sole body responsible for regulating and coordinating the primary and secondary corporate bond market. It was a major step in remove the lack of coordination that existed due to two regulators (SEBI and RBI). In April 2007, SEBI permitted both BSE and NSE to set up trading platforms. In April 2007, SEBI reduced the shut period in corporate bonds, to align it with that applicable for Government Securities, and tradable lots in corporate bonds. In December 2007 SEBI made further amendments in issuance procedures to reduce the cost and ease issuance. It also gave green signal to FMMIDA to start trade reporting platform for CBs. Moreover, the government has made changes in the Companies Act and on simplification and reduction in the stamp duty w. e. f. 2007. From December 1, 2009 all corporate bonds traded OTC or on the debt segment of the stock exchanges will have to be cleared and settled through the National Securities Clearing Corporation Ltd (NSCCL) or the Indian Clearing Corporation Ltd (ICCL). It will help in eliminating the counter party risk in trade settlement and ensure a smooth receipt and payment system. In June 2008, the investment limit for FIIs in corporate debt was increased from $1. 5 billion to $3 billion and further to $15 billion in January 2009. Ministry of Finance has hinted towards corporate market becoming Repo-able from 2010.

Asia Bond Monitor- ADB, April 2008

India’s Bond Market-Development and Challenges Ahead, Stephen Wells and Lotte Schou-Zibell, Working paper series on regional economic integration no. 22, ADB, December 2008.

CS Update, august 2008, ICSI

Equity and corporate debt report 2007, RBI

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