

Indian Capital Market

A Plinth for Economic Growth

MARCH 2020

The Associated Chambers of Commerce and Industry of India

Corporate Office: 5, Sardar Patel Marg, Chanakyapuri, New Delhi-110 021

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Dr. Niranjan Hiranandani

President
ASSOCHAM

MESSAGE

The capital markets are always seen as a reflection of the economic health and growth of a country. Today, the Indian capital markets truly reflect one of the fastest-growing economies in the world.

The basic purpose of the capital markets is to match the forces of demand and supply of funds and in the process, play a vital role in channelizing saving and investments in the financial system. For speedy economic development, adequate capital formation is necessary, and the capital market has a crucial significance to capital formation. In simple words, capital markets facilitate the buying and selling of debt as well as equity instruments, both in the primary and secondary markets. Not only is it important to ensure that these markets are well-advanced, but it is also crucial that the advancement is in sync with effective supervision and regulation.

The twin features of reasonable return and liquidity in the stock exchange are definite incentives to the people to invest in securities. This accelerates capital formation in the country. The stock exchange is a central market through which resources are transferred to the industrial sector of the economy, and the existence of such an institution encourages people to invest in productive channels. Thus it stimulates industrial growth and economic development of the country by mobilizing funds for investment in the corporate securities.

In India, both primary and secondary markets play a significant role in ensuring that the economy and the businesses are well fuelled in terms of liquidity. The Indian equity market is expanding in terms of listed companies and market capital, widening the field for brokerage firms, new products segments and the growth of derivatives trading. This substantial growth in the market capitalization would be the key to drive the advancement of primary and secondary market, bond market, fund management as well as currency and commodity market.

ASSOCHAM, along with CARE Ratings, has prepared this report with the objective of outlining factors which would provide impetus to the stakeholders for a better understanding about the details of the structure and problems of various segments of the market and also highlights key factors for the development of the market.

I sincerely hope that this report will be useful to all the stakeholders, investors, service providers, and Government agencies and will help in fostering informed debate.

I extend my best wishes for the success of the conference.

Niranjan Hiranandani



Deepak Sood
Secretary General
ASSOCHAM

MESSAGE

The Indian capital market has a history of more than a century wherein it acted as a catalyst for the economic development of the country. The Indian capital market plays a vital role in the global financial system.

An essential role of shaping resource allocation is played by the capital market, in addition to being an enabler for financial institutions and non-banking financial companies to access funds on a medium and long-term basis. The Government has undertaken various measures to strengthen the capital markets. Regulatory bodies like Securities and Exchange Board of India (SEBI) and Reserve Bank of India (RBI) continue to play a crucial role in protecting the investors and improving the microstructure of capital markets in India.

Over the years, India has witnessed a positive performance by benchmark indices, and there has been a consistent increase in fundraising from the capital market. Continuing its growth, supported by resource mobilization, trading volume, and the number of listed stocks, the market capitalisation increased more than 6% during 2018-19.

Trading platforms of stock exchanges have become more and more accessible from any part of the country, which is a result of increased application of information technology. Consistent investment interest by domestic institutions and foreign investments are the factors contributing to the recent development in the corporate bond market. Along with this RBI is making a conscious and continuous effort to expand the investor base, thereby increasing the market liquidity.

In FY ending March 2019, the Indian capital market witnessed improved performance over the previous year, recording double-digit growth and also outperformed various major global markets, including the US, the UK, China and Brazil.

However, as a proportion of GDP, India's total equity market capitalisation is much lower compared to the global average. Retail investors constitute a very low proportion of stock ownership in India. The number of Demat accounts in India is significantly lower as compared to the number of banking accounts. This low-level participation indicates a strong potential for involvement of retail investors in Indian capital markets and contributes towards the country's journey of becoming a US \$ 5 trillion economy.

ASSOCHAM, along with CARE Ratings, has prepared this report to highlight the importance of the Indian capital market and the initiatives taken by Government for regulating the same.

I hope that the stakeholders will find the report relevant and the views expressed therein will help in creating a comprehensive perspective about the capital markets in India.

Deepak Sood



T. N. Arun Kumar
Interim CEO
CARE Ratings

MESSAGE

Given the target of \$ 5 tn economy that the government has set for the country, the main enabler will be the financial system as the quantum of investment that is required to achieve this target would be contingent on the ability of the system to generate the resources. The Indian economy appears to be on the verge of a new takeoff after the slowdown witnessed in the last couple of years with the investment rate lagging. The focus on infrastructure development which is going to the thrust point for future growth along with the investment being done by the corporate sector would hold the clue to the time taken to achieve this objective.

The Indian financial system comprises two segments – the markets and institutions. The latter has been through a rather challenging phase involving addressing the issue of quality of assets as well as being well capitalized. It is hoped that the system has stabilized and the indications given by the RBI is that the worst is over for the banking system and that there would be stability in the coming years. However, there is also a realization that for funding investment of long duration, banks and NBFCs may not be the ideal source of funding and that a greater role has to be assigned to the markets.

It is in this context that the conference being organized by ASSOCHAM is very relevant as we in the credit rating business see a large contribution coming from the capital markets in the coming years. Globally too it has been seen that capital markets have been the vehicle to financing growth in the developed countries and this should also logically be the model which we should follow.

This knowledge paper gets into the details of the structure and problems of various segments of the market and also highlights the role of mutual funds and FPIs in the development of the same. One may recollect that the advent of FPIs in the nineties has had a significant impact on the equity market which has then been followed up by the mutual funds which allow retail participants to become part of the eco system. The trends in their investment have been analyzed also in some detail here.

Also being in the credit rating business we do see an important role to be played by the rating agencies in growing the debt market and have also presented the recent regulatory changes brought in by SEBI which has not just made the system robust but also reinforced market confidence.

We do hope that the reader finds this paper useful. We are thankful to ASSOCHAM for inviting us to be the Knowledge Partner for this Summit and are sure that the audience will benefit from the deliberations.

T. N. Arun Kumar

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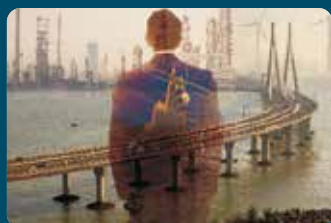
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Executive Summary

Capital markets, comprising the equity and debt segments, are critical to the economic development of a country by providing financial resources required for the long-term sustainable development of the economy. The various segments of the Indian capital markets have witnessed notable growth over the years, both in terms of primary and secondary markets.

India's equity markets hold the pride of place in the country's finance sector. They are increasingly been seen to be determining the pace and pattern of India's economic growth and the development of India's equity markets have led to a transformation in the financial framework of the economy. The Indian stock markets have grown exponentially in terms of number of listed companies/stocks, trading volumes, market capitalization, investors and resources mobilized, emerging as a force to be reckoned with. BSE and NSE two prominent stock market platforms in India are featuring in the top 15 stock exchanges across the world.

On the other hand, the Indian debt market has been largely dominated by the Government Securities market with the corporate bond market remaining comparatively undersized. Conventional bank loans have traditionally been the predominant source of funds for businesses in the country that resulted in the corporate bond markets remaining largely stagnant. Additionally, there are a number of challenges which the corporate bond market faces in terms of dominance of private placements, low retail participation and liquidity, regulatory restrictions among others. To address the myriad challenges and recognizing the growing need for businesses to tap the bond markets, the regulators along with the Government have increased their policy focus to develop and deepen the corporate bond markets. These effects are already being witnessed and it is hoped that with the regulatory nudge provided by both the RBI and SEBI the depth of the market will increase.

Foreign portfolio investors and mutual fund investments into the capital markets are seen to be important not only for the growth and development of the domestic capital markets but also for the country's balance of payments as they have supported the currency by strengthening the capital account in the face of persistent current account deficits. The advent of FPIs in the nineties has had a significant impact on the equity market which has then been followed up by the mutual funds which allow retail participants to become part of the eco-system.

The focus of the regulators is on making the capital markets more vibrant to ensure that companies are able to raise funds for long term investment purposes and hence reduce the burden on the banking system, which is the primary source of finance today. The regulators and policy makers have taken concerted measures and policies for the development of the Indian capital market in terms of products, technology, participants, surveillance and enforcement. With a target of \$5 trillion economy which the Government has set, the aim is to enhance the role of the Indian capital markets for facilitating long term finance.

The progress so far has been good on the equity side, but on debt, while a lot has been done to make the market buoyant, progress has been relatively slow. The regulators have been working on making the corporate bond market more active while simultaneously widening the scope of the equity market as a right blend of debt and equity is required when financing investment that is required to propel the economy on the path of high growth in the years to come.

CHAPTER 1

INTRODUCTION

Capital markets, comprising the equity and debt segments, are vital to the economic development of a country. They play a critical role in providing financial resources required for the long-term sustainable development of the economy. The development of a robust capital market is seen as being essential from the perspective of financial stability.

The Indian capital markets, especially the equity segment have witnessed significant growth and development over the years and are at par with markets in advanced economies in terms of efficiency, tradability, stability, resilience and maturity. Bearing testimony to their efficiency, resilience and maturity has been the ability of the Indian markets to withstand periods of stress that has impacted global markets such as the global financial crisis of 2008, the Asian financial crisis of 1997 to name a few.

The various segments of the Indian capital markets i.e. the equity markets including derivatives and corporate bond market have witnessed notable growth over the years, both in terms of primary and secondary markets.

The regulators and policy makers have on a continuous basis been undertaking various measures and policies for the development of the Indian securities market in terms of products, technology, participants, surveillance and enforcement. Global best practices are being adopted with customization for domestic markets with the aim of enhancing the role of the Indian securities market for facilitating long term finance.

Capital markets provide an alternative to the system of financial intermediation and with the sophistication in markets leads to lower cost for companies. The focus in our country is also on making this segment more vibrant to ensure that companies are able to raise funds for long term investment purposes and hence reduce the burden on the banking system which is the primary source of finance today. It is against this thought process that the regulators have been working on making the corporate bond market more active while simultaneously widening the scope of the equity market as a right blend of debt and equity is required when financing investment that is required to propel the economy on the path of high growth of 8% plus in the years to come.

The progress so far has been good on the equity side though on debt while a lot has been done to make the market buoyant progress has been relatively slow. This has more to do with the intrinsic nature of debt instruments which make the evolutionary process longer.

This paper looks at four aspects in some detail – equity market, debt market, role of mutual funds and FPIs in these markets and the importance of credit rating in this system. At the end the concept of the GIFT city which seeks to provide a boost to the financial markets is also covered.

CHAPTER 2

INDIAN EQUITY MARKETS

2.1 Overview

The role and importance of the equity market in a country's economic development and growth is undisputed. In addition to providing the much needed capital to firms, a developed and active stock market enhances the efficiency of the country's financial system and the allocation and utilization of its financial resources. An efficient stock market instills discipline in firms to perform better and plays a crucial role of channeling finance to the most productive sectors of the economy.

Equity markets also help garner savings of households, in particular, and serve as an alternative savings and investment avenue. Stock markets instruments equip such investors to diversify risks and maximize returns. These markets also serve as a source that helps households earn returns consistent with the prevailing inflation rate in the economy.

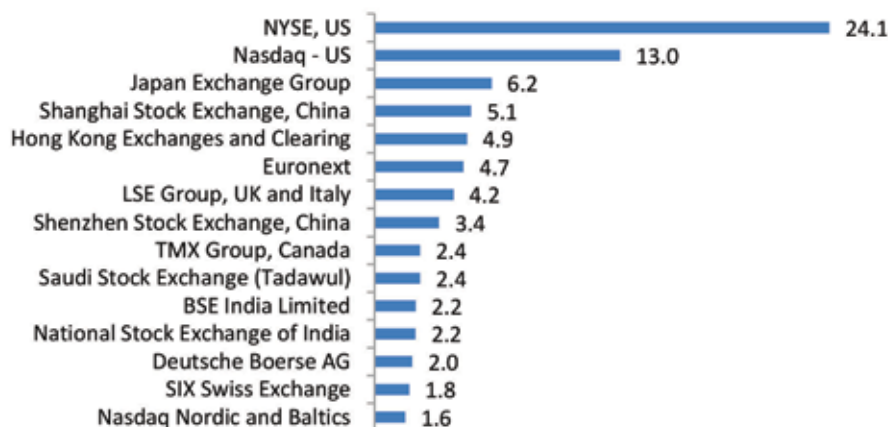
Equity markets are considered to be relatively risky compared with the debt market, but from the point of view of the issuer, it is critical as it determines also the amount of leverage that could be had from the lending institutions. Without equity, no project can be conceived. Therefore, a healthy equity market is a prerequisite for a buoyant capital market.

