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Liquidity Effect on Equities Bond Market in India – A Review

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Abstract

This paper seeks to present liquidity effect on equities bond market in india. The Indian financial system is changing fast, marked by strong economic growth, more robust markets, and considerably greater efficiency. But to add to its world-class equity markets, and growing banking sector, the country needs to improve its bond markets. While the government and corporate bond markets have grown in size, they remain illiquid. The corporate market, in addition, restricts participants and is largely arbitrage-driven. To meet the needs of its firms and investors, the bond market must therefore evolve. This will mean creating new market sectors such as exchange traded interest rate and foreign exchange derivatives contracts. It will need a relaxation of exchange restrictions and an easing of investment mandates on contractual savings institutions to attract a greater variety of investors (including foreign) and to boost liquidity. Tax reforms, particularly stamp duties, and a revamping of disclosure requirements for corporate public offers, could help develop the corporate bond market. And streamlining the regulatory and supervisory structure of the local currency bond market could substantially increase efficiency, spurring innovation, economies of scale, liquidity and competition. Such reforms will help level the playing field for investors. In deciding the course for reform, however, the innovations and experiences of markets in the region are also important. Present paper intends to study the stock market efficacy in the Indian economy, associated the challenges and the growth prospects. Developing markets often mimic more advanced European and North American markets. But complex structures designed for diverse developed markets are sometimes ill-suited to less-developed economies. Instead, looking to neighboring, emerging markets at similar stages of development can be more useful. For example, India's unique collateralized borrowing and lending obligations (CBLO) system and its successful electronic trading platform could usefully be studied by its neighbors, many of which suffer from limited repo markets or which have (like India) tried unsuccessfully to move bonds on to electronic platforms. India could benefit, by contrast, from the lessons of its neighbors in developing its corporate bond market.

Keywords: India, emerging East Asia, bond, stock market, securitization, collateralized borrowing and lending obligations (CBLO)

Introduction

This paper reviews these issues and discusses policies that can help further develop India's debt market. Section II highlights and compares market development and outlook to emerging East Asian economies. Sections III and IV summarize salient characteristics, reforms and obstacles. Section V discusses the development and prospects for India's securitization market. Section VI looks at the main market participants and the depth of the pool of available investors, arguably the most significant factor in market development. Section VII tackles policy issues. And Section VIII concludes with a look at the importance of the lessons and innovations of other countries. Bank and financial intermediation, however, remain undeveloped with respect to lending and deposits, and most banks remain largely controlled by public sector institutions, limiting the development of a true credit culture, the skills to assess credit risks, and a willingness to accommodate any but the lowest risk borrowers. Overseas investors bought a net USD19.5 billion of stocks and bonds during 2007, compared with the previous record of USD8.9 billion in 2006. The current year has seen net outflows in the first 9 months totaling USD6.9 billion. The bank rate is currently 6% (July 2008) and longer-term deposit rates have risen around 50 basis points (bp) to 9.55% in recent months. Real estate markets have been buoyant, although they have cooled recently, and the banking system remains sound and well capitalized. In March 2008, the capital adequacy ratio stood at 13.1%, well above the 8% minimum prescribed under the Basel I accord. Amid strong credit growth, the ratio of scheduled commercial banks' gross nonperforming loans (NPLs) to advances has fallen to 2.4% in March 2008 from 10.4% in March 2002.2 India has developed a world-class equities market from relatively unpromising beginnings. Since 1996, the ratio of equity market capitalization to gross domestic product (GDP) has more than trebled to 108% (down from 130% in September 2007), from 32.1% in 1996 (Figure 1). During the same period the banking sector expanded to 74% of GDP from 46.5%. In contrast, the development of government and corporate bond markets has not been so fast: the bond market grew to a more modest 40.0% of GDP, from 21.3%. In March 2008, the government bond market represented 36.1% of GDP, compared with the corporate bond market, which amounted to just 3.9% of GDP.

Objective:

This paper seeks to investigate the main challenges that affect Indian stock market the and possible reform opportunities that lie ahead in the path of global market competitiveness

Liquidity effect on equities, bond market

The Indian bond market is, however, less well-developed. While having seen rapid development and growth in size, the government bond market remains largely illiquid. Its corporate bond market remains restricted in regards to participants, largely arbitrage-driven (as opposed to driven by strategic needs of issuers) and also highly illiquid. The lack of development is anomalous for two reasons: First, India has developed world-class markets for equities and for equity derivatives supported by high-quality infrastructure. And second, the infrastructure for the bond market, particularly the government bond market, is similarly of high quality. Relatively weak development of bond markets is not unusual in the region, indeed in many ways the Indian market shows stronger progress—for example in the use of sophisticated and innovative tools such as collateralized lending and borrowing agreements—but it is the rapid development of its other markets which is in such stark contrast to its bond markets.

