NATURE AND STRUCTURE OF BOND MARKETS IN INDIA AND PROPOSALS TO AUGMENT ITS MARKET LIQUIDITY

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Abstract

Bond markets in India are rigid and less traded by retail investors. Through this study, we analyse the present scenario of bond markets in India and suggest measures to liquidate the market. This study is conducted from the perspective of a retail investor. We infer that accessibility of information with regards to the bond markets as the main reason for it's illiquidity. Hence through this study we analyse the nature of Indian bond markets, state its benefits and suggest measures that will ultimately liquidate the market.

Keywords: Bond Market, Retail Investors, India, Illiquidity

INTRODUCTION:

India has a well-developed and thriving equity market but still has a long way to go since only 1.3%(1) of the Indian population have Demat Accounts. While NSDL (National Securities Depository Limited) does not provide this data within the bond market, it is estimated that the number of individuals active in the bond markets in India is only a tiny fraction of the equity market participants.

In this paper, we aim to understand the characteristics of the bond market in India using publicly available data, analysing it and gathering insights from them. We also aim to provide a list of recommendations on improving access and liquidity of the bond markets and thereby reducing systemic risk within the Indian economy. The recent massive defaults by companies such as Kingfisher Airlines and Nirav Modi Diamonds have brought the lending practices of India's nationalized banks under scrutiny. The higher level of scrutiny that a bond issue brings, as opposed to banks just writing large cheques as they did, would go a long way in ensuring that large exposures are of good credit standing. The problem is that bond markets in India are not sufficiently liquid and there is simply not enough participation by retail investors. However,

India's Fixed Deposit market has over Rs. 100 lakh crores of FDs outstanding [(2)], therefore, there is definitely an appetite from individuals for fixed income securities. The problem is that retail investors are not able to find sufficient information and in a simple format in order to make an informed decision on buying and selling bonds. Banks and financial institutions have not bothered to address this issue since the market is illiquid. It is a circular issue – bond markets are illiquid because retail participants do not have much information; no market participant finds it profitable to provide information because markets are illiquid. We estimate that if this information distribution can be done effectively, we can bring millions more Indians into the bond market where they can earn better interest rates than on FDs for approximately the same amount of risk. Younger and/ or wealthier people with a higher risk appetite can potentially earn substantially higher interest on lower rated bonds. Corporates and the government can benefit by tapping a vast pool of retail savings to access money.

Literature Review

The lucubration states that bond markets in India are governed by the Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI) and Insurance Regulatory and Development Authority (IRDA). The author further states that multiple governing bodies, sluggishness in the legal proceedings and lack of a secondary bond market impedes liquidity. Major reforms such as tax incentives, credit enhancement, developing a bond market like the equity markets are some of the recommendations to liquidate the market while certain suggestions such as developing bankruptcy law is work in progress by the Government.. (**Chaudhari, Raje & Singh, 2014)**

The bond markets in India are rigid and most of the bonds are held till maturity, hence hardly traded. This is one of the reason retail investors prefer other securities over bonds. A point to be noted here is that the process of raising loans through banks is much easier especially for SMEs. Moreover there is no viva voce regarding the bonds which also resulted in the failure of Inflation Indexed Bonds by the Government. (**Sarma, 2014**)

The bonds unlike the treasury bills suffer from default risk in the Norwegian bond markets. The repeatedly low trading of bonds in this market has led to severe liquidity crisis compared to the neighbouring European Union. Liquidity in the bond market indicates improved performance in the economy. The varying liquidity is because the spread in these bonds are higher compared to equity markets and this has led to a mismatch in the buyer and seller market. The major reason in not being able to find suitable buyers and sellers is because of over the counter trading. Hence we can say that yield spreads are due to the default risk taken. Zero trading days shows a positive factor in affecting the bond liquidity. With continuity of the research the researcher is able to analyse that such liquidity would persist in the Norwegian bond markets after the first quarter, from the provided statistics. (**Heggen & Simarud, 2016**)