Efficient stock markets are needed to ensure completeness of the financial sector of a country. Well-functioning capital markets help shoulder the burden of excessive credit exposure of the banking sector, besides promoting risk diversification. Equity markets also are a useful barometer for the state of the economy and, if efficient, can provide valuable signals of overall sentiment in the country as these are imbibed in the market numbers. This in turn helps to bring in foreign funds that provide succor to the balance of payments especially for developing markets like ours where foreign capital flows are necessary to balance the external account given our perennial current account deficit.

Equity markets are thus vital in the financial system of an economy given their role in financial intermediation and capital formation. Also, well-functioning financial markets are crucial for the long term economic growth of a country.

India's stock markets hold the pride of place in the country's finance sector. It holds a place of prominence globally too. In terms of market capitalization and turnover, Indian stock exchanges feature amongst the 15 largest in the world (Chart 2.1). Although banks continue to dominate the country's financial sector, the growth and development of India's equity markets have led to a transformation in the financial framework of its economy. They are increasingly been seen to be determining the pace and pattern of India's economic growth.

**Chart 2.1: Market Capitalization of the Largest Stock Exchanges:
December 2019 (US \$ Trillion)**



Source: World Federation of Exchanges

The genesis of India's developed equity markets can be traced back to the early 1990s, where various capital market reform measures were initiated by the Securities and Exchange Board of India (SEBI) and the Government of India in the advent of the economic liberalization and the consequent increasing financing needs of the economy. The numerous structural and institutional changes brought about in the capital markets since has led to a transformation of the structure of the finance sector of the country.

The Indian stock market comprises the primary and secondary markets and is regulated by SEBI. In the primary markets, issue of new securities/shares by companies takes place. These issues are referred to as Initial Public Offerings (IPO). The secondary market deals with securities that have been previously issued i.e. the trading (buying and selling) of securities that have been issued in the primary markets and also with derivative products such as futures and options. The participants in the equity markets can be categorized into 3 categories – the companies issuing the share/securities, the investors in these securities and the intermediaries. The intermediaries are all those who provide the various services and perform the functions that meets the needs of the issuers and investors such as stock exchanges, brokers, depositories, underwriters, custodians, registrars, mutual funds, FIIs, primary dealers, bankers to the issue and the like.

The Indian stock markets have grown exponentially since the 1990s in terms of number of listed companies/stocks, trading volumes, market capitalization, investors and resources mobilized, emerging as a force to be reckoned with. The country also has a well-developed equity derivative market since 2000 which is on par with world standards and among the most prominent globally in terms of turnover.

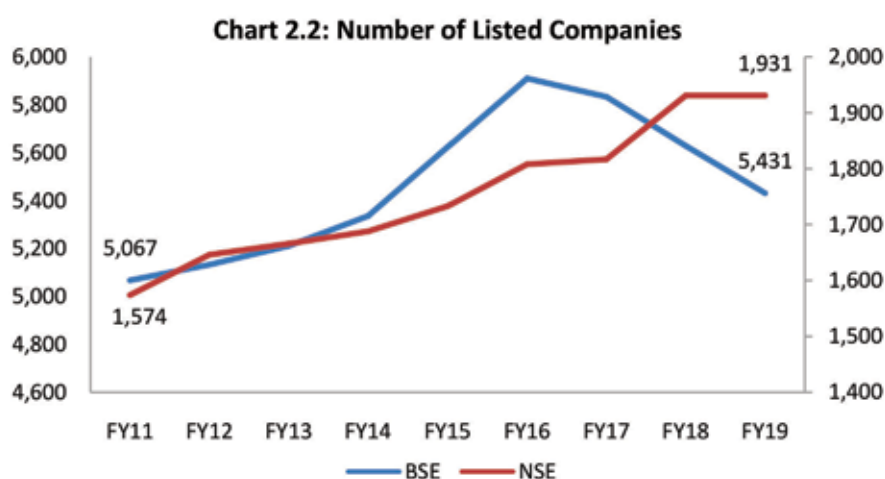
Currently, there are 9 operational stock exchanges. However, most of the trading takes place on two exchanges – the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE), with NSE holding the dominant position. The country also has exchanges dedicated to the SME (Small and Medium Enterprises) segment. Both BSE and NSE have set up SME Exchanges.

The SME Exchanges have been established to enable the small and medium sized companies to gain sufficient visibility and thereby attract trading in their securities, given the difficulty faced by these companies in doing

so when listed alongside securities of large companies in the main stock exchanges viz. BSE and NSE. Through the SME exchange platform, these companies which otherwise have to rely on promoter funds, and high cost debt, are able to raise the much needed funds at a lower cost burden. Although the SMEs have the option of listing on the main exchanges, the dedicated SME exchange makes it easier for them to do so as the listing norms and IPO process is simplified for them on this platform. Also, it makes it easier for interested investors to identify the SME stock on this exchange than on the main exchanges wherein they tend to get lost among the host of stocks of large companies.

2.2 Primary Market

2.2.1 Listed companies



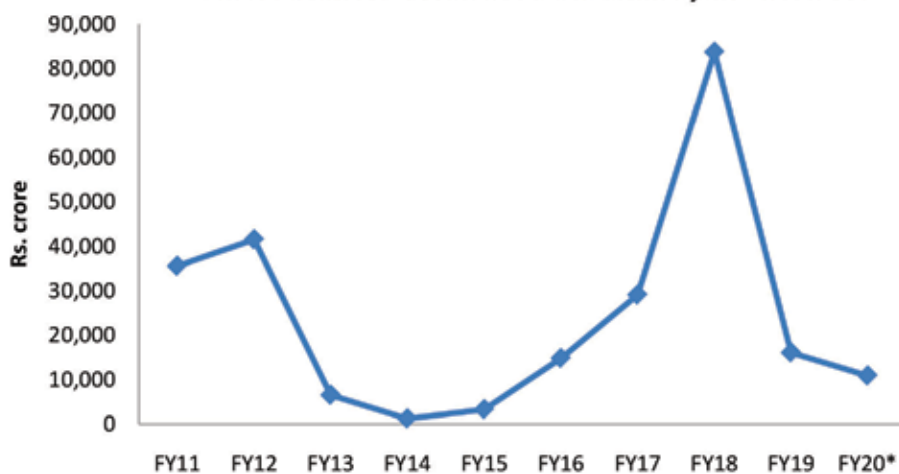
Source: SEBI

In terms of number of companies listed on the stock exchanges, India has the largest numbers of listed companies in the world at 5,431 as of 2018-19 on the BSE exchange. Amongst the world's stock exchanges, the BSE holds the unique distinction of having the highest number of companies listed on its platform and being the oldest stock exchange in Asia. Since the commencement of National Stock exchange in 1994, the number of listed companies have increased from 135 in FY95 to 1,931 in FY19 having grown by 11%.

2.2.2 Resource mobilization via IPOs

The domestic equity markets have helped companies mobilize significant amount of funds as can be seen from the resources raised from the primary markets. More and more companies have been accessing the capital markets to meet their financing needs through IPO's. The number of issues of IPOs has increased from 53 in FY11 to 201 in FY18. However, in FY19, the number of companies which filed IPOs declined to 123. In terms of resources raised from IPOs, there has been a sustained increase since FY14 from Rs. 1,236 crore to Rs. 83,684 crore in FY18. Thereafter, there has been a decline in the amount raised in the equity markets via IPO by 81% in FY19. In FY20 (April – December), the amount raised in equity segment via IPOs amounted to Rs. 13,948 crore, which was 15% higher than Rs. 13,948 worth IPOs in the comparable period a year ago.

Chart 2.3: Resources Raised from Primary Market -IPOs



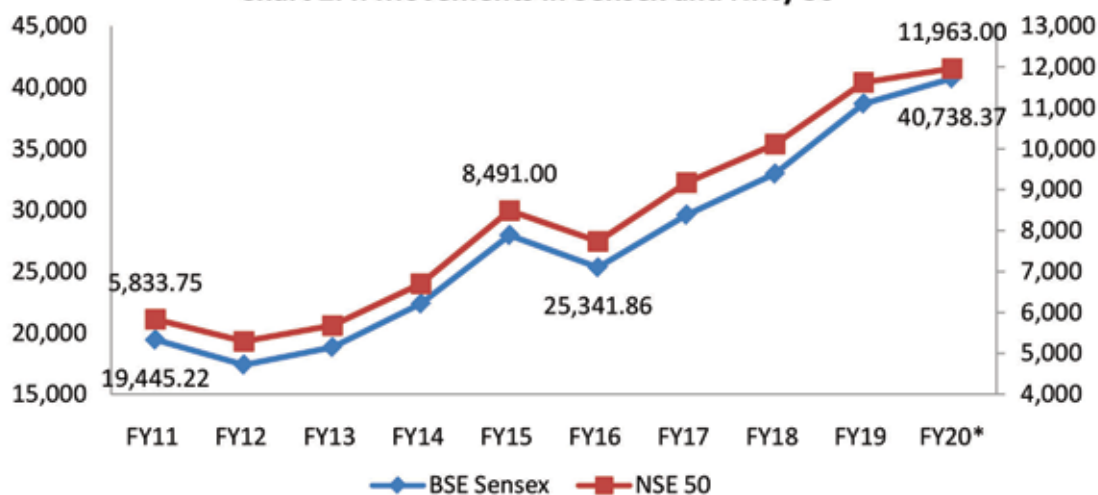
Note: * up to December 2019

Source: SEBI

2.3 Secondary Market

2.3.1 Market Movements

Chart 2.4: Movements in Sensex and Nifty 50

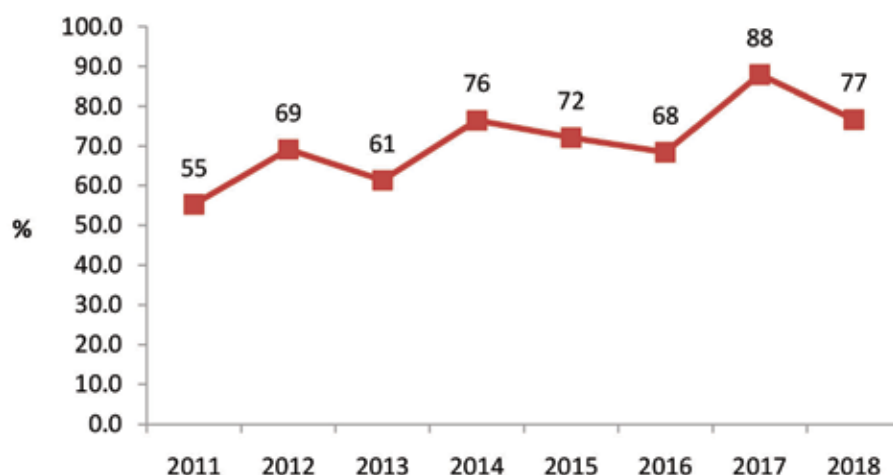


Source: BSE and NSE

BSE Sensex and Nifty indices have increased exponentially over the years. When compared with the previous decade, the market indices have more than doubled in FY19 and have set new records in FY20 so far. Sensex and Nifty 50 indices have grown at a CAGR of 9% of during FY11 to FY19 owing to increased inflows in the markets by the foreign investors as well as domestic institutional investors, who have pumped in funds in the capital markets in the past few years.

2.3.2 Market capitalization

Chart 2.5: Market Capitalisation (% of GDP)

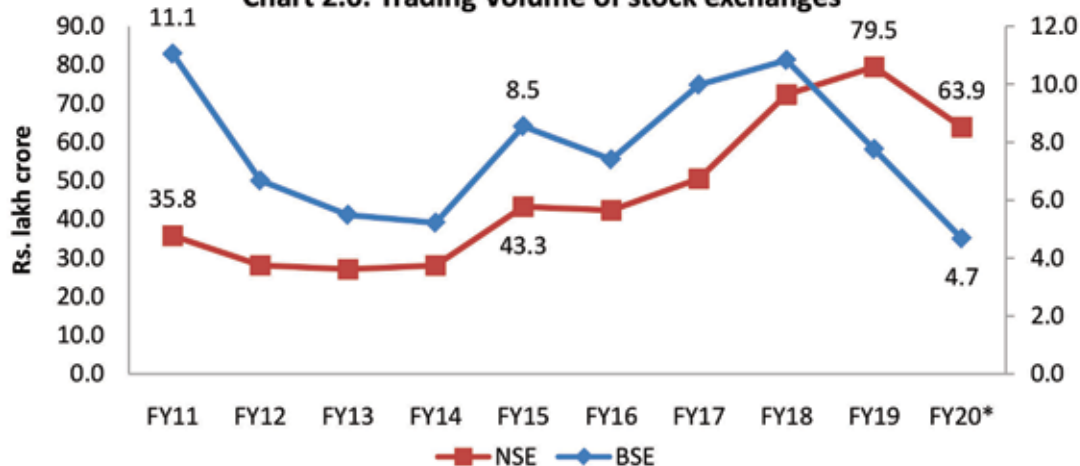


Source: World Bank

The growth of the Indian equity markets is evident from the significant increase in its market capitalization over the years. India's market capitalization as a percentage of its GDP (market capitalization to GDP ratio), a gauge of the value of the country's stock market as a percentage of its GDP, has risen from 55% in 2011 to 77% in 2018, as per the World Bank estimates. Such a substantial increase in market capitalization of the Indian equity markets can in part be attributed to the increasing number of companies accessing the country's stock markets by getting listed on the nation's stock exchanges. A high market capitalization to GDP ratio indicates high valuation of the country's capital markets and vice-versa. This is a useful indicator for potential investors looking to invest.

