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Bond Market- An Alternative Source of Financing

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Abstract:

This paper deals with the issues, challenges and potential of having well developed bond market in the economy. The data from various sources have been generated to analyze the current position of the debt market in India. On the basis of which remedies have been suggested to make India's bond market as efficient as other financial market. The whole paper is divided into five sections. In the first section we have discussed the conceptual framework of the financial market. In the second section, we have discussed the main focus of our study that is the bond market. Can bond market be a substitute for the banking sector in India? In the third section, we have discussed the present scenario of Indian bond market. In the fourth section, we have discussed why development of bond market is essential for the economic growth of India and then finally in fifth section, we have discussed why bond market can be an alternative source of financing?

Keywords: financial market, bond market, efficient, development, banking sector, alternative

I. Conceptual Framework of Financial Market

The development of efficient financial market is necessary for the robust growth of a country as it helps in efficiently mobilizing the flow of savings and investment in economy for the public and private sector development thereby, facilitating the accumulation of capital and the production of goods and services, reducing the exposure of economy to external vulnerabilities. Moreover, it increases the effectiveness of the monetary policy in the country.

Financial market is a market where the buyers and the sellers of the assets such as equity, bonds and currencies trade. It is characterized by having transparent pricing, basic regulation on trading and market forces determining the prices of securities that trade.

The financial market can be subdivided into following types:

1. Money market:
2. Equity market and bond market
3. Derivative market
4. Currency market

II. Bond, Bond Market and Banking Sector

A .What is Bond?

A bond is an instrument of indebtness of the bond issuer to the bond holder in which investor loans money to an entity (corporate or government) for a defined period of time and at fixed rate of interest. Bonds are commonly referred as a fixed income securities and main source of funding after equity and bank loan. Risk Associated with the Bond Market is as follows:

1. Interest Rate Risk: It's a risk that arises due to fluctuation in the interest rates. As interest rates rise, bond prices fall and vice versa.

2. Reinvestment Risk: The risk that future interest from a bond will not be reinvested at the prevailing interest rate when the bond was initially purchased. Reinvestment risk is more prevalent when interest rates are declining.

3. Inflation Risk: The risk that is associated with the decrease in the real value of the money or investment. Inflation decreases the value of the fixed rate income securities.

4. Credit/Default Risk: The risk that the creditor will default in payment of the principal or interest. Higher the credit risk, higher the rate of interest will be demanded by investors for lending their capital.

5. Rating Downgrades: The risk associated with the negative change in the rating of a security.

6. Liquidity Risk: The risk associated with lacking of marketability of investment.

B. Bond Market and the Banking Sector

Banks in India are highly protected and regulated, which restricts its ability to provide loan in the market. Introduction of base rate in the banking sector prohibits the sub prime lending activities of the banks. The Asian financial crisis of 1997-98 brought to the forefront the limitations of even a well-managed, regulated and supervised banking system in countries like Hong Kong and South Korea. The crisis clearly showed that banking systems cannot be the sole source of long-term investment in an economy.. Further, they list the following important advantages of bond financing over bank financing.

- Bank financing and corporate bonds deal differently with information asymmetries. While bond financing involves spreading credit risk over a large group of diverse bondholders, banks tend to minimize credit risks of borrowers and manage their risks by monitoring borrowers.

- Bank financing involves maturity transformation as liabilities of banks are typically short-term in nature and assets have longer maturities whereas in bond financing, investors are fully aware of the yields and time horizons of their investments.
- Bond market provides a yield curve or a market-determined term structure of interest rates. The yield curve serves as a benchmark for pricing credit risk and other financial products.
- Bond financing lowers funding cost for high quality borrowers as intermediation costs are lower for bond financing than for bank financing.
- A well-developed bond market introduces a healthy competition with the banking sector in providing corporate financing.
- Bond market allows pooling of risks through securitization (such as mortgage backed or asset-backed securities).
- A well-developed corporate bond market increases economic welfare as it complements other financial instruments and provides a full spectrum of investment vehicles whose payoffs across contingencies or states of nature cannot be easily replicated by other securities in the market (for example, pension funds and insurance companies like to hold low risk debt instruments, with a stable income stream, which, in general, are not be provided by the equity market).
- Bond market helps in spreading the risk among ultimate savers rather than get concentrated in the intermediaries.