India's government bond market has grown steadily—largely due to the need to finance the fiscal deficit—and is comparable to many government bond markets in emerging East Asia. At 36% of GDP, the Indian government debt market compares well

with the markets of its neighbors (Figure 4). In absolute terms, however, given India's greater overall size, the Indian government bond market is considerably larger than most other emerging East Asian markets (Table 2). The need to finance a large fiscal deficit has stimulated issuance and growth of the government bond market. Since 1992, deficit finance has relied increasingly on borrowing from the market rather than the previous policy of monetizing the deficit. The government market comprises approximately 104 issues with a total nominal value of about USD364 billion.

Economic growth in India has picked up in recent years, and like other integrating Asian economies, it too requires large amounts of efficiently intermediated capital to sustain its development. However, an important constraint to financial reform has been dealing with the vestiges of financial "repression"— deliberate policies that crowd out the private sector from credit markets and limit the ability of financial markets to develop as intermediaries for saving.

Years of deficit financing have led to large-scale intervention and state ownership of financial intermediation. High statutory reserve requirements, extensive directed lending to priority sectors (including mandatory holdings of government securities by banks), regulated interest rates, credit ceilings, and other controls are examples. Financial Market Liberalization Reforming and liberalizing financial markets began in the wake of the country's 1991 balance-of- payments crisis. The thrust of these reforms was to promote a diversified, efficient and competitive financial system, with the ultimate objective of improving the allocation of resources through operational flexibility, improved financial viability, and institutional strengthening.

Market Liberalization Effects since 1990

The pace of reform was, however, slower than those in product markets, partly because the introduction of stricter prudential controls on banks revealed significant problems in asset portfolios. Prior to the reforms, state-owned banks controlled 90% of bank assets—compared with approximately 10% at end-2005— and channeled an extremely high proportion of funds to the government. Interest rates were determined administratively; credit was allocated on the basis of government policy and approval from the Reserve Bank of India (RBI) was required for individual loans above a certain threshold. Capital markets were underdeveloped, with stock markets fragmented across the country. The major stock marketi acted mainly in the interest of its members, not the investing public. Derivative markets did not exist and comprehensive capital controls meant that companies were unable to bypass domestic controls by borrowing abroad. Concerns over the 1997/98 Asian financial crisis and its contagion effects further spurred Indian authorities to strengthen the domestic financial system. Reforms were, and continue to be, based on several principles: (i) mitigate risks in the financial system; (ii) efficiently allocate resources to the real sector; (iii) make the financial system competitive globally; and (iv) open the external sector. The goal was to promote a diversified, efficient, and competitive financial system which would ultimately improve the efficiency of resource allocation through operational flexibility, enhanced financial viability, and institutional strengthening. Banking Sector Reform Reform of the banking system has been gradual and sequenced, focusing on improved prudential control, recapitalization of public-owned banks, and the introduction of greater competition. Reforms have included the establishment in 1994 of a Board of Financial Supervision within Reserve Bank of India; substantially tightened rules on bad loans, and convergence of regulatory norms with international best practices.

Various legal and technology-related measures have likewise been implemented, such as the strengthening of credit information and creditors' rights, and the development of a dedicated communication backbone for banks. Work to introduce the new Basel II regulatory system is underway and a pilot project was launched in 2003 to operate a risk-based supervision system. The

introduction has, however, been postponed to 2009 for banks with only domestic operations, and to 2008 for other banks as it takes time to raise capital.

Enhanced competition has also been introduced by allowing new entries into the market. A dozen private Indian banks have been created and about 30 new foreign banks had entered the market and started operations by end-2006. Prudential reforms have been implemented. But while interest rates have been deregulated, controls remain in four areas—savings deposit accounts, small loans in priority areas, export credits, and nonresident transferable rupee deposits. The reduction in the lending requirement to government from 63.5% to 30.0% of bank assets has given banks greater lending latitude. Other measures include ending the RBI's participation in the primary market for government securities and lending to the government; removal of the legal ceiling on the statutory liquidity ratio; and abolishment of limits on both the floor and ceiling of the cash reserve ratio, allowing RBI to alter these ratios depending on prevailing monetary and economic conditions. Banking sector reforms have been sequenced to correspond with changing regulations of the foreign exchange market.