2.3.3 Trading volume

Chart 2.6: Trading Volume of stock exchanges



Note: up to December 2019

Source: SEBI

The volume of trading at the NSE platform has grown at a CAGR of 10% during FY11 to FY19. In FY19, the trading volumes on NSE reached to their highest level to Rs. 79.5 lakh crore. The trading volumes at BSE have witnessed fluctuations over the past 10 years and have declined by 4.3% CAGR during FY11 to FY19.

2.4 Recent Developments in the Indian equity markets

SEBI (Securities and Exchange Board of India) is the apex body that is tasked with the regulation of the Stock Exchanges and the orderly growth of Indian securities market. The mandate of the regulator is protection of interests of investors, market development and regulation.

SEBI has since its inception (in April 1992) undertaken various measures and policies for the development of the Indian securities market in terms of products, technology, participants, surveillance and enforcement. The regulator has adopted global best practices and standards as well as innovative custom solutions for the domestic market.

In order to ensure integration with the global markets and regulatory systems, SEBI is required to constantly undertake developmental and policy measures.

Some of the latest policy measures initiated by SEBI with regard to different segments and participants have been included here.

A. To refine the primary markets and boost investor confidence

1. **Eased norms for buy back of shares** – allowing buybacks resulting in post-buyback debt-to-equity ratio of up to 2:1, except for companies for which a higher ratio has been notified under the Companies Act, based on both standalone and consolidated basis.
2. **Relaxations provided to companies undergoing Corporate Insolvency Resolution Process (CIRP) under Insolvency and Bankruptcy Code (IBC) –**
 - (i) Acquisitions pursuant to an approved resolution plan have been exempted from the proviso that prohibits acquisition beyond maximum permissible non-public shareholding,
 - (ii) Corporate governance norms such as composition of board of directors, frequency of meetings of directors, composition of various board committees, etc. have been relaxed, provided that the role and responsibilities of the board of directors is fulfilled by the interim resolution professional or resolution professionals
 - (iii) Exit option provided to the existing public shareholders at a price specified in the resolution plan, subject to certain conditions (shareholders are given exit at a price not less than the liquidation value after paying off dues, and such exit price is not less than the price paid to the promoters and details along with justification for the exit price have been disclosed to the stock exchanges).
3. **Transfer of shares only in dematerialized form to improve ease, convenience and safety of transactions for investors.**
4. **Reducing the time period for listing of issues** – from T+6 days to T+3 days by introducing the use of Unified Payment Interface (UPI) with facility of blocking Funds (ASBA facility), as a new payment mechanism for

retail investor applications submitted through intermediaries. This would make the shares available for trading faster benefiting both issuers and investors.

5. **Allowing counter offer by promoter in reverse book building (RBB) process** - If the price discovered through RBB in case of voluntary delisting is not accepted by the promoters, a counter offer can be provided and the same can be successful if it is accepted by public shareholders such that the promoter shareholding reaches 90%.
6. **Flexibility to change Offer for sale (OFS) size**- fresh filing of offer document with the company board will be required, when there is a change in either the number of shares offered for sale or the estimated issue size, by more than 50% from the current 20%.
7. **Distribution of cash benefits through depositories in addition to registrars.** The option will widen the choice for investors with its benefits such as shorter turnaround time for receiving benefits, ability to get consolidated statements of all such benefits and to receive alerts (SMS / e-mails), etc.
8. **Exit to public shareholders pursuant to compulsory delisting** – within three months of delisting from recognized stock exchange. The delisting regulation has been amended.

B. To maintain competitive edge in the secondary markets

1. **Inter-operability among Clearing Corporations** - by linking of multiple clearing corporations and allowing market participants to consolidate their clearing and settlement functions at a single clearing corporation, irrespective of the stock exchange on which the trade is executed. This would lead to efficient allocation of capital for the market participants, thereby saving on cost as well as provide better execution of trades.
2. **Revision in haircut on central government securities (G-sec) accepted as collateral from clearing members by clearing corporations** – from 10% earlier to 2-10% for different securities based on their liquidity and residual maturity.
3. **Commencement of operations by a newly recognized stock exchange/clearing corporation** – with a minimum of 25 trading partners from the earlier requirement of 50 trading partners.
4. **Commencement of operations by a newly recognized clearing corporation** – with a minimum of 10 clearing members from the earlier requirement of minimum of 25 clearing members.
5. **Measures to strengthen Algorithmic Trading and Co-location / Proximity Hosting framework** – such as managed co-location service to facilitate small and medium sized members, manage latency for co-location and proximity hosting to bring in greater transparency.
6. **Cyber Security** – SEBI has laid down a detailed framework with regard to cyber security and cyber resilience that stock exchanges, clearing corporations and depositories are required to adopt.

There is evidently going to be a big role played by the equity market and one can expect more issuances as the companies seek to expand their business. It has been observed that with the growth of several start-ups and new ventures, the need for capital has increased and there would be a tendency for some shift to the market as companies become bigger and require additional doses of capital for expansion.

CHAPTER 3

INDIAN CORPORATE DEBT MARKET

3.1 Overview

With the Indian debt market being dominated by the Government Securities (G-secs) market, the corporate bond market is comparatively undersized. To put it in perspective, while the outstanding Government securities stock stands at Rs. 60.21 lakh crore (February 2020), the outstanding corporate bonds is Rs. 30.88 lakh crore (Sep'19). Conventional bank loans have traditionally been the predominant source of funds for businesses in the country that resulted in the corporate bond markets remaining largely stagnant. However, in recent years there has been a growing need for businesses to tap the bond markets given the constraints in the banking sector.

Indian corporate bond market comprises both long term instruments such as bonds/non-convertible debentures (NCDs), securitized instruments and short term instruments such as commercial paper issued by private corporates, public sector undertakings and financial institutions. Certificate of Deposits are issued by banks.

The issuance of corporate bonds is either by way of public issues and private placements. Private placement has all along been the preferred issuance route for corporate bonds. Over 90% of the corporate bond issuances have been through private placement. The public issuance of corporate bonds is yet to see any noteworthy pick up. The preference for private placement can be attributed to operation ease (lesser statutory disclosures compared with the lengthy disclosures and issuance process for public issuance), lower costs of issuance, ability to raise funds faster and custom made structures (to suit requirements of both the issuer and the investor). In addition, limited investor base also aids private placements.

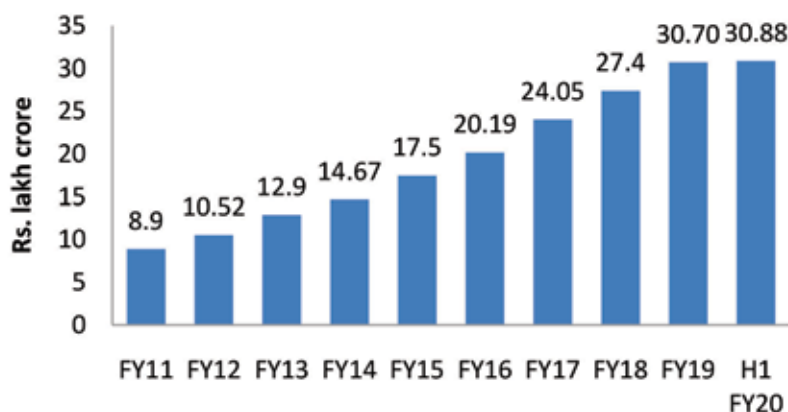
The high share of private participation is one of reasons for low retail participation in these markets. As the privately placed bonds are largely held by institutional investors who hold them till maturity, they are not available for trading in secondary markets, impacting liquidity and market depth for corporate bonds in secondary markets. Further, as transactions are restricted between large players/ investors, there is a lack of transparency.

There has been increased policy focus to develop and deepen the corporate bond markets given their growing importance and untapped potential. This segment is being increasingly seen as an alternative source of funding, essential for the country's economic development and progress. Corporates have been increasingly tapping the bond markets for their fund requirements with funding from the traditionally preferred banking channels being constrained owing to their high levels of non-performing loans and stressed assets. Further, these markets are being seen as a viable source of funding for the country's large infrastructure building requirements that require long term investments given their long gestation period. Measures are being undertaken by the government and regulators (SEBI and RBI) to address the various issues that constrain the growth and development of the corporate bond markets.

The prevailing scenario of the Indian corporate bond markets has been illustrated here.

3.1.1 Outstanding corporate bonds

Chart 3.1: Outstanding corporate bonds

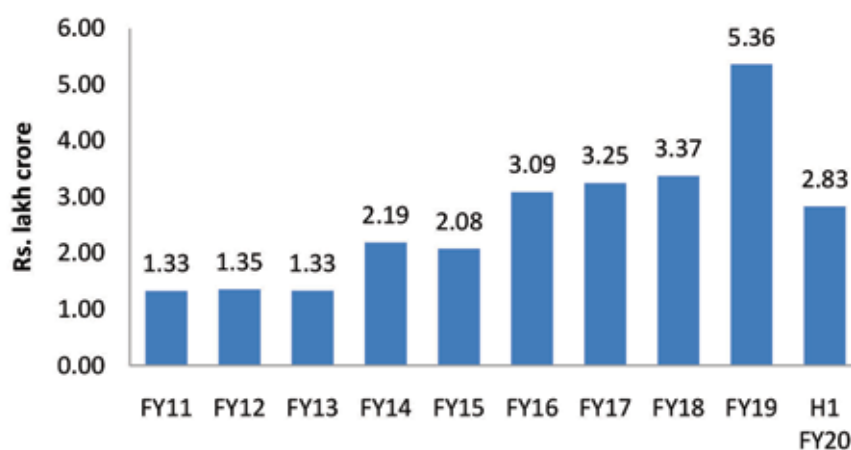


Source: SEBI

There has been a notable expansion in the corporate bonds markets in the last 9 years as can be seen from the sustained increase in the outstanding corporate bonds, which has grown at a CAGR of 17% from Rs 8.90 lakh crore to Rs 30.7 lakh crore during FY11–FY19. During the first half of FY20, the outstanding corporate bonds amounted to Rs. 30.88 lakh crore, 9% higher than that in H1 FY19 (Rs. 28.38 lakh crore).

3.1.2 Redemptions of corporate bonds

Chart 3.2: Redemptions of Corporate Bonds



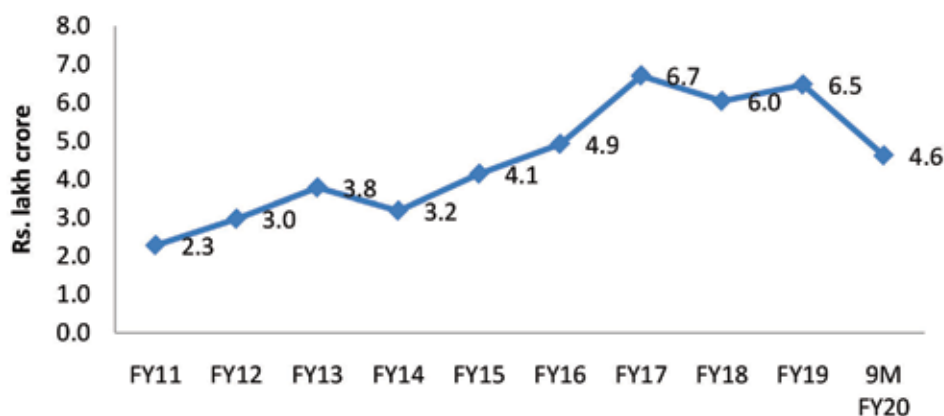
Source: CMIE

The redemptions of corporate bonds grew at a CAGR of 19% from Rs. 1.33 lakh crore in FY11 to Rs 5.36 lakh crore in FY19. During the first 9 months of FY20, the redemptions were 9% higher at Rs. 2.83 lakh crore than that in the corresponding period a year ago (H1 FY19: Rs. 2.63 lakh crore).