III. An Overview of India's bond market

A. Trend of India's Government Bond Market in Comparison With China.

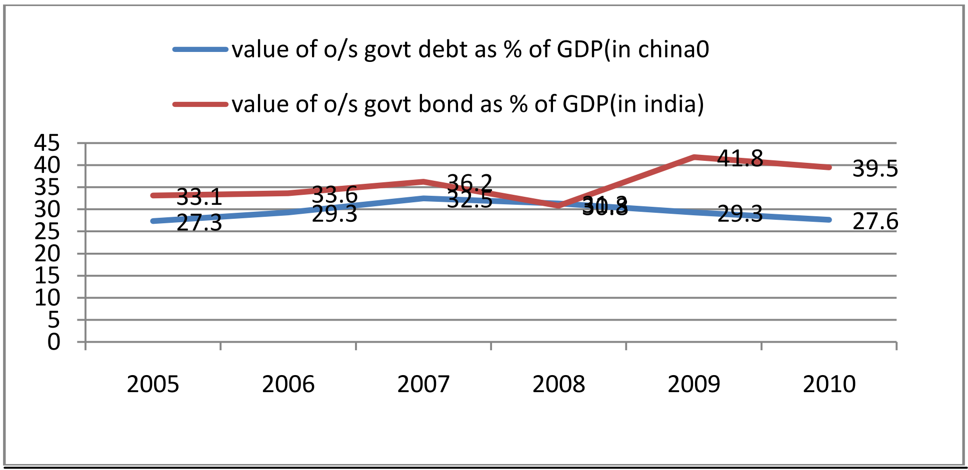

Fig1.Trend of India's and China's Government bond market from 2005-2010 (source: rbi.org.in)

In India, the Government bond market has experienced a steady growth over the years due to the need to finance the fiscal deficit. Government bond market in India was around 39.5 per cent of GDP at the end of 2010 which seems favorable as compared to China's government bond market , which was around 27.6 % of GDP in 2010.The Indian government bond market saw a sudden fall and rise before and after the recession of 2008. In 2007, it was 36.2% of GDP, which fell to 30.8% in 2008 and then increased to 41.8% in 2009. This was the period when the India's government bond market saw steep trend.

B. Bond Market in Trend of India's Corporate Comparison With China

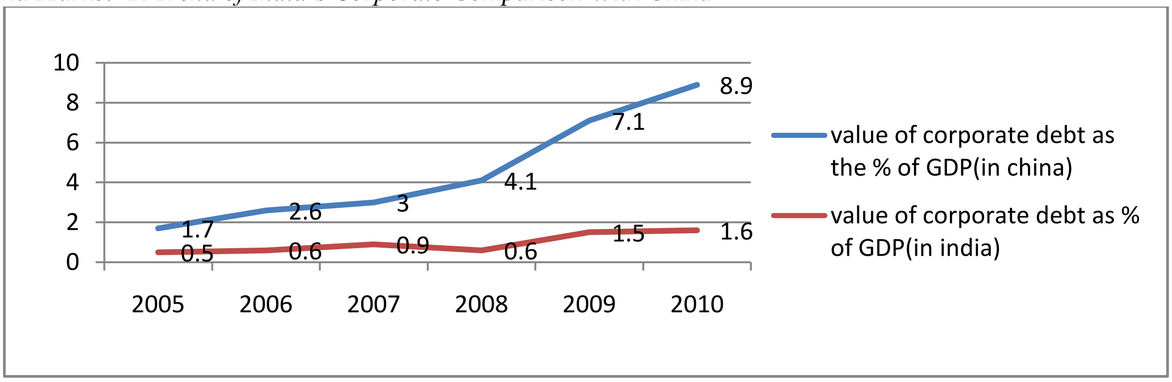

Fig2.Trend of India's and China's Corporate Bond Market from 2005-2010 (source: SEBI)

The corporate bond market on the other hand was just 1.6 per cent of GDP at the end of 2010, which was small in relation to the size of Indian economy. In value terms, the corporate bond market of India grew from $7.85 billion to $24.99 billion from 2008-2010 and thus, the growth rate during this period was just 1%. In comparison to other countries like China (8.9% of GDP or$ 522.09 billion in value term), the Indian corporate bond market appears to be under-developed. The under development of the corporate bond market in India is not incidental and is mainly attributable to the structure of the Indian financial system and regulatory structure.

