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# 14th Annual Capital Market Conference

# #CAPAM2017

## ENVISIONING THE NEXT PHASE OF CAPITAL MARKET

**September 6, 2017; Mumbai**

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# Foreword

After having commemorated 25 years of economic and capital market reforms in 2016; this year, FICCI's 14th Capital Market Conference - CAPAM 2017 - focuses attention on 'Envisioning the Next Phase of Capital Market'. We believe we are at the precipice of an inflection point for transformative change. Policymakers and regulators are leading from the front and industry needs to keep pace, effectively balancing capital management, risk and regulation. It is time to chart out a growth path for the capital market that would fuel industry's growth appetite.

CAPAM's discussion agenda brings to focus avenues to deepen the market, increasing retail and institutional participation, both domestic and foreign. It would also deliberate on facilitative regulatory framework that would boost capital inflow; fuel infrastructure financing, expansion and growth leveraging technology and at the same time ensuring that labyrinthine platforms are secure.

On this occasion, we are pleased to present CAPAM 2017 Knowledge Paper,'The Experts' Voice' a compendium of articles contributed by members of FICCI Capital Markets Committee focusing on the various segments of market. The articles also captures the recent reforms in the domain, their impact, challenges and puts forth possible solutions to ease out such challenges.

We would like to take this opportunity to thank the Regulators, senior bureaucrats and highly esteemed government officials for their participation in CAPAM 2017 and also for their support to the initiatives of FICCI Capital Markets Committee through the year.

We also express our appreciation for the members of the FICCI Capital Markets Committee who have contributed their valuable time and inputs over the years to strengthen FICCI's policy advocacy. A special thanks to all the members who have contributed to this compendium.

We do hope you will find this publication insightful.

**Sunil Sanghai**
Chairman
FICCI Capital Markets Committee

**Shilpa Kumar**
Co-Chairperson
FICCI Capital Markets Committee

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# Impactful first six months of the SEBI Chairman - Well begun, a lot done!

***Sunil Sanghai,*** *Chairman, FICCI Capital Markets Committee*

Leadership and management have very similar core principles. While one gives direction, the other seeks direction. At times, a new direction opens up a myriad of possibilities for an individual, an organization or a country as a whole.

Although it's merely been less than six months since Mr. Tyagi assumed the corner office at SEBI's headquarters, it seems like he is a *man on a mission.* In a short time under his leadership, SEBI has taken several measures to further strengthen the capital markets. Not only has it instituted committees to focus on important issues related to corporate governance and fair market conduct, but it has also introduced new fundraising instruments such as municipal bonds and InvITs, launched new products such as options contracts in commodity derivatives, and taken new measures regarding investments through P-Notes. During this period, the equity market has also seen healthy participation from both domestic and foreign institutions. Even the primary market has seen a healthy capital raise.

In this article, we attempt to enumerate and discuss some important changes made on various fronts.

## *P-Notes*

There has always been a debate around foreign investments routed through Promissory Notes because of their opaqueness. To solve such issues and to deal with the possibility of round tripping, multiple concrete steps have been taken. To reduce these transactions, both resident and non-resident Indians have been barred from making any further investment through P-Notes.Further, adiscussion paper was put out in May 2017, wherein SEBI proposed a levy of US$ 1,000 every three years on FPIs for each P-note issued.



Finally, in July 2017, SEBI also banned FPIs from issuing P-Notes for underlying derivatives. The new regulation requires the issuing FPI to liquidate such instruments by December 31, 2020 unless they have been created for the purpose of hedging the equity shares held by it.

Unlike during previous attempts aimed at changing the construct of P-Notes, the latest steps aimed at completely phasing it out have been received well in the Indian markets. FPIs inflow in equities was higher in July'17 at Rs. 5,161crores versus Rs. 3,617crores in June'17. While P-Note once accounted for up to 50% of all foreign portfolio investments, they now stand at a meagre c.6% of the total FPI investments in Indian stocks and equity derivatives.

