The way forward for builiding a Bond-Currency-Derivative (BCD) nexus

Anjali Sharma & Susan Thomas

Finance Research Group, IGIDR

Presented at the FCO – IGIDR Roundtable on
Building local currency bond markets for India
27th June, 2019

The need for bond markets

Why bond markets?

- Financing public debt
  - Lack of liquid bond markets $\leftrightarrow$ financial repression
  - In the long run $\rightarrow$ weak financial institutions, under developed financial markets $\rightarrow$ impact on economic growth
- Financing long term projects of enterprises
  - Financial institutions not the best source for this.
  - Banks have ALM issues
  - Insurance and pension funds can't make loans
  - Lack of long term debt capital $\rightarrow$ (1) financing risk, in addition to project risk, or (2) low incentive to undertake long term projects

Why bond markets?

- Financing infrastructure
  - Infrastructure investment critical to economic development, require long term capital
  - Equity financing not viable
  - Government financing limited, itself competes for household saving. Complex decision making process
  - Foreign capital for firms integrated with world trade. Infra projects do not generate trade-ables
- Attracting foreign flows to local currency markets
  - FCY flows not available to all. The "original sin"
  - Concerns around volatility of foreign flows, "hot money". Short term flows $\rightarrow$ uncertainty $\rightarrow$ short term flows
  - Long term flows associated with deep and liquid local markets

Why bond markets?

- India's economic growth will need an investment impetus.
- Business as usual will not work:
  - Indian banks already strained
  - Strain comes from their experience with infrastructure financing in the decade of 2003 to 2010
  - Even as bank books get cleaned up, there will be caution about where to lend
- Access problems will need to be addressed:
  - Many large firms, entire sectors, in stress. Will need to deleverage before moving forward. This process will be difficult for them and for their lenders, mainly banks
  - Meanwhile even the viable businesses will be starved of credit
  - "Good" firms must have a way of accessing debt finance
- Policy space is limited:
  - Monetary policy transmission is poor because bond markets are under-developed and banks are in stress
  - Fiscal space remains limited
- The perils of illiquid markets are in play, at NBFCs and MFs

Developing a bond market is complex

Why equity markets work where bond markets don't? (Herring and Chatusripitak (2000))

- Equity contracts have no promise of returns, or of repayment of capital
- They can function even at low levels of financial development. Requirements for equity markets to succeed:
  1. a transparent and reliable process for issuing securities
  2. trading, clearing and settlement infrastructure
  3. a system to record ownership rights
  4. secondary markets for price discovery
  5. a secondary market for risk management (derivatives)
  6. transparent, ongoing disclosures about firms

Why equity markets work where bond markets don't? (Herring and Chatusripitak (2000))

- Debt contracts promise: returns, repayment of capital. Bonds layer the promise of trade-ability
- Bond market need what equity markets need, and more:
  7. a benchmark for interest rates in the economy, at all maturities $\rightarrow$ a liquid government bond market
  8. markets for managing the risk of interest rates $\rightarrow$ interest rate derivatives
  9. markets for managing default risk $\rightarrow$ credit derivatives
  10. a legal framework for dealing with default $\rightarrow$ creditor rights and insolvency laws
- This is the bond market ecosystem

Bond market development is a complex reform

- Each component of the bond market ecosystem itself is not sufficient to achieve the goal of bond market development
- But they are all necessary
- This is a big ask $\rightarrow$ reforms of large parts of the financial system
- Will require long term commitment to Big, Hairy, Audacious reforms (Collins and Porras (1994)).

The state of bond market reforms

A favourite project for our policy makers

- Many committees have given attention to this subject:
  1. HLEC of Corporate Bonds and Securitisation, 2005
  2. Committee on Fuller Capital Account Convertibility, 2006
  3. HPEC on making Mumbai an International Financial Center, 2007
  4. Committee on Financial Sector Reforms, 2009
  5. Working Group on Foreign Investment, 2010
  6. Financial Sector Legislative Reforms Commission, 2013
  7. Committee to review Access to Domestic and Foreign Capital Markets, 2015
  8. Bankruptcy Law Reform Committee, 2015
  9. Working Group on Development of Corporate Bond Market, 2016

And for industry and foreign investors...

- And private agency reports:
  10. ASIFMA, 2013
  11. IUKFP, 2015
  12. City of London, 2016
  13. ASIFMA, 2017

Our analysis

BHA reforms need to take the path of an **input-output-outcome** framework:

1. Inputs: creating a holistic framework for the reform agenda across various reports
2. Outputs: mapping the status of implementation of recommendations for each element of the framework
3. Outcome: the current state of development of the bond market ecosystem

Required inputs: scope of reforms

Fiscal and monetary aspects: (1) management of fiscal deficit, and a (2) a stable inflation regime are pre-requisites for bond market development.

