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Disputes around corporate bond market in India

Balaji C
Student, BBA. LLB, Hons, IVth Year, Saveetha School of Law, Saveetha University, Chennai, Tamil Nadu, India

Abstract
Vibrant, deep and robust corporate bond markets are essential to enhance stability of financial system of a country, mitigate financial crises and support the credit needs of corporate sector, which is vital for the growth of an economy. The previous review of research and policy papers on the corporate debt markets in India reveals a persistent absence of efficient legal machinery in the present arena. Our paper seeks to flag this issue and help to fast track the development of the corporate bond markets in India.
Recent trends reinforce the need for strong policy measures to develop the corporate debt markets in India. A study of corporate bond market experiences across developed and emerging markets further underscores the importance of strong institutional and regulatory framework, along with support from policymakers for building robust corporate debt markets. A review of literature and an analysis of key trends in corporate debt market help us identify the issues with the three pillars of corporate debt markets – institution and regulators, market participants, and instruments. We find that this lack of depth and efficiency in the corporate debt market is mainly explained by inadequate infrastructure, illiquidity, regulatory gaps, limited investor and issuer base, and absence of benchmark yield curve across maturities. Finally, we apply the insights from literature review, the trend analysis and cross-country study to make recommendations to revive the Indian corporate debt markets. The recommendations span areas such as taxation, legal and regulatory, public policy, market micro structures, corporate laws, and banking regulations.

Keywords: corporate sector, corporate bond market, instruments, regulations

Introduction

A well developed corporate bond market supports economic development. It provides an alternative source of finance and supplements the banking system to meet the requirements of the corporate sector to raise funds for long-term investment. It is believed that this segment acts as a stable source of finance when the equity market is volatile, and also enables firms to tailor their asset and liability profiles to reduce the risk of maturity. It also helps in the diversification of risks in the system. In view of huge investment requirement for infrastructure sector, the presence of a well developed corporate bond market assumes significance in India. With the declining role of development finance institutions (DFIs), a developed and robust corporate bond market becomes all the more important.

Corporate bond market is likely to be more beneficial for business having longer term cash flows, where investors may be wary of risks associated with equity and long-term financing from banks may not be easily available [Report on High level committee on corporate bond and securitisation (2005), Singh (2011), Khanna and Varottil (2012)]. Experts argue that India's high growth can be sustained by improving infrastructure and expanding the manufacturing base, and a developed corporate bond market can make both the tasks easier. Furthermore, India is in need of US$1 trillion or Rs. 6430 Crore in the current five year plan for financing its infrastructure. The Bank dominated financial system is unlikely to finance such a huge amount; in this context, recourse to the corporate bond market can be helpful (Mukherjee 2013).

In India, while the banks still command a sizable presence in the economy, corporate sector is taking recourse to the overseas markets for raising equity, debt and loans. An underdeveloped corporate bond market can abet this trend, thereby increasing the external sector vulnerability. Fortunately, the presence of a big private sector, deregulated interest rates, well developed government securities market, highly developed clearing and settlement system, credible rating agencies, and supporting regulatory structure body well for the development of the corporate bond market in India.

Corporate bond enhances the risk pooling and risk sharing opportunities for investors and borrowers. Reddy (2002) highlights the argument of Allan Greenspan that 'co-existence of domestic bond market and banking system help each to act as a backstop for the other', and alludes to that 'in a relatively open economy since non-bank intermediation may get located outside the country… the domestic bond market helps in avoiding double mismatches of currency and maturity'. Khan (2012) reckons

"The capital flows to the country through External Commercial Borrowings (ECBs), while helping the country funds the current account deficits and corporate raise resources at a lower cost could also become a source of transmission of severe external shocks to the domestic economy". In fact, he also highlighted Greenspan's view that bond market act as a 'spare tyre', and it can provide corporate funding at times when banks ration credit in the face of weak balance sheet.

The development of corporate bond market has been a priority in the policy hierarchy for the last few years. The existing literature largely focuses either on developing this segment of market by reducing the transaction/trading costs involved or identifying an appropriate legal framework.

Corporate Bond Market in India

India has been historically witnessing the underdevelopment scenario of bond market. There has been lots of buzz going around the Indian corporate bond market. In the earlier write-up we discussed the changes brought to streamline the regulatory regime surrounding the Indian bond market. In India, the equity market is more vibrant and matured as compared to bond market; however, the same is in contrary to the other economies of the world, where bond market is more vibrant.