To facilitate direct investment in India without seeking the P-Note recourse, SEBI has eased several rules for registration of FPIs. In June 2017, it issued a discussion paper which proposes expanding the eligible jurisdictions for registration of FPIs, rationalizing the fit and proper criteria and simplifying the regulatory requirements among others.

## *Corporate Governance*

Strengthening Corporate Governance norms has been a key focus area for Mr. Tyagi. Earlier this April, SEBI came out with detailed corporate governance norms for listed companies providing for more robust disclosure norms and protection of investor rights including equitable treatment for minority and foreign shareholders. The new rules, which will be effective from October 1, 2017 requires listed companies to get shareholders approvals for related party transactions, to establish a whistle blower mechanism, to elaborate disclosures on pay packages and to have at least one woman board member.

It's about time that corporate governance norms in India were reviewed, as the last committee to deliberate the same was constituted more than a decade ago under the Chairmanship of Shri N.R. Narayan Murthy in 2003. Accordingly, SEBI has set up a 21-member committee in June'17 under the Chairmanship of Shri Uday Kotak to advice on issues relating to corporate governance and make recommendations to SEBI with the aim of improving corporate governance of listed companies in India. One of the key agendas of discussion for this committee will be to ensure independence and active participation of Independent Directors in the functioning of acompany. Improving safeguards and disclosures pertaining to related party transactions, issues in accounting and auditing practices by listed companies and disclosure and transparency are other areas that the committee will deliberate upon.

## *Bankruptcy Code*

SEBI is supportive of the new Bankruptcy Code and believes its successful implementation will lead to increased investor confidence and deepen the Indian corporate bond market. Notably, SEBI has shown strong intent to streamline the existing regulatory framework to facilitate turnaround of listed companies in distress. Preferential issue and open offer requirements have been relaxed by SEBI for new investors acquiring shares in distressed companies pursuant to such restructuring schemes undertaken in



accordance with RBI guidelines. Further acquisitions pursuant to resolution plans approved by NCLT under Bankruptcy Code, 2016 have been exempted from open offer obligations.

## *Insider Trading Regulations*

The securities market environment "being dynamic" requires periodic reviews of regulations and surveillance mechanisms. Accordingly, SEBI has formed a committee in August 2017 under the chairmanship of former law secretary TK Vishwanathan to identify opportunities for improvement in SEBI (Prohibition of Insider Trading) Regulations, 2015 ("PIT 2015") and SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 2003 ("PFUTP") and more particularly with respect to Trading plans, handling of UPSI during Takeovers and aligning Insider Trading Regulations to Companies Act provisions.

It is interesting to note that the review of the insider trading regulations is happening within two years of a similar exercise carried out in 2015 which replaced the 1992 norms. The PIT 2015 regulation has multiple grey areas in terms of dos and don'ts on price sensitive information which is open to interpretation. Further, PIT 2015 required companies to adopt a "need to know strategy" which, while noble in intent, led to lock

down of legitimate communication.

The committee shall suggest short term and medium-term measures for improved surveillance of the markets as well as issues of high frequency trades, harnessing of technology and analytics in surveillance. The committee will also suggest evidentiary issues in anti fraud enforcement.

### *Facilitating ease of conducting business*

Recently SEBI has taken several steps which will help in ease of doing business. Some notable actions are as follows -

- steps have been taken to enhance an early warning system and to identify the potential defaulter.
- strengthening of the ratings mechanism generally followed by credit rating agencies,
- unified license for brokers as a first step towards complete integration of equity and commodity segments.
- Based on understanding from stakeholders' feedback that the overall client level position limits for agricultural commodity derivative was inadequate, SEBI expanded position limits across all spectrums at the client, member and exchange level.
- registration of systemically important NBFCs in the category of QIBs and enabling their participation in IPOs with specifically earmarked allocation. This will help the issuer gain access to a larger pool of funds.
- Lastly, in a move towards making the KYC approvals simple and uniform for all sectors, SEBI is in advanced discussions with the government and RBI.