C. *Trends of Primary Market and the Secondary Market of Bond for the Period 2008-09 to 2013-14.*

Issuances of the corporate bonds in the primary market have risen very sharply in the past financial crisis period. Issuances of the corporate bonds to the public have shoot up from 9451.17(in crore) to 35610.71(in crore) in 2011-2012. It increased further to 42382.97(in crore) in the year 2013-14. Whereas the issuance through the private placement was smooth. It showed an increasing trend from 2007 till 2013 and then, fell in the year 2014.

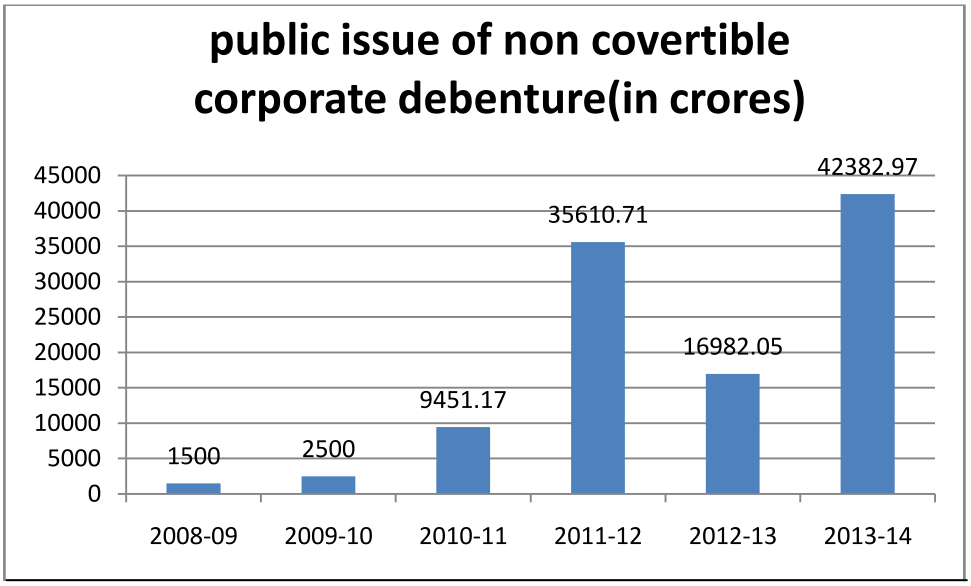

Fig3.Trend of Public Issue of Non Convertible Debentures from 2008-09 to 2013-14 (source: SEBI)

Private placement tend to dominate the landscape of the corporate debt market in India. In case of primary market ,nearly all the debt raised is privately placed and public issues of bond is rather minimum, thereby limiting the quantum of bonds available for circulation and trading in the secondary market. Lack of adequate participation in the public issue and the relatively stringent regulatory requirement associated with public issues that entail cost and the time on the part of the issues of debt.