In order to boost the Indian market, a High-level Expert Committee on Corporate Bonds and Securitization was formulated under the chairmanship of Dr. R.H. Patil with a mandate to identify the factors inhibiting the development of an active corporate debt market in India and recommend policy actions necessary to develop bond insurance in the country. In early 2013, RBI advised banks to issue subordinated debt for raising Tier-II capital to public investors through public issuance, to deepen the corporate debt market. On similar lines the government official released a statement saying, “We are examining if banks can be mandated to raise part of their requirements through public issue to retail investors” [1].

Further, in the Union Budget 2016-17, the Finance Minister announced various measures to facilitate deepening of corporate bond market. He further added that, “the enactment of Insolvency and Bankruptcy Code would provide a major boost to the development of the corporate bond market” [2].

The Indian bond market has witnessed its highest peak of public issuance in the year 2013-14 amounting to INR 42382.97 Crores and private placement in the year 2015-16 amounting to INR 458073.5 Crores [3].

Indian economy has always been dependent on banks for financing. Only in the 1980s, some activity was witnessed in the primary market of corporate bonds, where issuances were undertaken by PSUs, and investment was done by banks and FIs. Earlier, corporate were mostly dependent on DFIs (Development Finance Institutions), like ICICI, IDBI and IFCI for financing of their long-term investment.

With the conversion of these DFIs into banks, getting the finance for the long-term projects has become a challenge. Banks have managed to perform this role, but their capacity is limited as there are asset-liability mismatch issues in providing long-term credit. Furthermore, over the years, the bank credit as a proportion of GDP (Gross Domestic Product) is also rising, indicating that banks are getting stretched to finance the growth of the economy. With the cheap availability of funds in the overseas market, the access to ECBs and ADR/GDR route has also become more frequent [4].

The debt market in India comprises broadly two segments, viz., Government securities market and corporate debt market. Corporate debt issued by a firm is either in the form of commercial paper (CP) or corporate debentures/bonds (CB). While CP has maturities between one week and a year, corporate bonds have longer maturities. Corporate bonds have some distinct features. They do not necessarily have semi annual coupons nor have their cash flows fixed values. They may have some embedded options. Both public and private companies issue corporate bonds. At present, any company incorporated in India, even when part of a multinational group, can issue corporate bonds. However, a company incorporated outside India cannot issue corporate bonds in India [5].

Issues Prevailing

The underdevelopment of India’s corporate bond market has some historical perspective. The big companies, at the time of opening up of the economy, saw more benefits from the stock market liberalisation than from the bond market liberalisation (Armour and Lele 2009, Singh 2011, Khanna and Varottil 2012) [1]. The built up of debt in the 1970s and the 1980s was in the consciousness of the policy makers. Thus, the development of the bond market did not attract the attention of the policy makers. With the opening of the economy, there was high inflow of FIIs and GDRs, and it strengthened the primacy of equity market (Virmani 2001, Virmani 2006, Khanna and Varottil 2012, Ahluwalia 1999) [6].

Furthermore, the equity market liberalisation measures were in the hands of the regulators but the measures required for development of corporate bond market were in the hands of legislatures (Armour and Lele 2009, Khanna and Varottil 2012) [1, 7].

At present, there is miniscule participation of retail investors in corporate bond market, though they are coming gradually. FIIs can buy corporate bonds, but only up to a limit. Though there are instances of bonds selling like hot cakes in public issuances, they are few in number. Infrastructure bonds generated lot of interest with the allowance of Rs.20,000 tax deductions. Similarly, corporate bonds of some financial entities with high standing and robust distribution channel also saw huge subscription in public issuances [8].

These positive experiences indicate that rightly priced bonds along with an incentivised distribution channel can generate the interest of the retail investors. Recently, the Reserve Bank of India has advised banks that at the time of issuing subordinated debt for raising Tier-II capital, to consider the option of raising such funds through public issue to retail investors [9].

The major investors in the bond market are viz., banks, financial institutions, insurance companies, mutual funds, pension funds and foreign institutional investors. However, for each of the aforementioned categories there seems to be restrictive conditions with respect to participation in the bond

[1] http://www.business-standard.com/article/finance/rbi-asks-banks-to-issue-tier-ii-bonds-to-retail-investors-113012500006_1.html

[2] http://www.unionbudget.nic.in/ub2016-17/bs/bs.pdf

[3] Ibid

[4] Goswami, M. and Sharma S. 2011. “The Development of Local Debt Markets in Asia, An Assessment”, ADBI working paper series /326.

[5] Eichengreen, B. and Luengnaruemitchai P. 2004. “Why does not Asia have bigger bond markets?” NBER working paper series,No.10576.