### *Introduction of new products*

New product introduction is a focus area of SEBI. Several initiatives have been taken in this regard such as-

1. With the aim to deepen the market and boost liquidity, SEBI recently allowed options trading




in commodity future and hedge funds investment in the commodity derivatives market.

2. Several modifications for the MF market have been made. These include use of a new payment mechanism such as e-wallets and the unified payments interface for buying investment products. Earlier, money from redeeming a mutual fund got credited to a customer's account only on the next working day or two days after the request was made if it was not done through the immediate payment service (IMPS). This placed the liquid funds at a disadvantage to bank fixed deposits.

   To correct this anomaly, SEBI has also allowed investors to instantly redeem their liquid mutual funds up to Rs 50,000 a day.

3. Again, to encourage participation from foreign investors, SEBI recently approved the launch of 85 additional derivatives in stock exchanges of GIFT City IFSC.
4. The municipal bond framework has been eased.
5. In August 2017, SEBI has mandated listed entities who have defaulted in payment of interest/instalment obligations on loans from banks and financial institutions, debt securities (including commercial paper), etc. to provide a disclosure of defaults to the stock exchanges within one working day from the date of the default. This circular is effective from 1 October

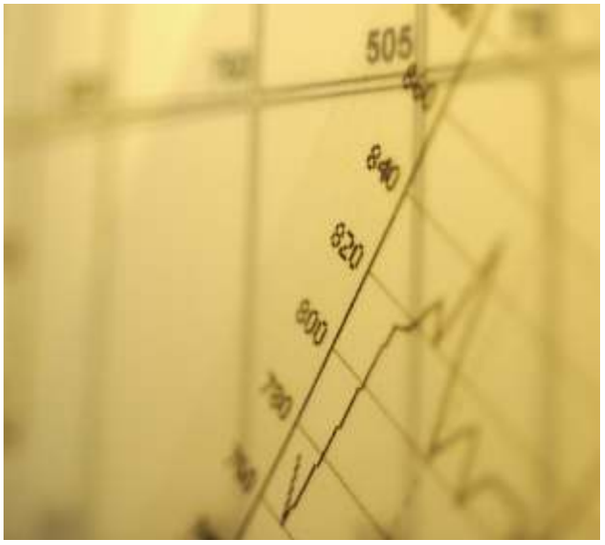
2017, and would help plug the gaps in reporting under different regulations that currently exist. Such disclosures by listed entities will help in availability of information to investors and other stakeholders.

6. Further, in June 2017, SEBI set tougher rules for the country's rating agencies, including mandating them to more closely monitor whether issuers are meeting their debt obligations and increasing disclosure requirements. Credit agencies would also need to review ratings after every "material event" and request monthly "no default statements" from issuers.

## *Technology and Cyber Security*

Importance of technology and Cyber Security cannot be undermined. To focus on this area SEBI has constituted a committee under the Chairmanship of Mr. T.V. Mohandas Pai. This committee will deliberate on the recent and medium-term trends in FinTech developments in securities markets worldwide. It will also track opportunities, challenge sand impact of the new FinTech Solutions on the Indian capital markets.

A four-member, high power steering committee on Cyber Security has also been set up to oversee and provide guidance on cyber security initiatives for SEBI




and the entire capital market. This committee is being chaired by Smt. Madhabi Puri Buch, Member, SEBI.It will advise SEBI in developing, maintaining and aligning cyber resilience requirements with global best practices.

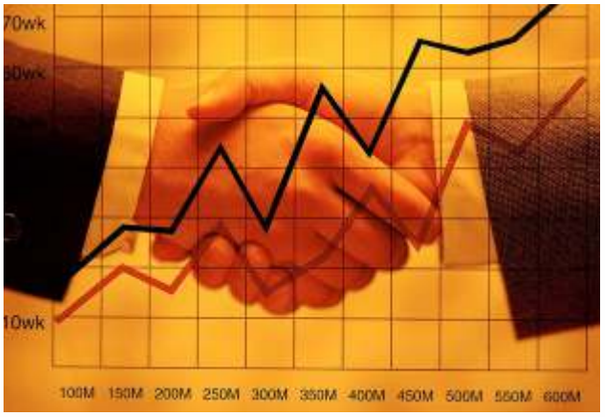
All in all, SEBI intends to put together a long term cyber security framework for markets amid concerns over technical glitches and possible data breaches.