3.2 Primary Market

3.2.1 Corporate Bond Issuances

Chart 3.3: Corporate bonds issuances

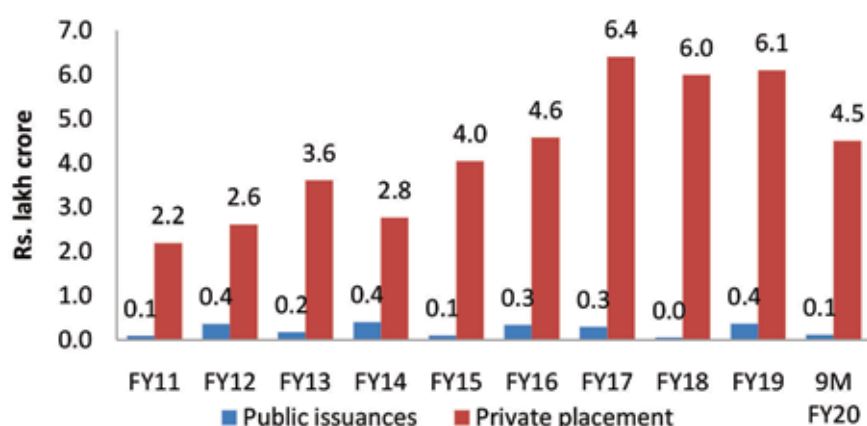


Source: SEBI

Corporates have been increasingly tapping the bond markets for their fund needs, raising between Rs. 2.3 lakh crore to Rs. 6.5 lakh crore during FY11-19. The corporate bond issuances have grown at a CAGR of 14% during FY11 to FY19. In 9M FY20, the corporate bond issuances have grown by 15% to Rs. 4.6 lakh crore compared with Rs. 4 lakh crore issued in 9M FY19. The growth in corporate bond issuances over the years indicates a partial shift in corporate funding from banks to the bond markets, which can be ascribed to the constrained bank lending owing to the high levels of stressed assets in the banking system and the faster transmission of rate cuts by RBI in the corporate bond markets compared with banks that led borrowers to migrate from banks to corporate bond market.

3.2.2 Public issues and private placements

Chart 3.3: Public Issue and Private Placements



Source: SEBI

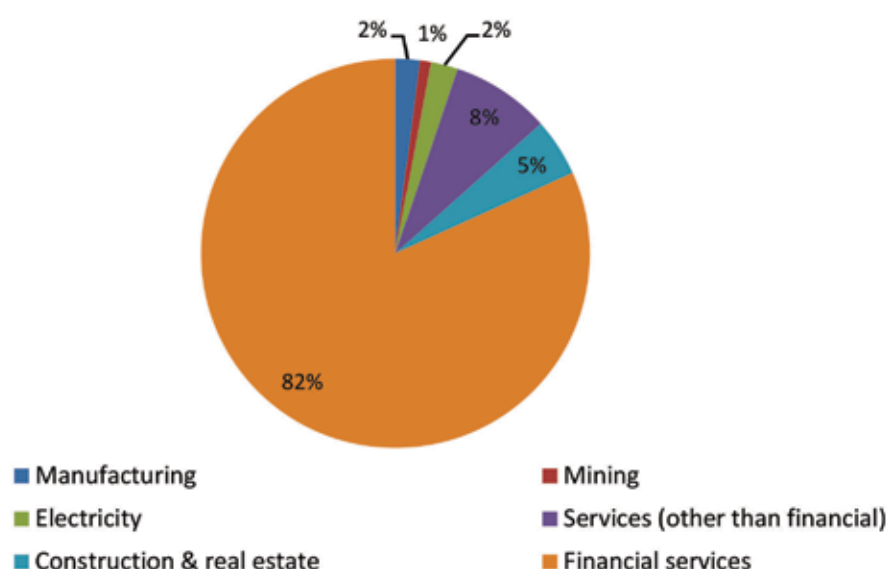
Private placements dominate the corporate bond issuances in the country. On an average, private placement has accounted for 94% of the corporate bond issuances in the last 9 years. The quantum of corporate bonds

raised via private placements grew at a CAGR of 14% during FY11–19 from Rs. 2.2 lakh crore to Rs. 6.1 lakh crore in FY19. During 9M FY20, the private placements grew by 21% to Rs. 4.5 lakh crore compared with Rs. 3.7 lakh crore in 9M FY19.

Public issuances have grown at a CAGR of 19% during FY11–FY19. However, during 9M FY20, there has been a reduction in the public issuances by nearly 60% to Rs. 11,746 crore as against Rs. 28,565 crore in 9M FY19.

3.2.3 Sector-wise corporate bond issuances

Chart 3.4: Sector-wise Corporate Bond Issuances: FY19 (% share of total issuances)



Source: CMIE

In terms of the sectors that have been raising funds from the bond markets in FY19, the financial services sectors accounted for over 80% of total bonds issued. These funds are used for on-lending and supplement the banking system. The remaining is raised by the non-financial services sectors such as manufacturing, mining, electricity, construction and real estate and services (other than financial services).

The sector –wise issuances show that the asset financing services accounts for the largest share of issuances at around 46 %, followed by other financial services (~26%) and banking services (~5%).

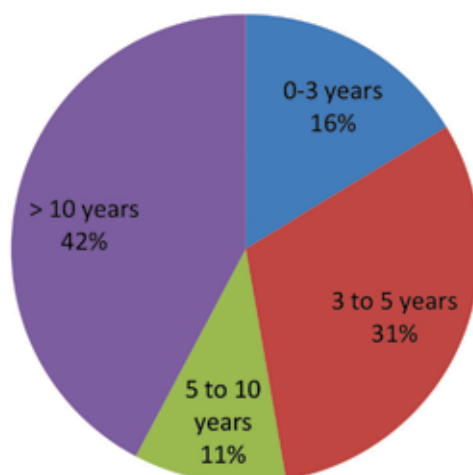
Sectors such as mining and fee based financial services are seen to have low reliance on the corporate bond markets for their funding requirements.

3.2.4 Tenure-wise in funds raised – debt private placement

Corporates are seen to prefer longer duration bonds for raising funds. Around 40% of the total corporate bonds issued during FY20 (April – January) had tenure of more than 10 years. The bond issuances with maturities during 3 to 5 years were nearly 31% of the total corporate bonds raised during this period while that of maturity period between 5 to 10 years accounted for nearly 11% of the total bond issuances. The shorter

duration papers between 0 to 3 years of maturity had 16% share in total corporate bond issuances during FY20 (April – January).

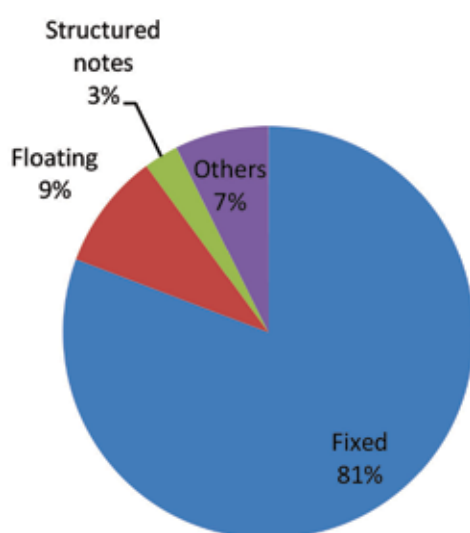
Chart 3.5: Tenure-wise corporate bond issuances: FY20 (Apr-Jan) (% share)



Source: Prime Database

3.2.5 Types of bonds issued

Chart 3.6: Types of bonds issued in FY19



Source: CMIE

The majority (over 80%) of corporate bond issued carry a fixed coupon rate.

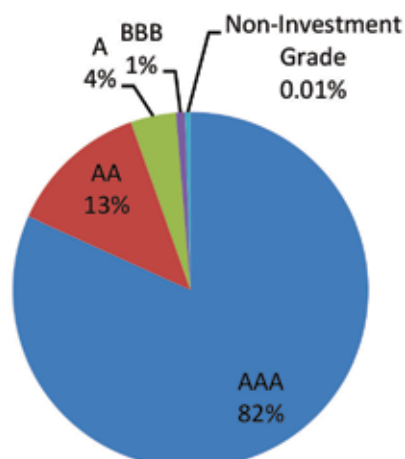
3.2.6 Limits on corporate bonds investment for various institutions

EPFO	→	20-45%
PFDA	→	Upto 45% for government employee, no restriction under NPS for all
Life Insurance	→	Debt instrument not less than 75%
General Insurance	→	Dt instruments not less than 65% (GSec, SDL and other approved)
Mutual funds	→	No limits
Pension and group business	→	Not exceeding 60%
FPI	→	Rs. 3.17,000 crore
Banks	→	NA

The trait of this market is that most of the investors are institutions which follow the policy of buying and holding till redemption as this helps them to match their liabilities with assets in terms of maturity. There are internal regulatory provisions on how much of bonds can be held by these institutions which also include the credit rating that can be accepted which though investment grade in effect gets restricted to AAA paper with a maximum step down to AA rated paper.

3.2.7 Ratings of bond issuances

Chart 3.7: Rating categories of bond issuances : FY19

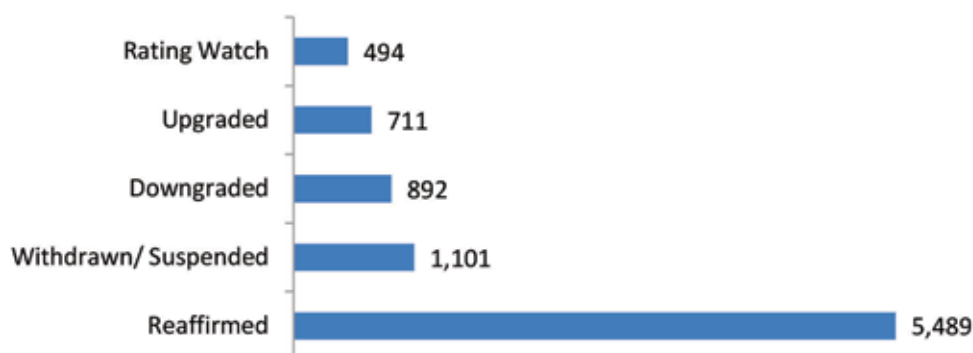


Source: SEBI

99% of the long term corporate debt securities with maturity of more than 1 year had an investment grade rating. Among these, majority of the long term corporate debt securities were rated AAA (more than 80%) while 13% were rated AA by various CRAs.

3.2.8 Rating changes

Chart 3.8: Rating Changes in FY19



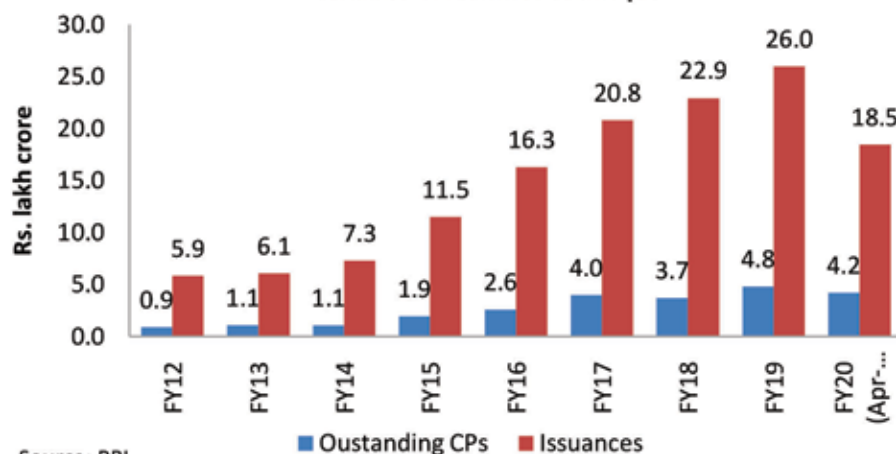
Source: SEBI

In FY19, majority of the rated papers had seen reaffirmation of the credit rating that was being assigned to these securities by the various CRAs. Out of the number of 8,687 rated corporate debt securities with maturity more than one year, which were reviewed by CRAs during FY19, 63% of the ratings were reaffirmed while 10% of the papers were downgraded during the year. 711 debt securities, accounting for 8% of total reviewed papers, have been upgraded in FY19.