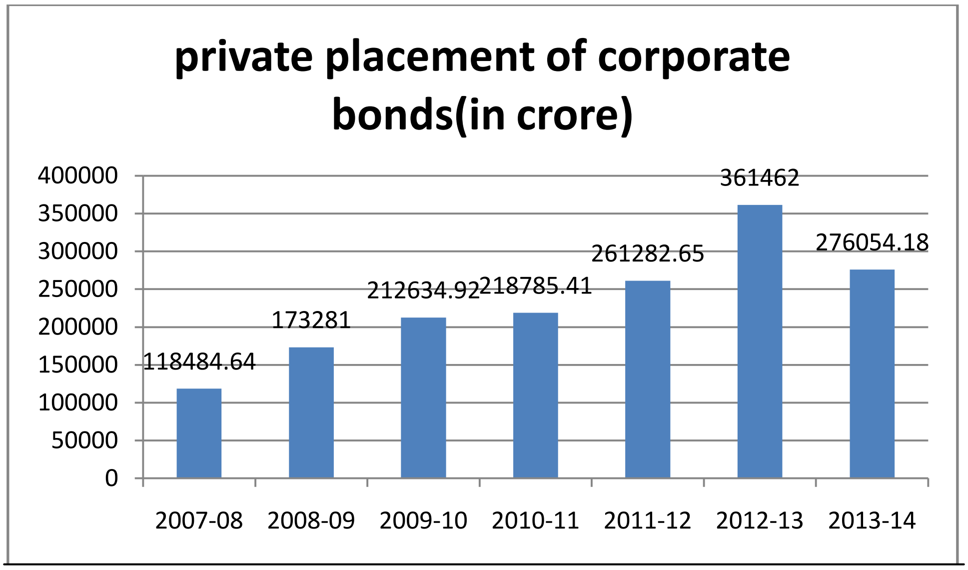

Fig4. Trend of Private Placement of Corporate Bonds from 2007-08 to 2013-14

Secondary market on the other hand is constrained by the lack of liquidity and transparency. The lack of liquidity in these market has been an inhibiting factor in its development. Investor base is limited and the long term investors dominate the market who buy and hold and do not enter the secondary market.

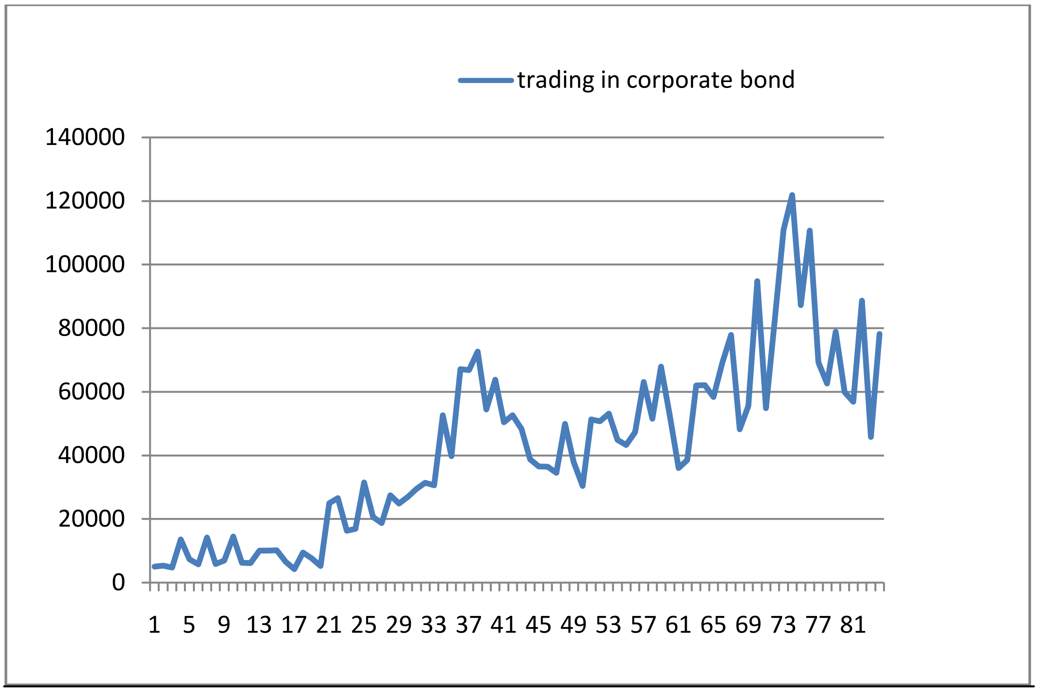

Fig5. Trend of trading in bonds from 2007-2014 (source: SEBI)

Trading in the secondary market though limited shows increasing trend. Thus, indicating the fact the investors have started taking part in the bond trading.