In conclusion, its very evident that the last six months have been very active in a very positive way, not only for the Indian Capital Markets but also for the Regulators.

# Robo Advisory – Democratising Investment Advisory

***Shilpa Kumar**, Co-Chairperson, FICCI Capital Markets Committee and Managing Director & CEO, ICICI Securities Limited*

Wealth management is traditionally viewed as an exclusive service, as something that only high net worth (HNW) investors can afford as it involves high client centricity. However, there is a real need to democratise investment advisory. Therefore, technology assumes a prominent role in enhancing the reach and cost efficiency of the traditional wealth management industry. Robo advisory is fast emerging as the next level of evolution in providing online wealth and asset management services to the affluent segment with the help of certain algorithms, which complement human advisors. Robo advisory has the potential to improve the productivity of traditional investment advisors. It is expected to drive financial inclusion by helping firms achieve scale, improve their propriety infrastructure and become more agile, nimble and cost efficient. Globally, robo advisory has started creating a niche for itself and is




expected to drive transformation in the investment advisory landscape. Although, globally the current asset under management under Robo Advisory is at ~$300 billion (less than 0.5% of total global AUM), it is accelerating rapidly and is expected to touch ~$1-2.2 trillion (as per various agencies like Business Intelligence, AT Kearney) by 2020.

**Typical robo-advisory model**

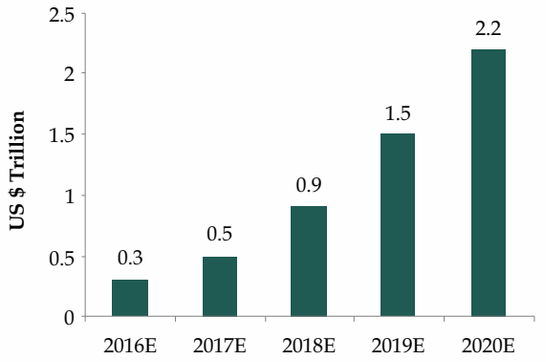



* Functionality typical in financial professional and client-facing digital investment advice tools

** Functionality typical in financing professional-facing tools only

Source: FINRA 2016 Report

### Global Robo advisory AUM to hit $2.2 trillion by 2020




*Source: AT Kearney, Statista (data as on Feb, 2017)*



### Key robo advisory firms & their AUM

| Name | Country | AUM (US$ mn) |
|---|---|---|
| Vanguard | USA | 47,000 |
| Schwab Intelligent Portfolios | USA | 10,200 |
| Betterment | USA | 7,360 |
| Wealth front | USA | 5,010 |
| Personal Capital | USA | 3,600 |
| Future Advisor (Blackrock) | USA | 808 |
| Nutmeg | UK | 751 |
| Asset Builder | USA | 671 |
| Wealthsimple | Canada | 574 |
| Financial Guard | USA | 454 |
| Rebalance IRA | USA | 403 |
| Scalable Capital | Germany | 125 |

## Robo advisory - The 'next-gen' wealth management ecosystem

- Robo advisors can offer an alternative solution to investors who have **limited capital to invest vis-à-vis human advisory where there is a minimum threshold limit for investment management.** They can do so at fees that are much lower than those for an investment advisor. The traditional portfolio managers charge anything between 1% and 2% of AUM as fees whereas **robo advisors charge ~one-tenth of the same (i.e, in the range of 0.15-0.25%)**. Savings on fees on AUM over a longer time frame do enhance investment return as the investor has relatively higher reinvestment proceeds at his disposal. Robo advisors can offer even small investors a fully diversified portfolio
- Robo advisors take the guesswork and timing out of the equation. They **rebalance at set intervals based on a predetermined risk tolerance**. They stick to a plan. In the long run, this can guard many investors from making costly mistakes
- Taxes can have a major impact on the investment rate of return. This is particularly true of capital gains and, especially, of short-term capital gains since they are taxed at regular income tax rates. Since they are fully automated, robo advisors are constructed in such a way that they are tax efficient. Some robo advisors also offer **tax loss harvesting** (TLH). This is a process in which capital gains are offset through the sale of investment positions that have experienced losses. The use of TLH can be engineered in such a way that it minimises capital gains, without materially lowering the performance of the account