3.2.9 Commercial paper

Corporates have been increasingly borrowings via commercial papers to meet their short-term funding requirements amid constrained and high cost bank lending. The issuances of commercial papers grew at a CAGR of 22.5% from Rs 11.5 lakh crore in FY15 to Rs 26 lakh crore in FY19. Commercial papers rose significantly by 41% in FY16, with the growth subsequently moderating in the following 3 years (13% in FY19). For the financial year ended March 31, 2019, the outstanding commercial paper -were Rs 4.8 lakh crore.

Chart 3.9: Commercial Paper



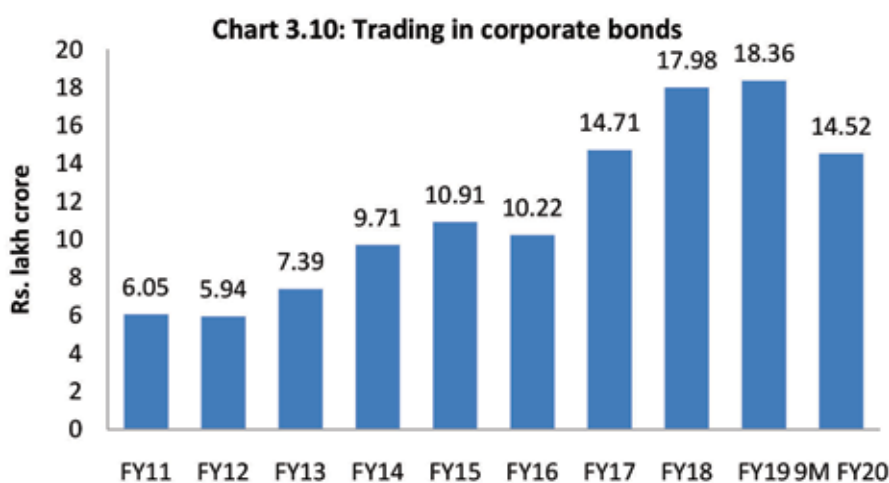
Source: RBI

3.3 Secondary Market

The secondary market of corporate bonds witnesses limited activity. This is in sharp contrast to the market for government securities, which witnesses robust trading and has registered exponential growth over the years. Secondary market activity in the corporate debt market continues to be negligible when compared with the turnover in the government securities market.

The secondary market of corporate bonds has nevertheless witnessed an increase over the years. However, its contribution towards the total turnover in the market remains low at around 11% as against the 89% share of the government securities market.

The secondary market for corporate bonds is severely constrained by lack of liquidity. As majority of the corporate bonds are privately placed; it results in low availability of bonds for trading in the secondary market. It is also seen that the share of retail investors in corporate bonds is very small. Predominantly, institutional investors such as banks, insurers, pension funds and the likes participate in these markets. Moreover, the secondary market trading of corporate bonds is heavily biased in favor of higher rated paper i.e. those carrying a rating of AAA or AA+. Investors thus are unwilling to trade in lower rated paper.



Source: SEBI

3.3.1 Turnover of corporate bonds

The trading in the secondary corporate bond market has increased over the years. Trading in the secondary corporate bond market has witnessed a CAGR growth of 15% from Rs 6.05 lakh crs to Rs 18.36 lakh crs during FY11-FY19. In FY20 (Apr-Dec), the secondary corporate bond market turnover amounted to Rs. 14.52 lakh crore, 12% higher than Rs. 12.95 lakh crore in 9M FY19.

Table 3.1: Corporate bond spreads over GSec

10 year (Bps)	FY19		FY20				
	31-Dec	29-Mar	30-Apr	28-Jun	30-Sep	31-Dec	31-Jan
AAA	1.15	1.08	1.13	1.25	1.05	1.01	0.99
AA+	1.50	1.45	1.47	1.56	1.39	1.31	1.27
AA	1.69	1.68	1.75	1.84	1.69	1.56	1.54
AA-	2.10	2.12	2.13	2.21	2.02	1.92	1.82
A+	2.60	2.82	2.83	2.91	3.02	3.32	2.82
A	3.60	3.82	3.83	3.91	3.72	3.62	3.32
A-	4.10	4.12	4.13	4.21	4.02	4.42	3.82
BBB+	5.10	5.12	5.13	5.21	5.02	4.92	4.07
BBB	5.35	5.37	5.38	5.46	5.27	5.17	4.32
BBB-	5.85	5.87	5.88	5.96	5.77	5.67	4.57

Source: FIMMDA

In FY20 so far, the corporate bond spreads over GSec have moderated across rating categories. This can be ascribed to the lowering of the repo rate by the RBI by 135 bps since February 2019. This can also be attributed to increased demand for higher rated corporate bonds from institutional investors. In addition to this, favorable liquidity conditions and stable exchange rates have also aided in narrowing the spread. The spread of yields of the 10 year AAA rated bonds over G-secs has narrowed from 108 bps as on end March 2019 to 99 bps by end of January 2020.

3.4 Recent developments in the corporate bond market

- **Consolidation and reissuance of debt:** SEBI in April 2017 laid down a specified framework for consolidation and reissuance of debt securities by reducing the number of International Securities Identification Number (ISIN) allocated to a single corporate to a maximum of 12 in a year. The aim was to reduce the fragmentation in the primary market and to enhance liquidity in the secondary market.
- **Investment in unlisted companies:** In order to enhance the investor base in unlisted debt securities and securitized debt instruments, SEBI has permitted FPIs to invest in these securities to the extent of Rs. 35,000 crore.
- **Permitting brokers in repo in corporate bonds:** Brokers registered with SEBI and authorized as market makers in the corporate bond market have been permitted to undertake repo/reverse repo contracts in the corporate debt securities. The measure was announced to facilitate brokers to meet their funding and securities requirement arising out of market making activities.
- **Repo platform to boost corporate bonds:** The National Stock Exchange and the Bombay Stock Exchange have launched electronic platforms for tripartite repurchase agreements (repo) in corporate bonds, which are expected to improve the liquidity of, and investor appetite for, these securities.

- FPIs allowed trading directly in corporate bond markets without involving brokers as is allowed for domestic institutions such as banks, insurance companies and pension funds.
- **Corporate Bonds under LAF:** The RBI in consultation with SEBI is considering accepting corporate bonds as collateral for liquidity adjustment.
- **Large corporate guidelines of SEBI:** SEBI on 20th July 2019 made it mandatory for large corporates to meet 25% of their financing needs through bond market. This is applicable to any corporate (excluding scheduled commercial bank) which as on March 31st has outstanding long term borrowing above Rs. 100 crore and has been rated AA and above. These are applicable to the long term funding requirement above 1 year and securities should be listed as per SEBI guidelines.
- **RBI's large exposure framework:** The RBI issued the large exposure framework for borrowings by large firm with an aim of limiting or capping banks' lending and thereby their exposure to large corporate entities. The framework stipulates the following key points:
 - o **For Single counterparty:** The sum of all the exposure values of a bank to a single counterparty must not be higher than 20% of the bank's available eligible capital base at all times.
 - o **For group of connected counterparties:** The sum of all the exposure values of a bank to a group of connected counterparties must not be higher than 25% of the bank's available eligible capital base at all times.
 - o Banks' exposures to a single NBFC will be restricted to 15% of their eligible capital base
 - o Banks' exposures to a group of connected NBFCs or group of connected counterparties having NBFCs in the group will be restricted to 25% of their Tier I Capital.
- **Withdrawal of FPI investment limit in the corporate bond:** In February 2019, the RBI withdrew a 20% limit on investment by FPIs in corporate bond of an entity with a view to encourage more foreign investment. Earlier, no FPI was permitted to have an exposure of more than 20% of its corporate bond portfolio to a single corporate.
- **Increase in FPI limit in corporate bonds:** The limit for FPI in corporate bonds was raised to 9% of outstanding stocks to 15% (Union budget 2020-21).
- **Tax incentives** have been announced in Union Budget (2020-21) to deepen the corporate bond market
 - o Concessional tax rate of 5% on interest income earned by FPIs from investments in GSec and certain corporate bonds to be extended up to June 30, 2023
 - o Interest on municipal bonds to be included under the concessional tax regime of 5%
 - o Relaxing the interest rate cap on all corporate bonds to qualify for 5% withholding tax rate
 - o Concessional tax rate of 5% on interest income payable to non-residents has been extended on money borrowed in foreign currency and rupee denominated bonds issued up to June 30, 2023

- o 4% tax withholding rate to the interest payment on bonds listed on the International Financial Service Centre's exchange
- Netting legislation to expand the scope of corporate default swaps markets (Union budget 2020-21)
- **Setting up of Credit Guarantee Enhancement Corporation:** Budget 2019 had announced setting up of credit guarantee Enhancement Corporation with an objective to provide bank lending to infrastructure projects.
- To deepen the corporate tri-party repo market in corporate debt securities, the Government is to work with regulators RBI/SEBI to enable stock exchanges to allow AA rated bonds as collaterals.

CHAPTER 4

CHALLENGES AND RECOMMENDATIONS FOR INDIAN CORPORATE DEBT MARKET

4.1 Challenges in the Indian corporate bond market

Although, the Indian corporate bond market has been in existence since a long time, it has remained a small part of the Indian Debt market. Despite having a well-functioning government debt market, which is regarded as a pre-requisite for the development of a vibrant corporate debt market (as it provides the benchmark rates), India's corporate debt market has not followed in the steps of its government debt markets.

The country's corporate debt market is characterized by myriad problems that severely constrain the growth and development of this segment. Addressing these challenges would be necessary for the growth and development of the domestic corporate bond markets. Some of the key issues that have held back the market are discussed here.

1. Dominance of private placements

In case of the primary markets, nearly all of the debt raised (over 90%) is privately placed and public issues of bonds is rather miniscule, thereby limiting the quantum of bonds available for circulation and trading in the secondary markets. The reasons for this includes lack of adequate participation in public issue and the relatively stringent regulatory requirements associated with public issues that entail costs and time on the part of the issuers (borrowers) of debt. Unlike public issuances, private placements do not require statutory disclosures. Also, the lack of adequate participation further prompts private placement. These markets are seen to be dominated by financial institutions i.e. NBFC and other financial institutions, which further make it difficult for corporates, especially those who do not enjoy high credit rating to source funds from public bond issues.

Private placement in the primary markets can in part be held responsible for the low level of retail participation in the country's corporate debt markets. As bonds in private placement are placed with institutional investors who generally hold them till maturity, the secondary market liquidity is limited for these. Moreover it is not mandatory to list privately placed debt on the stock exchanges. As such, private placement in the primary markets adversely impacts market depth in the secondary market and results in muted trading in the corporate debt markets with transactions taking place only among the large/big players. With majority of the debt being privately placed and the consequent lower availability of bonds for trading in the secondary markets, the price discovery process is not satisfactory. The corporate bond markets lack a benchmark yield curve across maturities, chiefly owing to lower availability of bonds by favoured/trusted issuers, which in turn impacts pricing and liquidity in the secondary markets. Private placement leads to a vicious circle i.e. the lack of transparency- lack of investors – lack of liquidity.

To encourage public placement of issues, there is need for a transformation in the institutional architecture. There should be large number of public placements of high volume and good quality debt papers of varying maturity. This would add to the debt in the market. The disclosure norms and listing requirement need to be reduced. This would in turn lower the cost and time associated with public issuances. Although SEBI has initiated measures for simplifying listing requirements, more needs to be done viz. the rationalization of the stamp duty structure across the country to encourage public issuances of corporate debt.

2. Low liquidity and market depth

One of the major challenges faced by the Indian corporate debt market is that of inadequate liquidity and depth. The secondary markets for corporate bonds are severely constrained by the lack of liquidity and transparency. The lack of liquidity in these markets has been an inhibiting factor for its development. Besides the investor base is limited. It is the institutional investors such as banks, insurers and pension funds that dominate these markets. And all these players are typically long term investors who buy and hold and do not enter the secondary market. Retail investors are almost absent from these markets. Moreover, it is only the higher rated papers, bearing ratings of AAA or AA+ that sees some investor interest. The low investor base also increases the cost of issuance.

Liquidity in bond markets is driven by the volume of debt offered by issuers in the primary market on an on-going basis coupled with the circulation of bonds in the secondary market supported by active investor participation.