[6] Khanna, Vikramaditya and Varottil Umakanth 2012. “Developing the Market for Corporate Bonds in India”; NSE Working Paper; WP/ 6/2012.

[7] ibid

[8] ibid

[9] ibid

market.

Further, if the investment is on account of investment in Securitisation papers issued for infrastructure projects, and bonds/debentures issued by Securitisation Companies and Reconstruction Companies set up under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) and registered with the Reserve Bank then an additional cap of 10 per cent is permitted on such investment [10].

A simplified and low stamp duty structure is an ingredient for building up of a vibrant corporate bond market. In India, now-a-days the secondary market transactions in corporate bonds through demat transfers do not require stamp duties. Nevertheless, stamp duty is still applicable in case of issuance, re-issuance and transfer (if held in physical form) of corporate bonds, and it is higher in comparison with international standards. It is also not uniform across the states.

However, as per the news piece dated March 18, 2016, the finance minister had approved the proposal mooted by the labour minister for holding back investments in corporate bonds up to 15 per cent in view of volatility of the stock market and invests the same in G-Secs, "*amid a surge in the number of loan defaults by corporate, retirement fund body EPFO will cut exposure in corporate bonds and park more funds in the secure government securities* [11]."

Legal Framework

Several missing and inadequate legal structures are observed in the context of corporate bond markets, the most prominent being those relating to enforcement contracts and corporate insolvency. A corporate bond is essentially a debt and the expeditious enforcement of debt contracts is a natural concern for lenders. In India enforcement contract litigation is often embroiled in delays and deficiencies of India's overburdened legal system, not the least of which are prohibitive costs. This lack of remedial opportunities increases the risk of corporate bond lending.

Similar inefficiencies have been observed in cases of corporate insolvency. Analogous to enforcement contracts, the process of liquidation and winding up of companies is important because it determines the distribution of assets to the lenders. In India, the RDBF Act and the SARFAESI Act form the pillars of insolvency laws. However, these are not sufficient since they address only debts due to banks and financial institutions and not ordinary creditors. As far as ordinary creditors are concerned, the only recourse available is ordinary civil court litigation [12].

India is considered to be more "regulators-friendly" than to be "business-friendly". World Bank, in its Doing Business Report 201619, has placed India at 130 out of the 189 countries for ease of doing business. From recovery perspective, the corporate bonds are deemed risky and the procedural requirement is too lengthy. In case of resolving insolvency, the World Bank has placed India at 136 out of 189 countries. Delay in resolving the dispute is a key hindrance for the financial entities looking to invest in the corporate bonds. Various trial and error with respect to regulations were ensured by the regulators; however, the success of the same was either limited or there was a mix success. There is a need for strong and faster process of deciding insolvency, winding up and liquidation [13].

The Sick Industrial Companies Act led to establishment of Board of Industrial and Financial Reconstruction for revival and rehabilitation of sick undertaking; however, the success was limited. The Corporate Debt Restructuring scheme introduced by RBI for safety of money given by banks and financial institutions, this scheme had a mix success [14].

The Recovery of Debts Due to Banks and Financial Institutions Act led to establishment of Debt Recovery Tribunals were established to avoid delays with courts in the enforcement for debt but unfortunately the success was very limited. In the year 2002 the SARFAESI Act was introduced for enforcement of security interest without courts intervention and the success was high [15].

However, the need for a uniform code led to enactment of the Insolvency and Bankruptcy Code, 2016 - In case of Insolvency Resolution and Liquidation for Corporate Persons - National Company Law Tribunal shall be the adjudicating authority and for individuals and partnership firms - Debt Recovery Tribunal shall be the adjudicating authority. The success of both the authorities will be determined in the years to come.

Conclusion

The government is in the process of incorporating various measures to intensify the corporate debt market and to curtail the issues and challenges faced by the industry. The enactment of the Insolvency and Bankruptcy Code, 2016 might bring reforms with respect to delay in resolving the matter. If the Code succeeds in achieving its objective, one may expect the end of never ending issues and challenges and boost in the corporate bond market. This study has found that the corporate bond market of India is not deep.

In Indian context, a combination of factors such as procedural hassles, legal issues, and preference of the corporate for private placement in issuance is not helping the cause of the corporate bond market. Keeping in view lack of availability of research and due to the time constraint, this study is an attempt to open further areas of research on this market. It may be added that any work taking the yield of individual corporate bond, would be highly helpful in taking the research on this area to higher level.

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[12] According to a World Bank survey, the completion of a corporate bankruptcy in India takes about 10 years and India ranks at position 128 in the world (which is actually an improvement over the years).

[13] Ibid

[14] http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB16-Full-Report.pdf

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