- From the financial service provider's point of view, a robo advisory **provides scalability in terms of garnering AUMs and resultant stable annuity fees coupled with relatively lower operating costs**. As of 2016, the global AUM under this model was pegged between $200 billion and $300 billion, which would mean ~$0.6-0.8 billion of stable fees for the industry. This would be earned with the same level of fixed costs. Furthermore, it is estimated that advisors empowered with robo technologies could service between 300 and 500 clients, i.e. around five to six times the traditional model. Consequently, it was found that with a hybrid robo - human advisory model, the required AUM to cover the costs of the advisor (salary plus overhead costs) would decline ~50%, clearly reflecting the scale and operating leverage benefits that it can offer.

## AI and machine learning to augment robo advisory offerrings

The future will increasingly involve automated services using artificial intelligence (AI) models such as machine learning where computers can make inferences about client behaviour and needs based on a large quantum of data.

Responsive AI is upping the ante when it comes to wealth management robotics. The next stage is financial planning driven by context and having goal-based systems. Coupled with AI, machine learning is also gaining traction where the task involves making the computer learn the necessary relationships and actions involved in completing a task intelligently. This training involves using a large data set that the computer algorithm can repeatedly go through. Thus, it would learn, through trial and error, how to connect the input data (e.g. credit history, employment history, assets, purchasing history) with the desired output (e.g. the correct identification of a suitable risk portfolio). Once this is learned, the algorithm can be used on real world data offering largely positive results.



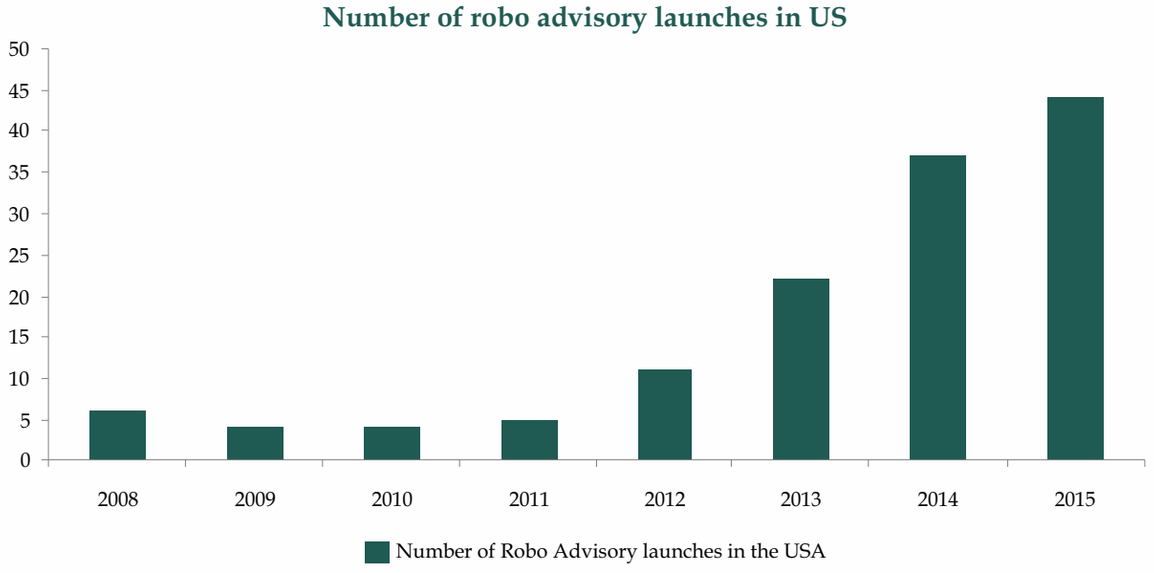
For example, global firms have started developing wealth management software, which will mine, manage and analyse all the data available about an investor - Facebook posts, spending habits, investment choices, tweets, etc, - using AI to find patterns to customise a financial plan and investment strategy. The benefits of developing enhanced software for the industry go beyond helping to understand clients better. Responsive AI, for example, currently provides software that handles the back-end office and compliance work for a wealth management operation. However, the future would involve creating AI that draws on a discipline of social psychology called psychometrics that uses statistics to build profiles of investors. This will help map personality traits etc., which can help prepare strategies that the advisor puts together for clients.