Several factors influence the liquidity or the lack of liquidity in the Indian corporate bond markets. Firstly, it is the limited issuer and investor base. Bulk of bond issuers in the corporate bond market consists of banks and financial institutions. With more than 90% of bond placements being private, availability of bonds for trading in secondary market is pre-empted by a handful of investors and this limits the price discovery in the secondary market. Secondly, investor profile and market regulation further limits secondary market liquidity. With key investors like insurance companies preferring to hold till maturity and limited activity from pension funds and FIIs in corporate bond market owing to policy limitation, only mutual funds and Banks are left to trade and offer volume in the secondary market. Search costs, demand-supply mismatches in debt instruments and lack of transparent pricing have curtailed liquidity.

Liquidity in the financial markets and deepening of the same proceed in parallel. In case of India, primary issuances continue to remain moderate, which implies that the pool of available instruments that may be traded is also small. Also, trading is often restricted to specific maturity baskets, which translates into trading in these limited securities. Chronically, less liquid markets grapple with other self-reinforced issues such as narrow investor base, insufficient infrastructure and low transparency levels.

3. Limited investor base

The limited investor base for corporate bonds can in part be attributed to the investor preference for government securities. The huge quantum of government borrowings i.e. supply of G-secs, coupled with regulatory requirements of mandatory investments in these by various financial institutions effectively leaves lesser amount of money in the markets and thereby crowds out investments from the corporate

debt segment. The G-secs have emerged as an attractive investment avenue for its holders, registering high turnover and exponential growth over the years. In sharp contrast, the turnover in the secondary markets for corporate debt is negligible, at around 10-11% of the turnover of the government securities market.

The investment guidelines of Insurance companies, provident and pensions funds thus need to be revised as the existing mandate of these institutions do not permit large investment in corporate bonds. Moreover, the specific characteristics of infrastructure bonds like long duration and high coupon make these bonds attractive for insurance and pension companies.

4. Regulatory restrictions

There are several regulatory restrictions that curtail investments of institutional investors in the corporate bond markets. Banks for one are not permitted to invest in below investment grade securities. Likewise, insurance companies and pension firms are constrained by various norms that stipulate/ govern their investment in corporate bonds, which severely limit their investment options in such bonds.

5. Ease of transacting

Constraints such as minimum trade size, high transaction costs and illiquidity of bond markets have been detrimental to investor participation in the country's bond markets. In addition to that, the absence of a standard stamp duty rate across the country as well the maximum amount payable and the charging of TDS (tax deduction at source) on corporate bonds is considered to be cumbersome and to adversely impact efficiency. TDS is deducted on accrued interest every fiscal year for all market participants barring insurance companies and mutual funds. This differential treatment meted out to insurance companies and mutual funds makes it difficult to introduce uniform computerized trading system. There is need for a comprehensive regulatory framework that is conducive to the deepening of the domestic corporate bond markets.

6. Market Makers

Market makers are essential to the development of any market as they assume the risk by providing both 'buy and sell' quotes. They help markets grow and evolve. This has been witnessed in both the equity and G-sec segments where market makers have added value by enhancing the depth of the markets.

The Indian corporate debt market segment does not have market makers who could add diversity to the markets. Market makers assume a lot of risk and need to be encouraged and provided with backing and incentives in terms of finances and supply of securities, for the much needed development in these markets.

7. Lack of awareness and risk aversion

Investors are seen to be prone to excessive risk aversion. Secondary market trading just as in case of primary issuance of corporate bonds is heavily biased in favour of higher rated papers i.e. those carrying a rating of AAA or AA+. Investors, taking into account risk aversion thus, are unwilling to trade in lower rated papers.

Also, investors (retail) participation in the Indian corporate bond markets remains low due to absence of knowledge and understanding of bonds as an asset class. Inadequate information or information asymmetry pertaining to the issuer and instrument have been factors that keep retail investors at bay.

Efforts need to be made at the regulatory level, by financial institutions and stock exchanges to build awareness about debt instruments as an asset class. Credit rating agencies too can play a crucial role by providing for the fundamental information asymmetry between market participants through their independent third party assessment.

8. Lack of effective credit enhancements

The Indian corporate debt market faces a poignant structural issue of credit risk and the nature of credit enhancements. For instance, if the private sector participates in infrastructure financing, it may essentially be regarded as project financing with each project being a Special Purpose Vehicle (SPV) and funding may thus be based on cash flows of individual projects. Herein, there is trouble of not obtaining a good rating, which culminates in difficulty in raising funds through the market, making credit enhancements vital. The introduction of appropriate credit enhancements enables each debt instrument to obtain a suitable credit rating, which in turn facilitates clearer distinction amongst instruments by market participants.

4.2 Issues that need to be addressed

- For increasing the public issuance of corporate debt the disclosure norms and listing requirement need to be reduced. This would in turn lower the cost and time associated with public issuances. Although SEBI has initiated measures for simplifying listing requirements, more needs to be done.
- Rationalization of stamp duty structure across the country and fixation of stamp duties based on tenor and issuance value to encourage public offerings of corporate debt still needs to be addressed.
- Offer tax incentives as is offered on equity sale in terms of capital gains to attract retail investors in corporate debt markets.
- Timely disclosure/communication of rating information that includes ratings assigned and changes/migration of the same should be made available in the public domain through a centralized database.
- Relaxation of investment guidelines for institutional investors like insurance companies, pension/provident funds to invest in corporate bonds
- Have tax free infrastructure bonds.
- Create a market for Junk Bonds: The junk bonds (bonds rated “BB” or lower) have been important worldwide fund raising instrument for the lower rated companies. Junk bonds have been used when a company has been facing a financial crisis, during mergers and acquisitions. It is also be used by the growing companies, which have initially lower bond rating but have been gradually improving it. A market for such bonds would serve as an alternative investment vehicle in companies with lower credit ratings but are regarded as rising stars
- Market-making in corporate bonds: Lack of adequate market making is one of the major impediments to the growth and development of the corporate debt market.
- Reinvigorate the CDS market to provide support to the debt market.

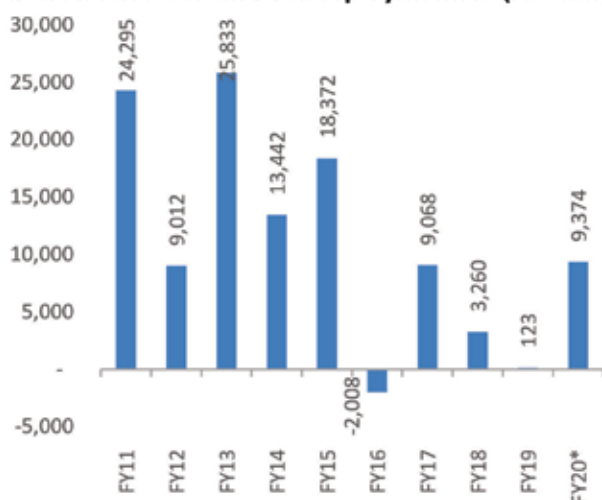
CHAPTER 5

FPIS AND MFS IN INDIAN CAPITAL MARKET

5.1 Foreign portfolio investments in capital markets

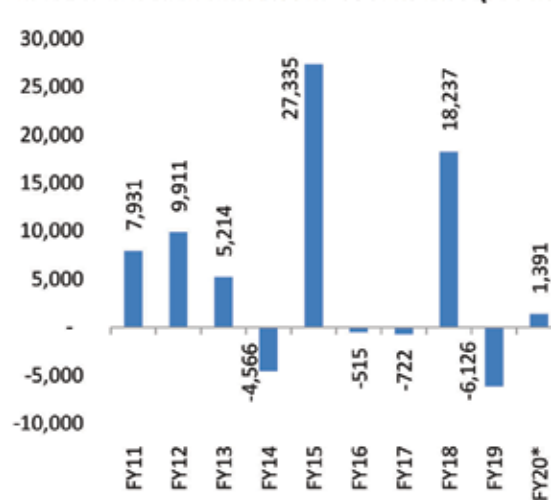
The influence of foreign investments in the Indian capital markets has been well acknowledged. The fast paced growth seen in the Indian stock markets over the years has in large part been attributed to the increased foreign institutional investor (FII)/Foreign Portfolio Investors (FPIs) participation in the same. FPIs viz. pension funds, insurance companies and mutual funds are holders of a sizeable portion of domestic corporate securities. Although the Indian equity markets are the preferred segment for foreign portfolio investors, the secondary debt market has been attracting sizeable FPI inflows, on occasions surpassing the inflows into the equity markets. Exhibits below provide the quantum of net FPI flows in both equity and debt markets.

Chart 5.1: Net FPI inflows in equity markets (USD mn)



Source: CMIE

Chart 5.2: Net FPI inflows in debt market (USD mn)



5.1.1 FPIs in equity markets

Foreign portfolio investors (FPIs) are seen to be important not only for the growth and development of the domestic equity markets but also for the country's economic progress. They are regarded as the driver of the domestic equity markets.

FPIs were allowed in the Indian equity markets since 1992. There has been a surge in capital inflows since then into the country. A notable increase in foreign investment in the domestic markets was seen starting 2003-04. This trend of increased foreign participation in Indian equities has been sustained till now barring

FY09 in the aftermath of the global financial crisis, indicating that India is an important destination for global investments. During FY11-FY20, FPI outflows were recorded only in one fiscal, FY16, barring which FPI inflows in the equity markets have been robust.

The high FII investment in the country's stock markets has had an impact on various facets of the stock market as well as the economy.

- It has increased trading volumes and capital inflows.
- Impacted stock prices - the high volatility in Indian stock prices is regarded to be caused by the changes in investment by foreign investors.
- FII trading in the domestic equity markets has also led to an improvement in market efficiency as involvement of foreign investors leads to better dissemination of information.
- It has also played an important role in shoring up India's forex reserves as well as helped finance the country's current account deficit.
- These investments have also indirectly enabled various economic reforms.

India's markets have emerged as attractive investment destination compared to the US and Europe in recent years owing to the ever increasing economic problems in these regions. Also, the monetary easing measures undertaken in these regions, since the global financial crisis, have resulted in money flowing into markets such as India which have been clocking relatively favorable growth rates.

On the other side, it has been agreed that the Indian economy offers a lot of potential in future in terms of growth given the capacity that exists and the labor and capital resources to be leveraged. Therefore, the future growth story has been responsible for drawing in more FII flows. In fact, investments have move towards the emerging markets of which India would be a major beneficiary given that it remains one of the fastest growing economies in this region. Going into the future too foreign money is likely to be directed towards India.

5.1.2 FPI in corporate debt market

The FPI investment in the Indian debt markets is mainly concentrated in government securities. In FY12 and FY15, the debt segment attracted 52% and 60% of the FPI inflows, respectively. In FY18, this share was notably high at 85%. Despite their sizeable investments, the inflows into the debt segment have been prone to fluctuations/ volatility with 4 of the previous 10 years recording outflows. During the previous decade, net FPI flows in the debt segment has fluctuated between (-)\$6.3 bn to \$27.3 bn. The foreign inflows into India's debt markets are influenced by the monetary and interest rate scenario in global markets viz. in the developed economies.

The participation by the foreign portfolio investors in the corporate bond market has been limited. The FPI in the corporate bond market has been less than the stipulated upper limit in most years. Barring FY18, in the 5 year period FY15-19, the FPI investments in corporate bonds has been on an average around 75% of the permissible limit. The upper limit of the FPI investment in the corporate bonds has declined consistently

since FY16 from Rs. 4.30 lakh crore to Rs. 2.44 lakh crore in FY18. In FY19 however, the upper limit of the investment by FPIs in the corporate bond market was raised to Rs. 2.89 lakh crore, 18% higher than that a year ago. For FY20 (Apr-Feb), the maximum permissible investment is 9.7% higher than a year ago at Rs. 3.17 lakh crore. Budget 2020 has highlighted that the Government plans to increase investment limit of FPIs in corporate bonds from 9% to 15% which could aid in deepening the corporate bond market.

