A quantum leap

India's capital market requires a further boost to its already healthy growth

India's new administration has made remarkable progress in putting the country back on a strong growth path. But there is still a long way to go to achieve its great potential. One of the best avenues is further boosting the already healthy growth of India's capital markets – an area where several developed and emerging countries are more advanced. The fixed income market presents a unique developmental opportunity as government bond issuance and trading dominates, while corporate and securitised markets remain nascent.

Financial development mobilises and channels savings to productive uses away from real estate and gold. Well-functioning markets improve resource allocation and impose discipline on corporate decision-making.

The Modi administration has taken steps on the fiscal and regulatory side to advance economic development since assuming office in 2014. The new portfolio investment regime and *masala* bonds are moves in the right direction. There have also been other directives aimed at financial deepening; however, the size and scope of these efforts pale in comparison to the amount needed to fund an accelerated path of investment.

In this first of a two-part series, we will lay out several recommendations to address the market microstructure challenges currently faced by the bond market in India.

Corporate bond market development should be a top priority, given that the market size in India is low, compared to both developing and advanced countries. Private placements dominate, with public sector enterprises and the financial sector accounting for most of the non-sovereign issuance.

Securitisation needs to be jump-started too. Volumes are small, measuring just ₹250 billion during 2015-16. With an infrastructure funding need of about ₹67 trillion over the next 5-10 years, deeper bond markets are essential to facilitate India's economic development.

Initial steps to address three key areas, factors limiting issuance, demand side constraints, and secondary market liquidity deterrents should be a priority. The RBI holds the key to encourage corporate issuance versus bank financing. The current cash credit system provides a structural incentive for corporate reliance on banks. The RBI's recent guidelines, aimed at curbing banks' large exposures to single or connected counterparties, will force banks to reduce credit lines and pressure firms to borrow from the market. In addition, the RBI should revise the current external commercial borrowing rules that restrict amounts raised, coupon paid, and end-use to encourage international debt issuance by companies.

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The demand for bonds is dominated by public sector banks and insurance companies. The RBI's statutory liquidity ratio requirement could be modified to reduce banks' preference for government versus corporate and other bonds. Minimum ratings constraints on life insurers' and pension funds' investments (AA) should be reconsidered, since few companies make the cut. The recent RBI move to increase the partial credit enhancement offered by banks to corporate bonds is a step in the right direction. Foreign ownership of India's government bonds at less than 5 per cent is low, compared to other emerging markets. RBI might therefore consider relaxing the caps imposed on foreign institutional investment to augment the supply of capital.

A key pillar of a deep corporate bond and derivative market is a well-functioning repo market. Corporate bond repo has languished and should be revived. Unlike government securities' repo, transactions with corporate bond collateral are bilateral (as opposed to centrally cleared), customised, operationally intensive, and carry settlement risk. Introduction of an electronic platform with a centralised counter-party could solve a part of the problem. The tri-party repo format is also a potential way forward.

Development of a derivatives market is important for risk management for dealers and price discovery. The credit default swap (CDS) market in India is moribund. CDS trading could be made less capital intensive by allowing the netting of exposures against the same counterparty. FX swap and forward markets are liquid with daily volumes of $7-10 billion, but the RBI allows only vanilla FX options in rupee crosses these can be broadened.

Given their role in facilitating market making and risk management, regulators also need to act to encourage liquidity in interest rate derivatives markets – the overnight index swap is liquid only up to five years. Liquid MIFOR swaps, cash-settled bond futures and interest rate options should be encouraged. ◆