## Global robo advisory adoption

The idea of a robo advisory business model surfaced a decade back when a start-up company Betterment ventured into the domain and attempted to alter the way the advisory business was done. Since then, its AUM has scaled to $7.4 billion and attracted cumulative funding of ~ $200 million (source: Bloomberg). The global robo advisory industry since 2012 has also attracted PE funding to the tune of $1.32 billion (source: Reuters), thereby highlighting the business model is gaining acceptance. Scalability benefits have also attracted mainstream players such

as Charles Schawb, which has launched its offering Intelligent Portfolios in 2014. Within three years of its operation, the offering commanded an AUM of $10.2 billion serving over 75000 clients. In the process, it has also surpassed the AUM of its smaller counterparts like Betterment and Wealthfront. Other instances also include firms like Vanguard that have scaled up their






*Source: Tracxn Report: Robo Advisors (Feb.2016)*

robo advisory as they manage an AUM of ~$47 billion while firms like Black rock and Fidelity have taken up the M&A/partnership model to shore up their offerings.

## Adoption challenges of robo advisory

The extent of transformation of robo advisory will depend on how the ecosystem evolves around the adoption of algorithm driven platforms, regulatory support, creating broader fund features and addressing technology led concerns.

- **Algorithm driven platforms**: An elementary robo advisor delivers digital advice by asking users to answer a few questions related to his financial goal, risk appetite and other basic financial details. Robo advisors use a human created algorithm or a mathematical formula that considers key elements viz. the historical long term performance various asset classes like equities, bonds & commodities, information the user provides about investing goals, timeline, risk loss tolerance, investible corpus and underlying investment options primarily index funds and ETFs. Algorithms assign portfolios based on financial requirement and expected risk return profile of the individual client. An important aspect of the whole robo advisory is the continuous monitoring and regular rebalancing of portfolios. There are various ways in which a robo advisory works but primarily it gets classified into two category viz. fully

automated model and hybrid or assisted model wherein the latter has more human intervention/support

- **Funds features**: Robo advisors were originally designed on the premise of passive, low cost investing. Some new online broker services go beyond just ETFs and offer actively managed funds. A few robo advisory services allow clients to pick between an all ETF portfolio or a hybrid that includes managed mutual funds and ETFs. In terms of ticket size, brokers require minimum investments of $5000 compared to their start-up counterparts who have even offered services with minimal investment criteria. The mass adoption of robo advisory, therefore, warrants its expansion across asset classes

- **Fees**: The fees charged by each broker for its robo advisory services is relatively competitive. Globally, the all-in fee ranges from 0.25 -0.4% of AUM, with a few charging no advisory fee but having certain expense ratio. There are also certain tiered structure offered that ranges from 15 to 35 basis points. This fee is relatively lower than the traditional fee which ranges at ~1-2% of the AUM

- **Thin margins warrant higher scalability to sustain**: The basic premise of a robo advisory is to offer investment advice in a cost efficient manner to a larger section of investors. Therefore, given the thin margin nature of the business, the scalability is of prime importance for sustainability of such a business model. It is to be noted that concerns on thin margins would be addressed as the robo advisory model is adopted by mainstream financial services companies, thereby making it a large scale play