In this research study we find the comparison between the existing financial markets in India and the growing financial needs of people in India. Though it is considered that India has a developed financial structure, it cannot cater to the needs of the medium and other small enterprises. Most

people feel that the bond markets do not give returns like other markets. Hence they prefer it over bonds. With rise in the number of users of financial sector, Indian bond markets and the financial sector as a whole needs to undergo changes and this would improve the standards of growth in the economy. (**Sengupta & Anand, 2014**)

According to study the authors, Stephen and Lotte found that the Bond market in India is not as evolved or liquid as the Equity markets. The paper also states that though several changes were introduced over the years to increase market transparency, it lags behind in terms of development (mainly the corporate bonds) due to its low demand and preference given to private placements (owing to their flexibility and easier regulatory standards). The authors have also justified reasons as to why certain factors present in the economy restrict further developments in this sector. Hence to see any further growth , it is necessary for India to self-evaluate and reform the Bond market structure with new policies , easier regulatory standards and increased market participants also taking into account financial experience and innovations from its neighbouring countries. (**Wells & Schou-Zibell, 2008**)

This report has explored the liquidity of the secondary corporate bond market along with the impact of changes in the structure and regulations of the bond market since 2004 – more importance was given to the period prior to the financial crisis of 2015. The survey revealed significant changes regarding the structure and characteristics of the secondary corporate bond market like increasing technological use and electronic trading venues, changes in role of the market participants and many more. The committee also could not find substantial evidence to conclude any deterioration in the liquidity of the secondary bond market prior to the crises – IOSCO has examined various potential metrics to assess the liquidity. .

(**Board of INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, 2017**)

Research Design

Statement of Problem

Bond markets in India are under developed. They cannot be traded in the secondary market by retail investors as compared to developed countries.

Objectives of the Study

1. To study the nature of bond markets in India
2. To identify the causes behind low rates of investment in bond markets
3. To provide suggestions to the Government in improving the liquidity in bond market

Limitations:

1. Lack of awareness regarding bond markets

2. Lack of availability of data on bonds from a single source unlike equities

Sources of Data

Secondary data has been obtained for the purpose of this study.

1.		Date	Source	Link
No. of Active Trading Accounts:	17,567,772	17/09/2018	NSDL	https://nsdl.co.in/about/facts-figs.php
Population of India	1,357,245,119	17/09/2018	worldometers.info	http://www.worldometers.info/world-population/india-population/
%age with Demat Accounts	1.3%			

2. Population of India 2017. Digital image. Population Pyramids of the World from 1950 to 2100. https://www.populationpyramid.net/india/2017/
3. "Number of smartphone users in India 2015-2022 | Statistic." Statista. https://www.statista.com/statistics/467163/forecast-of-smartphone-users-in-india/.
4. https://www.interest.co.nz/print/52985

Structure of Bond Market in India

There are 3 primary types of Issuers in India:

1) Sovereign
   Issuers: Central & State Governments
   Instruments: G-Secs (government securities of various maturities), T-bills (Treasury Bills), State govt. securities, Indexed bonds, Zero Coupon Bonds
   Investors: Reserve Bank of India (RBI) and Development Financial Institutions (DFI)

2) Public Sector
   Issuers: Public Sector Undertakings (PSUs) and Commercial Banks
   Instruments: Govt. guaranteed bonds/ debentures, PSU bonds, Commercial paper (CP)
   Investors: Banks, Pension Funds, FII, Corporates

3) Private Sector – Corporates & Private Banks
   Issuers: Corporates, Private Sector Banks
   Instruments: Bonds, Debentures, CP, Floating Rate Notes, ZCBs etc.
   Investors: Individuals, Provident Fund, Insurance Companies, Trusts, Mutual Funds

The private sector bonds are the most accessible ones and are available to retail investors but the same approach can be used for PSU/ infrastructure bonds. In fact, the government needs to raise almost Rs. 6 Trillion through bonds for infrastructure projects (source: Hindustan Times 24/04/2018), however, there does not seem to be enough appetite in the market. This is primarily due to lack of information about these bonds among retail investors.