R.1 Adherence to FRBM targets

R.2 RBI to move to an inflation targeting regime

Legal and regulatory architecture: of financial sector laws and regulators, creditor rights laws, taxation laws

R.3 Principal based drafting of financial sector laws

R.4 Comprehensive law for enforcement of creditor rights

R.5 Comprehensive bankruptcy law for non-financial firms

R.6 Comprehensive mechanism for financial firms' resolution

R.7 A rational and clear tax framework for financial instruments and markets

R.8 Re-alignment of regulatory roles

R.9 Regulatory accountability mechanisms

R.10 Regulatory coordination and systemic stability

A markets ecosystem: creating deep and liquid markets required for the bond market ecosystem.

R.11 A widely accessible auction platform for government bond issuance

R.12 Secondary market for government bonds for discovering the "yield curve"

R.13 Repo market for government bonds

R.14 Primary market for corporate bond issuance

R.15 Secondary market for corporate bond trading

R.16 Repo market for corporate bonds

R.17 Primary market for structured bonds issuance

R.18 Secondary market for structured bonds trading

R.19 A market for credit enhancement

R.20 Interest rate derivatives

R.21 Credit derivatives

R.22 Currency derivatives

Market infrastructure: for electronic and negotiated markets.

R.23 Trading, clearing, settlement and dissemination infrastructure for electronic markets

R.24 Negotiated deals in the OTC market through an electronic limit order book with central clearing

R.25 De-segmentation of trading venues

Information infrastructure: for issuers, investors, intermediaries, and instruments

R.26 Creating securities markets information utilities

Widening issuer base: across instruments and organisational forms.

R.27 Rationalising eligible issuer base across instruments

R.28 Clarifying the status of trusts as issuers

R.29 Rationalising issuance costs

Widening investor base: creating a diverse set of participants in financial markets.

R.30 Allowing domestic FIs to participate

R.31 Creating organisation capacity and incentives at domestic FIs to participate

R.32 Allowing domestic non-financial participants. Firm level governance and disclosures to improve risk management

R.33 Allowing foreign participants in rupee instruments on the same terms as domestic participants

R.34 Allowing foreign investors to manage their investment risks through access to risk management instruments/markets

R.35 Removing "hedgers only" rules. In lieu of these use of prudential regulations and/or governance and disclosure requirements

R.36 Rationalising trading costs

R.37 Creating policy certainty for all classes of investors

Consumer protection: a consumer protection framework for securities markets.

R.38 Disclosure based regime for professional investors
R.39 Suitability regime for small investors
R.40 Consumer complaints and resolution mechanisms

Adjudication infrastructure: for financial markets disputes and for appeals against regulator's actions

R.41 Infrastructure for contract disputes
R.42 Specialised Financial Sector Appellate Tribunal

Summary

- There is recognition of the broader reform agenda required to be undertaken to make bond markets work.
- The specific asks remain constrained by the complexity of the dynamics of reform.

Outputs: what has been done so far

	Recommendation	Status
R.1	Adherence to FRBM targets	-
R.2	Inflation targeting	Underway.
R.3	Principal based financial sector laws	Not implemented
R.4	Creditor recovery law	Partly implemented
R.5	Bankruptcy law for non-financial firms	Underway
R.6	Resolution framework for financial firms' resolution	Not implemented
R.7	Tax policy and certainty	Not implemented
R.8	Re-alignment of regulatory roles	Not implemented
R.9	Regulatory accountability	Not implemented
R.10	Regulatory coordination and systemic stability	Partly implemented
R.11	Modern auction platform for G-sec issuance	Not implemented
R.12	Secondary market for government bonds	NDS-OM
R.13	Government bond repo market	NDS-OM, Repo & CBLO
R.14	Primary market for corporate bonds	Public issue & private placement
R.15	Secondary market for corporate bonds	Exchange & OTC

	Recommendation	Status
R.16	Corporate bond repo	Exchange, Basket & special
R.17	Primary market for structured debt	Public issue & private placement
R.18	Secondary market for structured debt	OTC
R.19	Credit enhancement products	Originator enhancements
R.20	Interest rate derivatives	Exchange, CCIL-OTC, ASTROID
R.21	Credit derivatives	-
R.22	Currency derivatives	Exchange & OTC
R.23	Trading, clearing, settlement and dissemination infrastructure for exchanges	
R.24	OTC market with EBP and central clearing	Partly implemented
R.25	De-segmentation of trading venues	Not implemented
R.26	Creating information utilities	CKRs, CRAs, CRILC, IBC-IUs, MCA-21
R.27	Rationalising eligible issuer base across instruments	Not implemented
R.28	Clarifying the status of trusts as issuers	-
R.29	Rationalising issuance costs	Underway