C. Bond market, Mutual Fund and the Foreign Institutional investors.

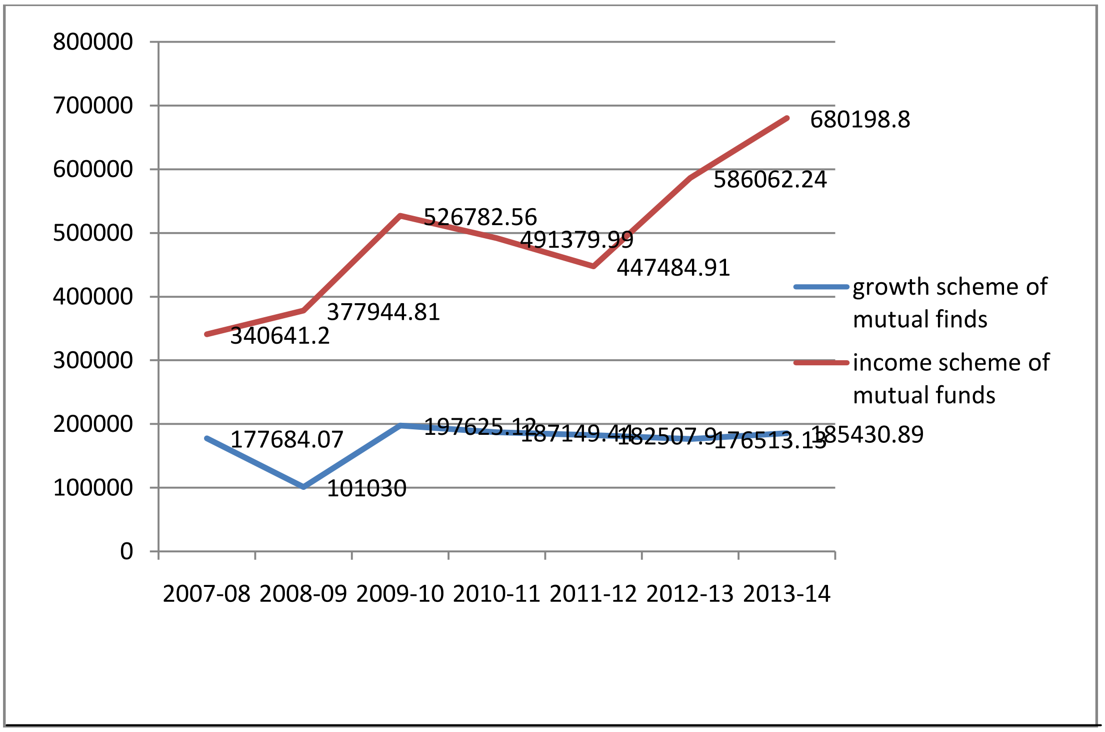

Fig6. The Amount of Mutual fund Investment in Equity Growth Scheme and Debt Income Scheme.(source:SEBI)

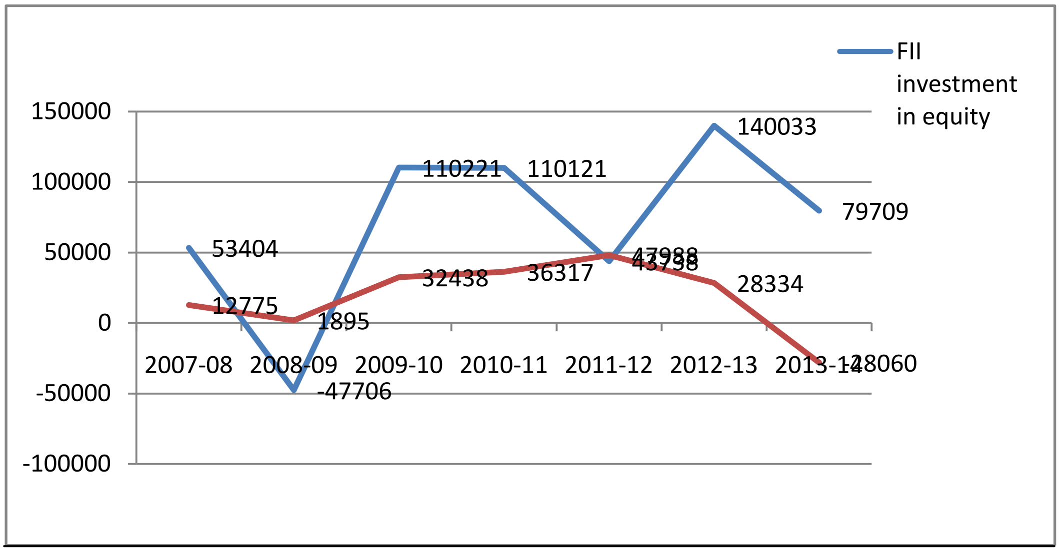

Fig7.FII's investment in the equity market and the debt market.(source: SEBI)

The figure6 shows that mutual funds have strong inclination towards the income scheme than the growth scheme of the mutual funds. This may be due to the fact the Indian investors are the risk averse and want the regular source of income. The trend also shows that at the time of economic recession equity investment declines but the investment in the income scheme remains positive. On the other hand FII have the strong will for investing in the equity as their purpose of investment is generally to earn the maximum profit. But at the time of recession their investment in the equity becomes negative whereas debt investment remains positive which highlight the fact that at the time of economic crisis debt remains the safe bet.