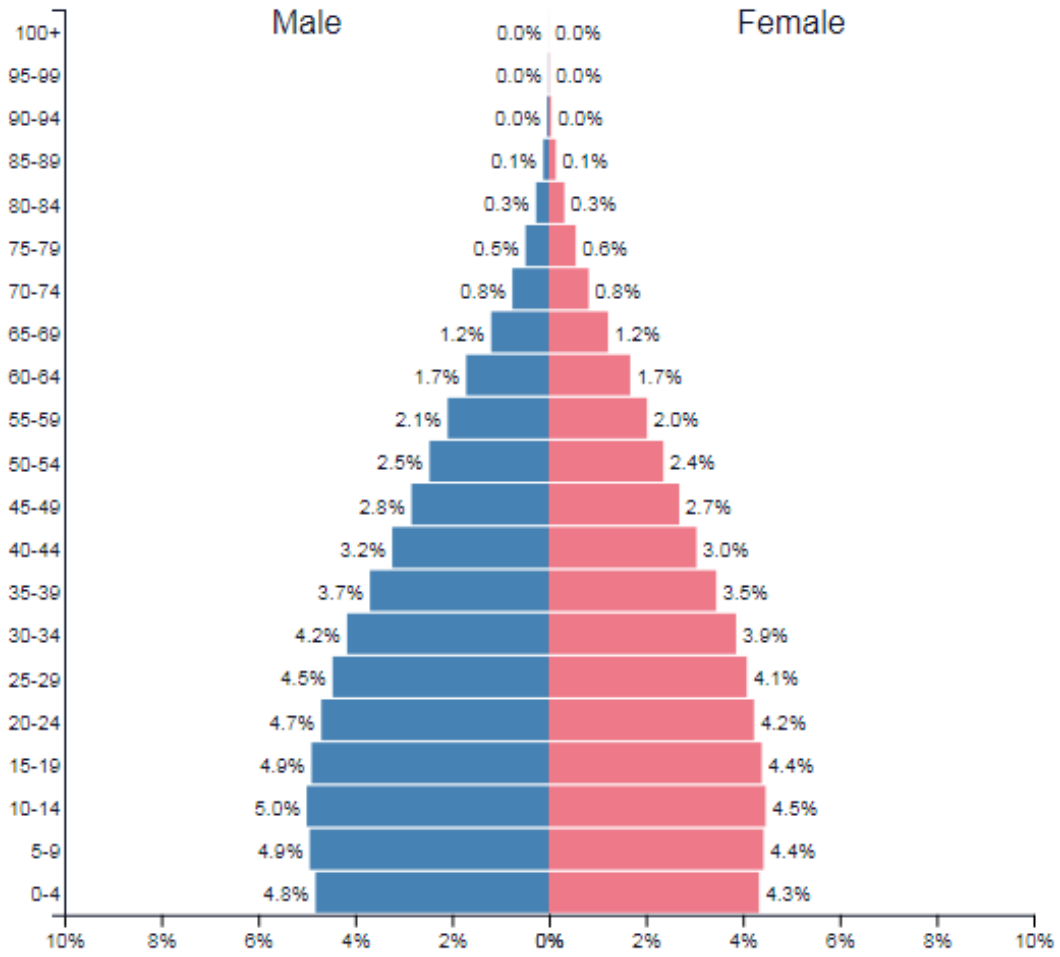
Analysis and Interpretation

While India's Fixed Deposit outstanding of over Rs. 100 lakh crores[(1)] indicates a high rate of savings, it was observed that post demonetization, the amount of investments in mutual funds was higher than that in FDs for the calendar year 2017.

Although FDs remain popular, the wealthier and slowly even the younger populace are willing to move into higher risk higher reward instruments such as shares and even futures and options. However, they have limited knowledge on bonds and if this knowledge is given in a simple & accessible format, the bond market could grow substantially.