Capital Market Reforms by Indian government

The government has allowed the exchange rate to gradually float (as opposed to a "crawling" peg), and full current account convertibility has been introduced, with de facto capital account convertibility for nonresidents, and calibrated liberalization for residents. Other recent measures include foreign participation in the Indian foreign exchange market, unlimited hedging of genuine foreign exchange risk, and the introduction of new instruments such as interest rate and currency swaps, options, and forward contracts. Capital Market Reforms Significant effort has similarly gone into strengthening India's capital markets, particularly through the creation of various institutions such as the Securities and Exchange Board of India (SEBI) in 1992, an insurance market regulator in 1999, and a pension market regulator in 2004. The National Stock Exchange (NSE)—one of the first in the world to have a corporate structure—was likewise created in the mid-1990s. This has developed into the world's third largest exchange in terms of number of transactions, with foreign shareholders approved to own up to a maximum of 26% (the amount allowed by FDI regulations). In contrast to equity markets, the government and corporate bond markets have been held back by the more restrictive regulatory framework. A number of reforms were introduced to the government bond market in 1992 when the price of newly-introduced bonds was set by auction. But it was not until 2005—11 years after the equity market—that bond market became an electronic order limit market. Several measures were implemented to minimize risks in equities trading and to create a national market in stocks. These included the introduction of a clearing and settlement system, creation of a centralized counterparty for transactions, establishment of a modern depository system for stocks, and a shift from a relatively primitive carry-forward system to the introduction of futures contracts. Trading in derivatives on the NSE started in 2000—the Indian market is now the tenth largest globally for futures contracts on single stocks and indexes and the largest for futures on single stocks. As part of the package of financial reforms, commodity exchanges were also fundamentally overhauled. Starting in the mid-1990s, the commodity market regulator began to reform the domestic markets and while initial attempts were unsuccessful, three new markets were eventually created in 2000 based on the architecture of the NSE.

FDI in Indian markets

Since the mid-1990s, the Indian financial system has been steadily if incrementally deregulated and more exposed to international financial markets. Its rapid transformation has been accompanied by strong economic growth, increased market robustness, and a considerable increase in efficiency. Reforms are continuing with the development of appropriate market regulation and an associated payment and settlement system, as well as greater integration into global financial markets. The

financial market as a whole, however, remains subject to a number of constraints that need to be eased if efficiency is to improve further. The level of bank and financial intermediation remains low, for instance, both with respect to lending and deposits, and most banks remain largely controlled by public sector institutions. While household savings are high, individuals generally prefer to invest in real assets and gold rather than in financial assets. A major challenge is thus to deepen financial intermediation. This can be achieved by further improving the environment for financial investment through better regulation, greater transparency, and generally stronger institutions and legal frameworks.

The Reserve Bank of India acts on Primary markets

The Reserve Bank of India has introduced a number reforms since 1992 in an effort to move toward a more transparent and market-driven structure. The process of auctioning new issues was introduced in 1992, replacing the previous system whereby government issues were allocated to investors—largely banks and state-owned investment institutions. Until prohibited under the FRBM in 2006, the RBI frequently intervened in the auction, taking substantial holdings onto its own books ("devolvements") to ensure the auction achieved the right price. 1. Primary Dealers Primary dealers were introduced in 1996 to support the auction system. Primary dealers may be independent or may be linked to banks. In 2006, the primary dealer structure was modified to allow banks to operate directly as primary dealers (separate primary dealer subsidiaries of banks were permitted to reintegrate into the parent bank). There are currently six primary bank dealers and 11 "stand-alone" primary dealers. Primary dealers have privileged access to preferential finance at the RBI through the liquidity access facility and through repos. Primary dealers are also given favored access to the RBI's open market operations. They are permitted to borrow and lend in the money market, can raise resources through commercial paper, and have the same access to finance from commercial banks as any other corporate borrower. Issuance is a two-stage process with primary dealers bidding to underwrite the issue and then bidding for the issue itself. Primary dealers are assessed on their performance in auctions and in the secondary market. The auction process permits noncompetitive retail bids to be submitted through primary dealers. Models for primary dealerships vary across countries. The purpose is to construct a system, which provides primary dealers sufficient privileges to encourage them to undertake the obligations.

The obligations are usually to bid in all auctions and to support some form of continuous secondary market. Privileges usually involve preferential access to central bank finance and some degree of exclusivity in the auction. But not all countries follow the exclusivity model. Thailand for instance allows major (government-sponsored) savings institutions to bid directly for government securities. Other countries allow institutions to make separate bids though these must be routed through primary dealers. The Indian model, however, where primary dealers aggregate interest from their client and submit single bids is the most commonly used. 2. Issuance A "when-issued (grey) market" was introduced in May 2006. Initially, it was only permitted when the issue was a re-opening of an existing bond (one that was currently trading). The rules were subsequently relaxed to allow when-issued trading in selected new issuances (bonds that were not re-openings of old bonds).