Table 5.1: FPI utilization status in corporate bond markets

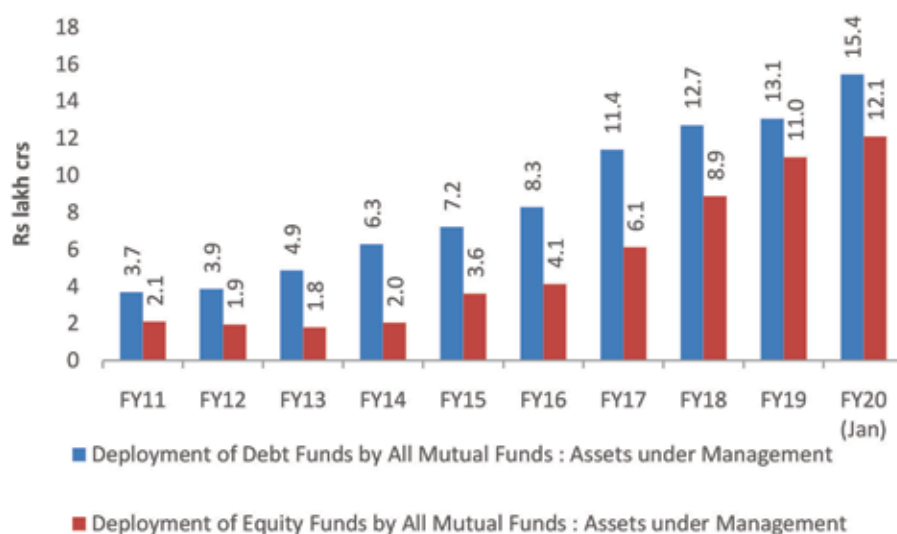
As on	Upper limit (Rs crs)	Total investment (Rs crs)	% of limit utilized
March-2015	397,892	342,133	86.0
March-2016	430,823	342,727	79.6
March-2017	349,992	357,361	73.6
March-2018	244,323	224,406	91.9
March-2019	289,100	219,428	75.9
February 14, 2020	317,000	184,715	58.3

Source: NSDL

5.2 Mutual Funds in capital markets

The assets under management (AUM) of the mutual funds have grown at a robust pace during FY11 – FY20 (Jan, 2020) at a CAGR of 18.9%. Out of the total AUM as on January 2020, 56% of the AUM has been in debt funds while the balance has been in equity funds. The share of deployment of funds in debt funds was higher at 63.6% in FY11. The CAGR in case of equity funds during the previous decade has been higher at 21.4% as against CAGR of 17.2% in case of debt funds.

Chart 5.3: Deployment of funds by all mutual funds: Assets under management



Source: SEBI

Out of the total deployment of funds into debt markets, 33% of the total debt funds are in the corporate bond market in FY19 compared with 28% in FY15. This share had peaked at 38% in FY18 following which it has moderated. Table 5.2 below shows the deployment of funds into real estate, NBFC and other sectors. 1/4th of the total funds are deployed into the corporate bonds of the NBFC sector.

**Table 5.2: Deployment of funds by all mutual funds: Assets under Management
in corporate bond market**

Year	Total Amount (Rs. Lakh crore)	Corporate Debt			
		Total	Real estate	NBFC	Others
FY15	7.20	2.01	0.04	0.53	1.44
FY16	8.28	2.55	0.03	0.71	1.81
FY17	11.38	4.17	0.05	1.01	3.11
FY18	12.69	4.83	0.06	1.18	3.58
FY19	13.06	4.35	0.07	1.11	3.17
<i>Source: SEBI</i>					

CHAPTER 6

CREDIT RATING AGENCIES AND CAPITAL MARKETS

Credit rating agencies (CRAs) play a vital role in the financial system and holds systemic importance. They assess debt risk and its distribution in the system. CRAs help to reduce the information asymmetry between lenders and investors, on one side, and issuers on the other side, about the creditworthiness of companies. By doing so, the rating agencies help firms to access private capital at lower cost and investors take investment decisions by balancing their risks and returns. CRAs can thus by pricing risk appropriately help allocate capital efficiently across all sectors of the economy.

When funds are mobilized directly from savers and investors, who assume the credit risk, an independent assessment of creditworthiness of the borrower by an independent and competent credit rating agency becomes critical. The credit ratings assigned by rating agencies, which is an opinion on credit worthiness of borrowers and not a recommendation to buy, sell or hold the security is seen to be very influential. In case of issuers, ratings play a key role in determining the cost and conditions for access to the debt markets. For investors, ratings influence the investment decisions and the composition of their portfolios. Ratings are also used as a part of regulation to determine the suitability of certain debt and other financial instruments in the portfolio of certain institutional investors.

Role of Rating

As a regulatory requirement by SEBI, any amount of debt raised by companies have to be rated by one of the credit rating agencies. Credit rating assesses risk in the financial system and plays a key role in enhancing the market.

Reducing Information Asymmetry

Creditrating helps reduce the knowledge gap, or information asymmetry between borrowers (issuers) and lenders (investors). The essential subject matter of this information asymmetry is borrower's creditworthiness. A borrower knows its own creditworthiness better than a lender does.

Improving Market Function and Efficiency

Essentially, credit ratings reduce the ability of one investor to outperform another by making better judgments about creditworthiness. In this view, ratings act as an equalizer in the fixed-income capital markets, helping to put investors on more equal footing, thereby minimizing variations in returns that can arise from differences in the ability to make sound credit judgments.

Advantage to investors

Credit Rating provides objective, independent and reliable opinion on credit quality which facilitates an informed investment decision. It gives superior information about the rated product and that too at low cost, which the investor otherwise would not be able to procure so easily. Thus the investor can easily recognize the risk involved and the expected advantage in the instrument by looking at the symbols.

Marketability of securities

Issuers seek ratings for a number of reasons, including to improve the marketability or pricing of their financial obligations, to improve the trust of their business counterparties or because they wish to sell securities to investors with preferences over ratings.

Benefits for the issuer

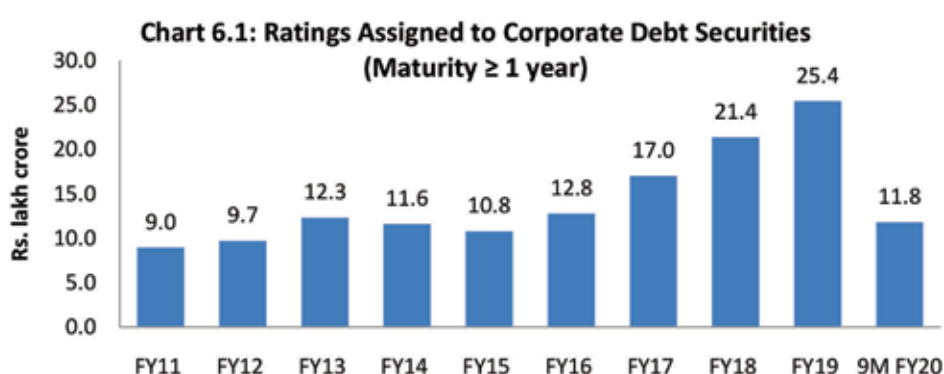
Credit rating enhances the ability of the borrower/issuer to access the money and capital markets for tapping larger volumes of resources from a wider range of investment options. It helps in procuring funds at a better interest rate and helps establish credibility among investors. Credit ratings also help in imposing healthy discipline on corporate borrowers and encourages financial discipline.

The role and importance of credit ratings has undergone changes under the Basel II adoption of banks capital requirements. The Basel norms for financial stability include the credit ratings of CRAs for assigning risk weights for determining minimum capital charges for different categories of borrower.

The history of credit rating agencies in India dates back to over 3 decades. Credit rating agencies in the country are regulated and governed by the Securities and Exchange Board of India and its regulations. The role of CRA's has grown significantly with the advent of global financial integration.

Over the years, there has been sustained increase in the corporate debt rated by various CRAs. During FY11-19, the corporate debt (over 1 year of maturity) rated by various CRAs grew at a CAGR of 14%.

The portfolio of CARE ratings highlights the increase in the volume of debt that is credit rated over the years. The volume of debt rated grew at a CAGR of 13% during FY09 – FY19. Nearly 40% of the rated instruments are bank loan ratings.



Source: SEBI

Table 6.1: Volume of debt rated by CARE Ratings (Rs. lakh crore)

Year	Short & Medium term	Long term	Bank Facility Ratings	Total
FY09	0.91	1.11	3.89	5.91
FY10	1.52	1.46	3.55	6.53
FY11	0.90	1.97	5.20	8.07
FY12	0.53	1.96	6.79	9.27
FY13	0.33	2.64	4.82	7.79
FY14	0.31	2.98	5.57	8.86
FY15	0.72	3.80	6.45	10.97
FY16	1.17	4.23	5.45	10.85
FY17	1.28	5.97	5.93	13.19
FY18	3.56	6.54	6.38	16.48
FY19	3.27	8.13	8.50	19.91
<i>Source: CARE Ratings</i>				

6.1 Changing regulation

The regulatory framework for the credit rating industry has two main pillars – transparency and processes, which in a way are interrelated as they seek to ensure that the contours of operation and process that go into arriving at the credit rating are robust and credible.

In the past few years, the regulation for credit rating agencies has been strengthened which also progressively improves the confidence level of investors. This is important because, eventually it is the investor who uses the rating of the CRA and needs to believe in them as a large volume of investments use the credit rating of the instrument as an important input for decision making.

CRAs are required as per regulation to undertake and publish default and transition studies, aimed at increasing awareness and accountability of performance of their ratings. This is a very important bit of information that investors look for as it tells one about how well the ratings have fared or how stable the ratings have been over a period of time. Ratings essentially need to follow the principle of ordinality i.e. lower probability of default in the higher rating categories. As ratings are a measure of probability of default, a higher rating given to an entity implies lower credit risk and should therefore have a lower probability of default.

As per recent regulations, SEBI has mandated CRAs to have uniform benchmark probability of default for all rating categories, which are essentially ‘target’ probability of defaults which a CRA is to achieve, which would

also be used to evaluate them. Similarly there are disclosures in rating rationales, about liquidity indicators and rating sensitivities, that will provide more information to the users of these ratings. The sensitivities aspect is useful for investors as they would talk of the potential triggers that could affect the rating going forward. Therefore, users of rating would be aware of what could potentially change the rating and would hence be more cognizant of such action when it is taken. CRAs too would be putting on the table the risk factors that could notch the rating were they to materialize. Such disclosures also enhance accountability on the issuers as the ‘targets’ set by the issuers are transparently disclosed in the rating rationales too.

SEBI had also (w.e.f. January 1, 2017) brought in a regulation relating to unaccepted ratings which now have to be disclosed to the public and put on the web site of the rating agencies. This is significant as it eliminates the incentive to look for better ratings if the company is not satisfied with the one assigned by the first CRA. While even today the company can choose to get a rating from another CRA, there is a trail of how other agencies have evaluated the same. By making it public, the client can judge the rating which one is using after juxtaposing with those given by other agencies. This was a very important development which also helped to address the issue of what is called ‘rating shopping’. In fact with this regulation in place, the second credit rating agency would have to be doubly sure of the rating being given as the investing community would keep benchmarking the final rating with those that have not been accepted. This was probably one of the more significant changes brought in by SEBI.

An area which requires specific mention pertains to non-cooperation from the client. The credit rating mechanism is quite singular in terms of how it is conducted. There is an initial rating assigned by the CRA once the mandate is signed between the two parties. However, regulations require that there is regular monitoring or surveillance of the ratings (once in 12 months in case of non convertible debentures and once in 15 months in case of bank loans) until such time that the debt has been redeemed.

Prior to 2017, if the rated entity was not co-operating with the CRA in the review exercise, the CRA would suspend the ratings that was assigned and remove it from rating coverage. SEBI has now mandated that in case of non-cooperation, the CRA would have to assign ratings on the basis of best available information and the rating symbol would also include a suffix which would indicate that the issuer is not cooperating. This will ensure that the user of the rating would know the background as well as gauge the company better as non-cooperation normally does not have positive connotations.

Surveillance is a very important activity as it tracks the company and financial paper over the entire life until it is repaid. This information is crucial for the investors as they take decisions based on the creditworthiness of the company which can change over time. Regulation now makes surveillance as important as the initial rating and CRAs have to monitor closely and identify potential defaults much before they happen. All material news that comes along has to be analyzed and assessed in terms of how it affects the credit position of the company and has to be reported. This is one way of warning the investors that something could be amiss in the company. Further, issuers are mandated to provide monthly updates to CRAs on their debt payment status (by way of “No-default statements”).

CHAPTER 7

GIFT city

GIFT city, which stands for Gujarat International Financial Tech-City, is an integrated business development of close to 900 acres of land between the commercial capital of Gujarat (Ahmedabad) and the administrative capital (Gandhinagar). It includes office spaces, residential apartments, schools, hospitals, hotels, clubs, district cooling system, underground utility tunnel automated waste collection system. Promoted by the Gujarat government through a joint venture, it is India's first operational smart city and international financial services centre.