- **Technology trust deficit and missing human interface**: One of the major concerns of any fintech service has been the technology trust deficit. The need for regulatory supervision in robo advisory also emanates from its lack of ability to make



human judgements in asset management algorithms. Therefore, with stringent regulatory requirements as seen in the US and Europe by SEC and European supervisory authorities, it is likely that the same would be addressed by everyone (including India) for wider adoption. Similarly, the absence of a human interface can be overcome by focussing more on a hybrid model, which brings in the best of both worlds i.e. traditional and robo advisory

## Robo advisory in India - still at nascent stage

Robo advisory is at a nascent stage in India and has just started gaining traction in India with many start-ups and a few brokers launching the model. Most players who have started giving automated advice are currently following a basic model of asset allocation based on the risk return matrix. Currently, most robo advisories are being offered in mutual funds while an advisory on direct stocks or other asset classes is yet to witness a kickstart. In India, a commission/brokerage model is the prevalent model for robo advisory. There is still some time to move to a fee-based model.

## Robo advisory to complement traditional wealth management

The rise of robo-advisory services has challenged the traditional financial services providers to recalibrate how technology can improve their current service

offerings. With wider adoption of robo services, it can bring on board small scale investors and thereby boost the economy by enabling wealth planning to become mainstream. We believe the robo advisory will complement the financial advisory lanscape, paving the way for enhancing the financial inclusion of small investors. The way forward in the investment advisory business model will be the hybrid model, which offers the best of both worlds where the advantages of technology are combined with human wisdom.



# Board Managed Companies: Changing the Landscape

***Amit Tandon**, Founder & Managing Director, Institutional Investor Advisory Services*

Institutional ownership of the S&P BSE 500 companies has been steadily increasing. But there is another discernible shift within regarding governance of these companies that is taking place: the number of companies that are both institutionally owned and board managed, has rapidly started to increase. This will have far reaching consequences for our markets and also for its regulations.




**Exhibit 1: NSE500 ownership by category 2011-17**

| | Promoters | Corporate Bodies | Institutional Investors | Individuals |
|---|---|---|---|---|
| **31-Mar-01** | 48.5% | 6.1% | 31.0% | 14.4% |
| **31-Dec-08** | 58.9% | 4.0% | 29.2% | 7.9% |
| **31-Mar-15** | 51.3% | 3.6% | 37.3% | 7.8% |
| **31-Mar-16** | 50.2% | 4.5% | 37.4% | 7.9% |
| **31-Mar-17** | 50.2% | 4.4% | 37.9% | 7.4% |

*Source: ACE, IiAS*

**Exhibit 2: NSE500 ownership by management 2011-17**

| Ownership Category | 2011 | 2015 | 2016 | 2017 | % increase |
|---|---|---|---|---|---|
| Board managed company | 21 | 23 | 24 | 31 | 147.6 |
| MNC's | 46 | 61 | 62 | 59 | 128.3 |
| Promoter Owned | 372 | 347 | 347 | 344 | 92.5 |
| PSUs | 61 | 69 | 67 | 66 | 108.2 |
| | 500 | 500 | 500 | 500 | |

*Source: Market, IiAS*

Institutional equity ownership (- FII's, DII's and other institutions) - which is widely tracked, shows institutional ownership at 37.9% in March 2017, up from 31.0% in March 2001 and a low of 29.2% in December 2008. The second set of companies - board managed company's (BMC's) have also evidenced an increase. One should expect companies in this category to see the most rapid growth going forward, for a number of reasons.

First, expect more of the existing board managed companies to list their existing subsidiaries. ICICI Bank has listed its life insurance subsidiary, and is working to list its general insurance arm. Larsen & Toubro listed two of its subsidiaries. HDFC is looking to list its mutual fund and life insurance subsidiaries. Though promoted by ICICI, L&T or HDFC, these better fit the board-managed category. For those not convinced, I will go back a few decades: HDFC, promoted by ICICI, snapped its umbilical cord as they treaded on each other's toes. The pace of change is faster now. Two, market infrastructure companies like stock exchanges and depositary companies are beginning to get listed. Three, spin-offs like Crompton Greaves carving out its consumer business and selling it to private equity (PE). I expect PE to steadily add to this number as they back professional teams - the number of buy-out funds and transactions today is a clear pointer. In the past, the scale of operations of such companies was small, and they exited to other larger PE firms or did strategic sales. But as PE have put more and more capital to work, its markets that provide the most viable exit. And though PE's may 'control' the business today, expect them to exit completely tomorrow, leaving these businesses to be run by boards. Finally, while regulators still frown on promoter-less listings, these are no longer black swan sightings. There is a steady stream of such offerings in the market. Collectively these will matter particularly as they become a part of the frontline indices - which they will.

