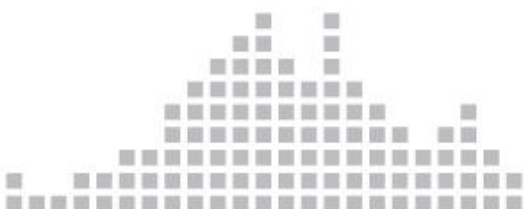


Research Digest

Development of Corporate Bond Markets in India - Global Lessons Part II

March 2014, Vol 2. Issue 3 (Monthly)



Development of Corporate Bond Markets in India - Global Lessons – PART II

Institutionalization of Domestic Savings aids Financialization of the Economy: With greater institutionalization of domestic savings in developed nations, pension funds and insurance occupy a larger portion of their respective economy. India has a long way to catch up with other emerging and developing nations despite having a healthy savings rate of about 30 percent of GDP.

Table#1: Pension funds and Insurance as % of GDP (2012):

Rank*	Country	Pension Funds % of GDP	Insurance Gross Premium as % of GDP
1	UK	104.01%	14.80%
2	US	74.46%	14.00%
3	Chile	60.03%	4.20%
4	Japan*	13.95%	7.80%
5	Spain	8.41%	5.50%
6	South Korea	5.35%	14.40%
7	India#	0.29%	3.90%

Source: OECD Pension statistics; Ranking on the basis of pension funds as % of GDP

*2011 data for Pension funds; # 2011 data for insurance

Along with institutionalization of savings, participation of DIIs in Indian debt markets should be widened: A look into the norms governing investments by pension funds in their respective domestic LCY bonds, reveal that none of countries compared below impose any investment restriction other than India, Chile and China. As against limits on debt investments by insurance firms in India, countries like UK, China, South Korea, and Spain do not impose any limits.

Table#2: Corporate Bond Markets – Bonds- Investment Limits by Pension Funds & Insurance

Country	Bonds- Investment Limits by Pension Funds & Insurance	
	Investment Limits for Pension Funds	Investment Limits for Insurance
India	Limit. (Govt. Sec: 55% & Corporate Bonds: 40%)	Limit. (Govt. securities : 25% ; other securities : 50%. housing and infrastructure investments bonds : 15% ; Corporate Bonds : AA & higher)
UK	No Limit	No Limit
Japan	No Limit	Info Not Available (INA)
South Korea	No Limit	No Limit
Chile	Limit. (Fund wise limits : A :40% ;B: 40%;C: 50%, D:70%;E: 80%;)	No Limit
Malaysia	No Limit	NA
US	Some limits on employer bonds	No Limit
Spain	No Limit. (30% in bonds not admitted to trading on a regulated market)	No Limit
China	Investment only in govt. bonds	No Limit. (Guaranteed corporate bonds (A or above) 20% of Total assets (Non-guaranteed corporate bonds rated AA or above)

Source: Respective Countries official Pension Fund/ Insurance regulations

Role of Debt in Asset Allocation of Institutional Investors: Despite the absence of regulatory limits to their investment in debt and other asset classes, pension funds have a higher exposure in asset classes other than bills and bonds and insurance firms had a higher exposure to bonds in terms of percentage of their total assets under management.

Table#3: Pension Funds and Life Insurance Funds' Asset Allocation (2012):

Rank*	Country	Pension Funds (% allocation, 2012)		Life Insurance (% allocation, 2012)	
		Bills and bonds	Others	Bonds	Others
1	Spain*	62	38	74	26
2	Chile*	58	42	65	35
3	Japan*	36	64	68	32
4	Germany	36	64	39	61
5	India#	34	66	81	19
6	United Kingdom	22	78	62	38
7	United States	16	84	74	26

Source: OECD* 2011 Data for pension; # 2011 Data for insurance

*Rank on the basis of pension funds allocation towards bills and bonds

Risk Management and Derivatives Trading by Pension/Provident Funds: Most countries compared below allow trading in derivatives by their pension funds or agencies vested with managing their money as a means to manage their debt portfolio in an efficient manner and for the purposes of risk and liquidity management. However, regulations of few countries compared below reflect product and market developments. Additionally insurance firms across most countries below also adhere to the risk based capital framework of Basel.

Table#4: Trading in derivatives and Risk Management - Pension/Provident Funds Regulations

Country	Derivatives Trading	Risk Management Note
India	Yes, (Provident Funds)	Credit Default Swaps as eligible derivative instruments
Japan	Yes (GPIF)	Collateralized loan obligations and collateralized debt obligations (Hedge funds hired by Japanese Pension Funds use these instruments)
South Korea	Yes	Korean pension funds are only able to invest in structured products as a means of alternative investment.
Chile	Yes	Derivatives for investment purposes and eligible underlying assets for hedging (e.g. currency, stocks, interest rates, stock index, and bond index)
Malaysia	Yes	Risk Based Capital framework (RBC)
US	Yes	For US pension plans mandatory swap clearing for certain interest rate swaps (IRS) and credit default swaps (CDS) is required.

How do pension funds account for the assets they hold in their balance sheets: Different countries follow different methods in accounting for their corporate bonds. India and South Korea largely refer credit ratings for their fair value calculations (except for the current PFRDA regulations); UK refers to market value, Japan and Malaysia follows a mark-to-market.