	Recommendation	Status
R.30	Domestic FIs participation	Underway
R.31	Organisation capacity/incentives at domestic FIs	-
R.32	Allowing domestic non-financial participants	Underway
R.33	Participation parity for foreign investors	Not implemented
R.34	Risk management tools for foreign investors	Underway
R.35	Removing "hedgers only" rules	Not implemented
R.36	Rationalising trading costs	Underway
R.37	Creating policy certainty for all classes of investors	Not implemented
R.38	Disclosure based regime for professional investors	-
R.39	Suitability based regime for other investors	-
R.40	Consumer complaints and resolution mechanisms	By each regulator
R.41	Infrastructure for contract disputes	-
R.42	Specialised Financial Sector AA	SAT

Summary

- Actions can be characterised as “the sound and the fury”.
- Few big actions, a lot of tinkering.
- Most big reforms remain un-implemented.

Outcomes: status of bond market development

Financial sector development over time

	(As % of GDP)			
Segment	1996	2008	2015	2018
Equity market	32.1	108.4	80.0	77.8
Bank assets	46.5	73.8	89.0	82.1
Government bond market	14.3	36.1	34.3	31.5
Corporate bond market	0.9	3.9	14.0	15.8

Source: SEBI, RBI, World Economic Outlook

Non-financial firms' sources of finance over time

Component	(As % share of total) 1995-96	2005-06	2015-16
Capital & reserves	**36.3**	**33.7**	**36.2**
Paid-up equity	13.2	9.6	7.3
Retained earning	3.3	3.6	0.5
Other reserves	19.8	20.5	28.4
Borrowing	**38.8**	**32.0**	**33.0**
Banks & FIs	17.5	16.4	16.8
Bonds	6.6	2.1	1.4
Foreign	4.9	3.8	4.6
Inter-corporate	1.8	2.5	2.4
Current liabilities	**23.4**	**27.7**	**31.0**
Number of firms	5,109	14,284	12,457
Total finance (Rs. trillion)	7.4	23.6	122.8

Source: CMIE Prowess

International comparison: size of debt securities market

	Size		Issuers share (%)			Location share (%)	
	USD bn	% of GDP	F	NF	G	D	O
US	41,301	194	39.0	15.2	45.2	-	5.7
UK	5,748	203	45.2	8.9	45.8	-	54.1
China	12,907	96	37.9	23.9	38.6	96.7	1.7
Japan	12,498	251	20.2	6.2	73.6	96.4	3.5
Brazil	2,249	120	25.1	9.6	65.3	94.8	5.2
Korea	1,887	123	35.6	31.2	33.2	89.6	10.4
India	1,333	49	-	-	64.3	96.5	3.5
Russia	446	28	28.7	37.4	33.9	66.6	20.6
Thailand	405	89	38.8	24.2	37.0	96.5	4.2
Malaysia	382	108	11.8	41.9	46.3	90.3	12.6
Turkey	244	32	23.0	3.3	73.8	52.5	57.8
Phillipines	137	42	4.4	10.9	84.7	-	-

Source: Bank of International Settlements, SEBI

Sizing the bond market ecosystem

Segment	Period	(In Rs. bn)	
Issuance			
G-Sec	18-19	1,45,790	
T-bills	18-19	11,271	
Corporate bond	18-19	6,470	
Masala bond issuance	17-18	196	
Securitised paper	17-18	900	
Total		1,64,627	
Outstanding			
G-sec	Jun-19	58,982	
T-bills	Jun-19	5,236	
Corporate bond	Mar-19	30,672	
Securitised paper	Mar-19	2,572	
CPs	Jul-18	6,395	
CD	Jul-18	1,639	
Total		1,05,496	
Trading			
G-sec trading	18-19	72,459	(287.5)
T-bill trading	18-19	9,192	(36.5)
G-sec repo	18-19	1,17,944	(468.0)
CBLO	18-19	2,98,568	(1,184.8)
Corporate bond trading	18-19	18,359	(72.9)
IRF	18-19	3,566	(14.2)
IRS	18-19	59,449	(237.9)
OTC FX derivatives	18-19	4,64,138	(1,841.8)
FX F&O	18-19	1,59,126	(631.5)

Source: RBI, SEBI, CCIL, ICRA

Summary

- Bond markets remain small:
  - relative to other segments of the financial sector,
  - relative to other countries
  - as a source of finance for firms
- The only element in the bond market that is working somewhat is the government bond market.

The way forward

Three steps required

1. Take what has been done and make it work
2. Take what has not been done and prioritise implementation
3. Keep at it!
   Persistence is the key to getting reforms done.

None of this is easy.

Putting it in context...

What's the similarity between bond market reforms and a second marriage?

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It's the triumph of hope over reality!
(Samuel Johnson)

Thank you

Comments / Suggestion/ Questions?

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