IV. Why India Needs an Efficient and Well Functioning Bond Market?

A sound bond market with a significant role played by the corporate bond market segment is considered to be important for an efficient capital market. The corporate bond market ensures that funds flow towards productive investments and market forces exert competitive pressures on lending to the private sector. While India boasts of a world-class equity market, its bond market is still underdeveloped as compared to other Asian countries (*e.g.* South Korea). Jiang, Tang and Law (2002) point out that one of the principal benefits of a well-developed corporate bond market is to provide an effective alternative source of financing to bank financing.

Economic growth of a country depends on availability of adequate capital to meets its funding requirement. There are many sources through which long terms funds can be raised like equity, banks, government borrowings etc. but each source has its own limitation due to which country requires other sources to meet these requirements. In case of India, the country has huge potential for growth but various sectors of the economy are deteriorating for the want of funds. According to the 12th five year plan India roughly needs $1 trillion for its infrastructural development. Infrastructure is the backbone of any country's development. Vibrant bond market would help in easing financing constraints which act as a hurdle in economic growth of any country. In context of India, despite of remarkable progress made in financial markets over the years and having a place of prominence in equity market globally, the country's corporate bond market have been by and large stagnant. India's corporate bond market has not managed to build the investors interest over the year and account for less than 5% of India's debt market.

V. Debt Market as an Alternative Source of financing

The development of debt market reduces the adverse impact of financial crises or its likelihood. The reason is bond market could provide an alternative source of financing if other financing channels dry up. The effectiveness of alternative source of financing depends crucially on that there not being a co-movement among bank lending, bond and equity financing in a domestic setting. Bonds financing spreads the risk over a large group of diverse bondholders. A well developed debt market increases the economic welfare as it complements other financial instruments to provide a full spectrum of investment vehicle whose state of nature can't be easily replicated by other securities in the market.

No doubt India has one of the leading financial market in the emerging economies and despite of having equity market capitalization of 68.0% as of GDP which is better than that of China(44.9%) and Brazil(54.6%) its bond market is in nascent stage. There are many structural and institutional factors which act as the hindrance for the development of the bond market.(1) stringent regulatory requirement increases the time and cost to issuers, which makes debt less attractive as the source of investment also rigid requirement on the part of the authorities demotivate the entity to raise the funds through debt.(2) generally investors in the bond market are the insurance funds, pension funds etc which has no interest in the trading of the bond on regular basis which makes the secondary market unattractive for the retail investor.(3) lack of trading in the secondary market results in difficulty in obtaining long term maturities curves for the bond.(4) compulsory investment by some investor in the government securities and restrictions on bank for investment in certain graded bonds also limited the fund availability for the bond in the market. In spite of, the above bottlenecks regulatory bodies have taken many steps to deepen the bond market.(1)Information asymmetry between retail investors and the institutional investors have been minimized by grading of the bonds.(2) Tax incentives such as tax breaks on interest income give incentive to invest in bonds thereby, broaden the investor base.(3) steps should be simplified for the documentation and disclosure requirement for the intended companies.(4) Rationalization of stamp duties in different states will reduce the cost of issuance of bonds.(5) Unlike share market, there is no well defined trading platform for bond. Such platform will reduce the transaction cost and will bring all the retail investors on same platform.(6) Appointment of market makers will reduce the information asymmetry and increases the retail investor base in the bond market.(7) A complete infrastructure development like technology platform, settlement procedures along with robust legal framework is required for successful bond market.

VI. Conclusion

India's government bond market is well developed in comparison to bond markets of the other developing countries. But its corporate bond market is still in its nascent stage. Rigid regulation, low investor base and private placement to institutional investors keep the retail investors away from the debt market. Also still India is a bank dominating economy which act as a strong competitor for the bond market. On the contrary, by accepting the benefit of the corporate bond market, the Indian government has taken strong policy measures for the development of the bond market.

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