Table#5: Pension/provident Funds Accounting Procedure

Country	Pension Funds Accounting Procedure
India	- Mark-to-market (PFRDA) - Theoretical calculations (Provident Fund)
UK	Market value
Japan	Mark-to-market (GPIF)
South Korea	Specific identification of cost method (National Pension Service): - If the value is different from the face value, a theoretical calculated value as per prescription is used by the stakeholders - Debt securities that have no market reference, an average value determined by independent credit rating agencies authorized as debt evaluation agencies is used to determine fair value.
Malaysia	Mark-to-market
Chile	Mark-to-market

Trends in Issuance of Foreign Currency Bonds Vis-à-vis External Commercial Borrowings (2012): Corporate borrowing in India is largely dominated by the banks resulting in lower fundraising through corporate bond issuances in India. However, the growth of asset backed securities in countries like South Korea, Malaysia makes their banks the largest lenders compared with their well grown domestic corporate bond markets. Though Indian corporates raise a large portion of their debts through foreign currency (FCY) bonds, issuance of FCY bonds as a percentage of total issuance has been lower than that of Brazil and Indonesia but has been higher than that of South Korea and Malaysia on the back of lower corporate bonds issuance.

Table#6: Bank Lending to Corporates Vs External Corporate Debts Vs FCY Bonds Issuance

Rank*	Country	FCY Bonds as % total corporate bonds (2013)	External debt of private nonguaranteed as % of GDP (2012)	Domestic Credit by Banking Sector as % of GDP (2012)
1	Indonesia	56.79%	9.80%	42.60%
2	Brazil	32.54%	12.70%	110.50%
3	India	20.02%	8.70%	76.60%
4	Malaysia	18.03%	9.10%	134.00%
5	South Korea	17.61%	NA	168.70%
6	China	5.61%	1.90%	155.10%

Source: World Bank and Bloomberg

Note:* Ranking on the basis of FCY Bonds as % total corporate bonds

FCY Vs LCY Bonds the Story of Outstanding: Outstanding Value of FCY Bonds issued by corporates vis-à-vis LCY bonds is a good 6 percent indicating a healthy demand from foreign investors in India's debt assets. However, compared with GDP as the base, India's FCY debt outstanding has been far lower than countries in comparison below such as South Korea, Malaysia and Singapore.

Table#7: Foreign and Local currency bonds outstanding as % GDP

Rank*	Country	Debt issues (2012)	
		Local Currency corporate Bonds amount outstanding % GDP	Foreign currency corporate bond amount outstanding % GDP
1	Korea	79.6%	5.2%
2	Malaysia	43.0%	5.0%
3	Singapore	32.5%	4.9%
4	Japan	16.6%	0.4%
5	India	11.2%	0.7%
6	Indonesia	2.2%	2.3%

Source: Asia Bond Online

Note: * Ranking on the basis of Local Currency corporate Bonds amount outstanding % GDP

FII Limits and incentives: Most South East Asian nations including Japan do not have any limits on FII investments in the LCY Bond markets unlike in India. Additionally, while most countries compared below exempts FII investors from taxes on interest arising from profit-linked bonds besides allowing them to freely transfer profits post complying with all other fiscal measures.

Table#8: FII Limits and incentives

Country	FII Limits on corporate bonds	FII Incentives
Japan	- No limits	Tax exemption on interest arising from profit-linked bonds
South Korea	-No Limits	NA
Chile	-No Limits	Certain capital gains obtained by FIIs are treated as a non-taxable. Profits post taxation may be transferred abroad – No Limits
Malaysia	- No Limits	Exempted from paying withholding tax on interest income and profit earned from ringgit-denominated debt securities
India	Limit for Corporate Bonds: USD 51 billion	NA

Notable Initiatives to Retail Bonds: Most nations have taken measures to retail their government bond issuances. Common among them include smaller denominations, retail friendly structure, one rate for both wholesale and retail, etc. However Singapore took measures to distribute its government bonds through ATMs and Brazil like USA took measures to distribute through a web based platform.

Table#9: Key Initiatives for Retailing Corporate Bonds by other countries

Country	Key Initiatives by other countries
Indonesia	<ul style="list-style-type: none"> Ministry of Finance (MOF) issued regulations to sell government retail bonds in the primary market with smaller denomination bonds.
Australia	<ul style="list-style-type: none"> <i>Vanilla bonds offered to retail and wholesale investors are at the same price.</i> (ASA)
Malaysia	<ul style="list-style-type: none"> Special web site for retail investors—the Malaysian Investor to provide information on different securities.
Japan	<ul style="list-style-type: none"> The Ministry of Finance (MOF) has launched <i>a special JGB series designed with tenor, rate structure, and face value that cater specifically to retail investors.</i>
United Kingdom	<ul style="list-style-type: none"> LSE launched a retail bond market electronic trading platform for retail investors, which provide them direct access to fixed income products.
Singapore	<ul style="list-style-type: none"> In Oct 2012, the SGX began trading of retail bonds (small denomination corporate bonds) targeted for retail investors. <i>Individuals are able to subscribe to SGS or corporate bonds via the ATM network in Singapore; and subsequently trade these bonds in the secondary market on the SGX.</i>
Brazil	<ul style="list-style-type: none"> BM&FBOVESPA took an initiative to increase the accessibility of the public debt markets by introducing a Treasury Direct programme with minimum investment threshold as low as BRL30.

MOOT POINTS:

- Despite a healthy savings rate, channelization of the same into financial products needs to be focused upon.
- Increased effort towards loosening investment restrictions by pension and insurance funds would go a long way in providing the much needed width and depth in the Indian corporate bonds market.
- Relaxed risk management norms and lenient HTM norms would help in improving liquidity in the debt markets.
- Global efforts to retail government and corporate bonds are worth considering.
- Additionally, enabling easy accessibility of bonds to retail investors would enable widening participation and improving the efficiency of price discovery.

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