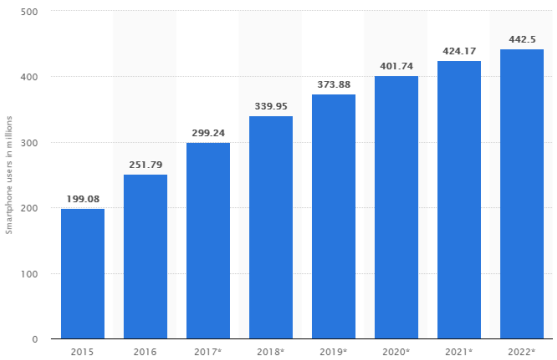
Two major macro-trends for this higher interest is the growing number of millennials and the overall growth in smartphone usage. Some statistics are discussed here as follows:

India's population pyramid



India has 344mn millennials i.e. 25% of the 1.3bn population.

India's smartphone usage:



Smartphone usage is huge and growing with over 300mn users already[(4)].

Most stock and share trading websites and investment funds already have user-friendly websites and applications and from December 2018 all instruments will have to be in 'Demat' format

thereby further ensuring online access. The last frontier for the Indian capital markets is to make bond information simple and intuitive and available – as it has with equities.

This is the same pool of investors that we believe will be interested in bonds if provided with the right tools to make investment decisions in trading bonds.

What Information does a retail investor need to invest in bonds?

We feel that a retail investor needs to look at a bond as an FD that can be traded i.e. bought or sold. Currently, if one invests in an FD they are stuck with it until maturity. In case of urgent expenditure requirements such as hospitalization expenses, the investor needs to withdraw the FD amount prematurely and ends up paying a small penalty and the interest also gets reduced to the lower term.

A bond typically provides better interest than an FD – for example, ICICI's 10-year FD interest rate is currently (Sept 2018) up to 6.50% p.a. However, there are several bonds issued by ICICI for 10 years or more that pay between 7.25% p.a and 11.5% p.a (depending on various factors). While FD's are guaranteed by the government up to a maximum of Rs. 1 lakh, the risk factors are not substantially different. Some bonds may be riskier however some (even with higher interest rate than an FD) are safer due to being backed by collateral.

The most advantageous part of the bond is that it can be bought and sold. And if market interest rates have reduced post the purchase, then the price of the bond appreciates (and conversely it depreciates if the market interest rates have increased, however, the investor continues to receive the original coupon rate).

Note however that many bonds in India are illiquid i.e. they is not easy to buy and sell mainly because of a lack of awareness about them and the complexity in understanding the bond.

While bonds have various factors, we feel that the most basic information that an investor needs about a bond consists of just 5 factors:

1) Name of the Issuer (e.g. ICICI Bank inspires confidence, however, Kosamattam (Gold Loan) Finance Ltd may be considered highly risky)
2) Yield on the bond (or Coupon rate if it is a Primary Issue)
3) Credit Rating of the bond
4) Term
5) Price

There are a whole lot of secondary factors, such as periodicity of coupon, embedded options such as convertibility, callability etc. While all this information needs to be provided the first 5 factors listed are all that are needed to get an investor interested. Currently, it is not easy to find this information and we recommend that established financial institutions or ambitious startups focus on providing this information in order to 'create' a thriving bond market in India.

Conclusion

Despite its existence for more than two centuries, bonds in India are out of reach from the hands of a retail investor. The Government policies and lack of incentives deter investors on one hand while the lack of sufficient and appropriate information is an impediment to tap this market.

Investors with a high-risk appetite opt for equities and derivatives while investors with low risk appetite immobilise their funds in FDs. The return on FDs are reducing every day and as mentioned above it is a cumbersome process to break an FD at times of exigencies.

Moreover, recent scams in the banking sectors such as the PNB scam has led to an increase in demand for an alternative way of financing and also resulted in investors to explore other opportunities. In fact, major projects by the Government such as the one by ministry of transportation was not funded by banks which opens the door to issue bonds.

Thus, bonds can be a better investment irrespective of the risk appetite as the risk and return trade off in bonds vary based on the ratings. Furthermore, the interest of the investors will be protected by the governing bodies which can give early warning signs of scams and prevent them.

Hence the bond markets in India can be liquidated by:

1. Promoting start-ups to provide information and a trading platform on bonds.
2. Bringing better credit rating systems
3. Government initiatives such as tax incentives
4. Reduction in transaction costs

Besides bonds have been manded to be converted to dematerialised form which creates a new milestone to validate our suggestions.

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