It is an emerging global financial centre, designed to be at or above par with globally benchmarked business districts. It is supported by state-of-the-art infrastructure encompassing all basic urban infrastructure elements along with external connectivity. The city also has a multi-service special economic zone (SEZ) and International Financial Service Centre (IFSC) with the latter eventually competing with other IFSCs such as Singapore and Dubai. It was built with the objective of recognizing the potential of Gujarat as a centre for the financial services industry by placing Gujarat as a Centre of excellence in the financial and IT/ITeS services. In addition, the rationale for setting up also included creation of large employment in the field of services industry.

The GIFT city targets different industries which include off-shore banking, brokerage and exchange services, insurance, IT and ITeS services and other ancillary services (legal, auditing, analytics). LIC, GIC, Tata Consultancy Services, Tata Chemicals, Oracle and a number of banks like State Bank of India, Yes Bank, Axis Bank, Kotak bank, Bank of Baroda, Bank of India, and HDFC bank among others are key occupants in the city. BSE and NSE have subsidiaries to offer a trading platform for both foreign and global investors.

Advantages of the GIFT city

- Strategic Location
- Integrated development of offices, residential apartment and institutions
- Multi-services special economic zones – where companies that are into services exports can re-locate and export from
- India's 1st International Financial Services Centre (IFSC) with an objective to facilitate flow and investment of international capital
- Smart city with state of the art infrastructure on town design and planning, utility services, residential accommodation and services
- Green infrastructure
- Single window clearance

Tax incentives

- A variety of tax incentives are offered to companies that operate out of GIFT IFSC which include commodity transaction tax and long term capital gains waived off while dividend distribution tax abolished. The minimum alternate tax charged for companies in the IFSC have been low at 9%.
- As per section 80LA of the income tax law, profit-linked deduction equal to 100 per cent of income for the first five consecutive assessment years and 50 per cent of income for the next five consecutive assessment years is provided to units of an IFSC. The Union Budget 2019 increased the profit deduction limit from 50% to 100% for any 10 consecutive years out of 15 years beginning with the year in which the necessary permission was obtained.
- Custom duty and central excise duty exemptions are granted for all goods imported/ domestically procured into the SEZ.

This paper has been authored by Kavita Chacko, Dr Rucha Ranadive and Sushant Hede from Economics Research Department.

About CARE Ratings

CARE Ratings Ltd. is the second largest credit rating Company in India in terms of domestic rating income in FY19. CARE Ratings offers a wide range of rating and grading services across a diverse range of instruments and has over 25 years of experience in the rating of debt instruments and related obligations covering wide range of sectors.

CARE Ratings provides ratings in the financial, infrastructure, corporate, public finance and MSME spaces. CARE Ratings' clientele in the financial sector includes banks, NBFCs, housing finance companies, insurance companies, mortgage guarantee companies and mutual funds. CARE Ratings also rates various types of securitization programmes and is a leading player in this space. Corporate sector ratings include debt issuances such as bonds/debentures/commercial paper etc., bank loans, issuer rating and corporate governance rating.

CARE Ratings rates various entities in Infrastructure space – in the segments of power, roads and ports and also rates Infrastructure debt funds. CARE Ratings in consultation with the Ministry of Finance and other stakeholders has developed a distinct credit rating framework for infrastructure projects to facilitate greater participation of long-term investors by enabling better risk-based pricing. The new ratings will be a comment on the expected loss (EL) of a debt instrument after factoring in the probability of default (PD) and recovery prospects.

Further, MSME ratings include SME ratings for micro and small enterprises. Public finance business includes implicit ratings of State Governments for the rating of state enterprises and urban local bodies. The Company also has rated innovative debt instruments, such as perpetual bonds. CARE Ratings also rated the first Alternative Investment Fund (AIF) which is an opinion on the asset selection ability and asset management capabilities in their respective segments for these schemes.

Under the umbrella of grading services, CARE Ratings carries out grading of IPOs, assesses financial strength of shipyards, grades various courses of Educational institutions and provides grading services to Energy service companies (ESCO), Renewable energy service companies (RESCO), Real estate projects, Maritime training institutes. CARE Ratings also provides equity grading for listed entities. CARE Ratings has also rated entities under the IREDA Credit Rating Model for Renewable Energy Financing.

CARE Ratings does grading of ITIs. Further, CARE Ratings is the first credit rating agency to launch the grading of REITs. CARE Ratings has also been accredited by the Government of Karnataka for a grading product for tourism facilities. Facilities with a certain level of rating would be entitled to several concessions from the state government. CARE Ratings had launched the Green Initiative Rating (GIR) aimed at measuring the green initiatives of entities beyond the basic compliance requirements. A risk assessment by an independent entity such as a credit rating agency would enable the lenders, the investors and the society at large to understand the initiatives undertaken by the company beyond minimum requirement for minimizing the adverse impact caused by the units' economic activity on the environment with focus on sustainability.

CARE Ratings is recognized for being a knowledge based company and has continued to work towards deepening the base. The Economics Department provides near real time research on all domestic and global economic developments which is widely circulated. Special studies and surveys are also undertaken on different subjects. The Industry Research team tracks and publishes around 50 sector reports on an on-going basis (available on www.careratings.com).

The company has a subsidiary CARE (Ratings) Africa Private Limited (CRAF) in Mauritius and CARE Ratings Nepal Limited in Nepal. The company has two wholly owned subsidiaries in Mumbai, India namely CARE Risk Solutions Private Limited and CARE Advisory Research & Training Limited. The Company has its registered office in Mumbai, and branches in Ahmedabad, Bengaluru, Chandigarh, Chennai, Coimbatore, Hyderabad, Jaipur, Kolkata, New Delhi, and Pune.

About ASSOCHAM

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EVOLUTION OF VALUE CREATOR: ASSOCHAM initiated its endeavour of value creation for Indian industry in 1920. Having in its fold more than 400 Chambers and Trade Associations, and serving more than 4,50,000 members from all over India. It has witnessed upswings as well as upheavals of Indian Economy, and contributed significantly by playing a catalytic role in shaping up the Trade, Commerce and Industrial environment of the country.

Today, ASSOCHAM has emerged as the fountain-head of Knowledge for Indian industry, which is all set to redefine the dynamics of growth and development in the technology driven cyber age of 'Knowledge Based Economy'.

ASSOCHAM is seen as a forceful, proactive, forward looking institution equipping itself to meet the aspirations of corporate India in the new world of business. ASSOCHAM is working towards creating a conducive environment of India business to compete globally.

ASSOCHAM derives its strength from its Promoter Chambers and other Industry/ Regional Chambers/Associations spread all over the country.

VISION: Empower Indian enterprise by inculcating knowledge that will be the catalyst of growth in the barrierless technology driven global market and help them upscale, align and emerge as formidable player in respective business segments.

MISSION: As a representative organ of Corporate India, ASSOCHAM articulates the genuine, legitimate needs and interests of its members. Its mission is to impact the policy and legislative environment so as to foster balanced economic, industrial and social development. We believe education, IT, BT, Health, Corporate Social responsibility and environment to be the critical success factors.

MEMBERS – OUR STRENGTH: ASSOCHAM represents the interests of more than 4,50,000 direct and indirect members across the country. Through its heterogeneous membership, ASSOCHAM combines the entrepreneurial spirit and business acumen of owners with management skills and expertise of professionals to set itself apart as a44 Chamber with a difference.

Currently, ASSOCHAM has more than 100 National Councils covering the entire gamut of economic activities in India. It has been especially acknowledged as a significant voice of Indian industry in the field of Aerospace and Defence, Auto and Auto Ancillaries, Arbitration & Legal Affairs, Corporate Social Responsibility, Environment & Safety, HR & Labour Affairs, Corporate Governance, Information Technology, Luxury and Lifestyle, Biotechnology, Telecom, Banking & Finance, Company Law, Corporate Finance, Economic and International Affairs, Tourism, MSMEs, Textiles, Civil Aviation, Infrastructure, Energy & Power, Education, Legal Reforms, Real Estate and Rural Development, Startups & Skill Development to Mention a few.

INSIGHT INTO 'NEW BUSINESS MODELS': ASSOCHAM has been a significant contributory factor in the emergence of new-age Indian Corporates, characterized by a new mindset and global ambition for dominating the international business. The Chamber has addressed itself to the key areas like India as Investment Destination, Achieving International Competitiveness, Promoting International Trade, Corporate Strategies for Enhancing Stakeholders Value, Government Policies in sustaining India's Development, Infrastructure Development for enhancing India's Competitiveness, Building Indian MNCs, Role of Financial Sector the Catalyst for India's Transformation.

ASSOCHAM derives its strengths from the following Promoter Chambers: Bombay Chamber of Commerce & Industry, Mumbai; Cochin Chambers of Commerce & Industry, Cochin; Indian Merchant's Chamber, Mumbai; The Madras Chamber of Commerce and Industry, Chennai; PHD Chamber of Commerce and Industry, New Delhi.

Together, we can make a significant difference to the burden that our nation carries and bring in a bright, new tomorrow for our nation.

Deepak Sood
Secretary General, ASSOCHAM; sg@assochem.com



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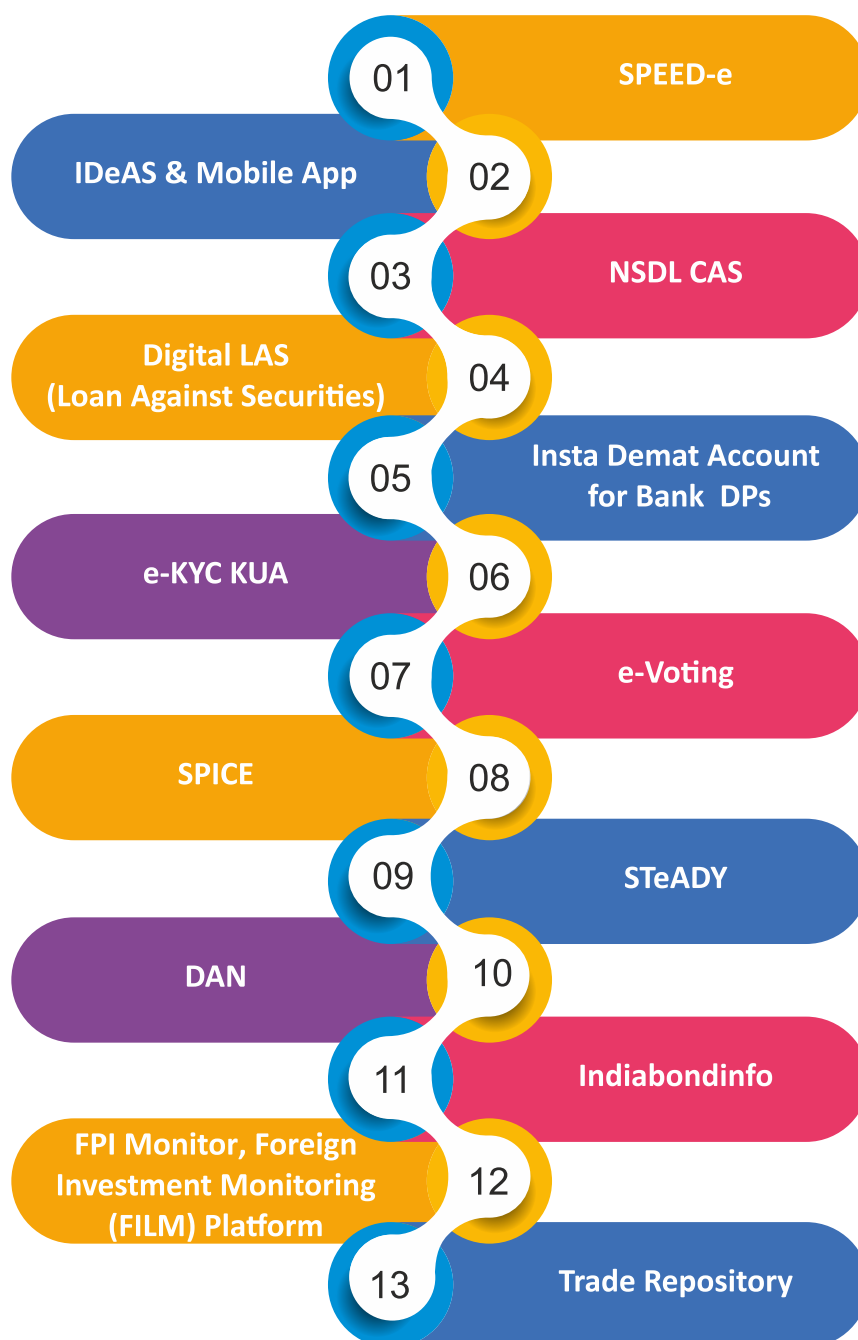
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