Major Reforms

- Banks are especially attracted: (i) securities held in any of the three types of holding accounts—held to maturity, available for sale, and trading—can be used as collateral for CBLOs; and (ii) the RBI grants limited exemptions from following cash reserve ratio (CRR) and SLR requirements to encourage the development of the market. Banks are therefore able to borrow more cheaply on the CBLO market.

- CBLOs are more flexible than normal repos (note that repos with counterparts other than the RBI are rare anyway), because they can be traded and hence positions can be closed earlier than originally intended if circumstances change.
- The collateralized nature of the instrument means that rates are typically lower than in the conventional call market. Furthermore, the fact that additional participants, notably mutual funds, can access the market reduces the CBLO rate below the repo rate. Recent figures show the call market at 6.75%, the repo rate at 6.4% and the CBLO rate at 6.25%. The security of collateral also means that the market is open to participants who would not be able to make unsecured borrowings at acceptable rates.
- The instrument is traded in a transparent, auction-based market, which is likely to lead to greater pricing efficiency and fewer pricing anomalies.
- The infrastructure requirements are small as the CBLO system is integrated with the existing settlement processes allowing Straight-thru Processing.
- Like all products that allow increased leverage, CBLOs and repos have the potential to increase systemic risk—so strong regulatory supervision of exposures is essential. In the current climate there will inevitably be concerns—especially from regulators—that easing borrowing, while it might enhance and develop the market, will increase systemic risk. And CBLOs are not immune from these concerns:
- The CBLO market removes some regulatory control since participants can lend among themselves without going through central bank repos. However, the RBI has been a staunch supporter of the CBLO market and it has a justified reputation for caution in relaxing regulations.
- CBLOs encourage a wider range of participants and potentially allow them to gear up their holdings of government bonds. However the risk management rules applied by CCIL limit the risk of default and normal regulatory structures prevent participants acting imprudently. Interest-rate derivative markets are OTC—there is no exchange-traded interest rate derivative market.

Registered Interest and Principal of Securities and Market

Most issuers now publish some form of timetable of forthcoming issues. In 2001, a published timetable was introduced for Treasury bill auctions but not for longer-dated bonds. In part, this was a consequence of weak control of the budget deficit, leading to frequent revisions in funding requirements during the course of the year. Since September 2006, the RBI has published a yearly issuance timetable for dated bonds. Indian state governments raise finance through omnibus issues organized by the RBI. State issues are not government guaranteed. The omnibus issues are sold at fixed coupons and prices (the same for every state). Potential buyers subscribe at the fixed-coupon rate for the bonds of a particular state (the amount on issue for each state is not announced). The subscription is closed after 2 days even if some issues are under subscribed. Current government bonds are fixed-coupon with maturities from 1 to 30 years. The RBI has experimented over the years with a number of different types of bonds. These include (i) zero- coupon bonds; (ii) capital-indexed bonds (inflation-linked principal); and (iii) floating-rate bonds. None has generated much interest and all have now been discontinued. The RBI is now working to develop a market for Separate Trading of Registered Interest and Principal of Securities (STRIPS). Primary dealers are obliged to support the secondary market by providing continuous two-way quotes.

Conclusion

Many markets have received a major development stimulus from foreign investors. Typically foreign investors are seen as a source of funds but they are also catalysts for more general development. Foreign investors are an important element in building investor diversity and encouraging participation tends to lead to significant improvements in the local market. There are many reasons for this: • Most obviously foreign investors command extremely large liquid pools of assets and so can add significantly to local market liquidity. They operate on global strategies that are less sensitive to short-term local issues—making them valuable contrarian investors. • They are likely to be accustomed to following active trading strategies in home markets and will try to do the same in emerging markets. Also, their global business means their trading strategies will be partly driven by external factors—such as exchange rates and comparative economic performance—which brings a new dimension into local markets. There is also diversity in investment horizons. This particularly holds when local institutional investors are poorly developed—as is true in many developing Asian markets—and markets are therefore driven by speculative retail investors. However the willingness of foreign investors to take a long-term view is highly sensitive to the treatment they receive. Arbitrary and discriminatory treatment of foreign investors will encourage them toward a "hot money" strategy. • Foreign investors often have skills and experience that are lacking in local markets. Exposure of local practitioners to foreign investors tends to lead to skill improvements and to better regulatory decisions. • Foreign investors will tend to push strongly for innovations such as the introduction of derivatives—often they will have access to OTC derivatives on local assets traded in offshore centers. Unless local firms are permitted access to derivatives—ideally through developing a local market—they will trade at a disadvantage and so will reinforce the pressure from foreign firms.

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