What should one expect when professionally-managed companies gain ground? As more and more of the business is board-managed, the boards will



move stage-center, with the roles becoming more complex. The buck will stop at the board: look no further than boards of ICICI or HDFC. There are no 'promoters' to turn to for taking strategic decisions or to recapitalize if needed. The skill levels expected by the board are of a higher order as they balance between the appropriate amount of over-sight and guidance. They will need to be familiar with the company's business, but also bring an outsiders perspective to the boardroom. While all this no-doubt is true today, for the majority of companies, there is a promoter - whether a business family, the foreign parent or the Government of India - so boards are not being stretched. Going forward, though, the needed skills are set for a dramatic overhaul.

Just now the fuss is all about related party transactions. Is it abusive? Are these being using to tunnel money? Regulations are focused on how do you protect minority investors. This will need to change.

Markets and regulations will need to evolve from defining board composition with reference to promoter and non-promoters, and ask boards to focus on skill sets on the board and from liabilities of the promoters to dealing with boards that glad-handle CEOs.

This focus will also shift to compensation. We already

see many 'promoters' disregarding performance-linked pay when voting their own pay rise. Their membership of the remuneration committee makes this easy. In professionally-managed firms, we are already seeing senior management cornering a large portion of the ESOPs for themselves, and then doubling-up on these by grabbing them from subsidiaries. As boards come to rely more on the CEOs to deliver, and CEOs drive decisions on board rewards, the risk of an unhealthy bond between them will only increase. Compensation is difficult to regulate. So institutional investors will need to evolve their approach. We are seeing some global investors routinely shoot down compensation if it is higher than the median pay rise. This will need to be more widespread if it needs to be effective.



Admitted this change will not happen overnight, but the market does not have the luxury of taking a generational view either. It is therefore important that both regulators and investors develop a framework to deal with the coming shift. The best time to begin is now.

*Amit Tandon is with Institutional Investor Advisory Services. Twitter handle: @amittandon_in*

# Review of the current Monetary Policy Framework

***Ananth Narayan,*** *Regional Head, Financial Markets, ASEAN & South Asia, Standard Chartered*

Per mandate, the Monetary Policy Committee (MPC) focuses on targeting Consumer Price Inflation (CPI), and determining appropriate policy interest rate responses.

In the Indian context, there is an argument to be made to consider multiple financial stability variables besides inflation, and deploy responses beyond a single policy interest rate alone.

For one, projecting CPI in India is a hazardous task. To a large extent, this involves estimating food and commodity prices over the medium term. That makes this exercise subjective art, rather than objective science.

Additionally, the impact of interest rates on our CPI merits review. The traditional monetary axiom is that higher interest rates reduce aggregate demand, and therefore controls inflation. It bears noting that higher interest rates also increases input cost for borrowing producers. In the US, household debt is at 78% of GDP, and is a little higher than private corporate sector debt. In India, household debt is at just 14% of GDP, while corporate debt is 56% of GDP. This is a complicated way of stating the obvious – that the US is a borrow-to-spend economy, while India is a borrow-to-produce economy. Other things being equal, given interest rates could impact input costs more than aggregate demand, perhaps the traditional monetary axiom could work differently in India, as compared to the US.



High interest rates could still control inflation in India, under the right broader context. If we have high twin deficits, for instance, high interest rates could help attract foreign inflows, stem currency outflows, penalise the fiscal deficit, and stabilise financial markets. This could in turn help stave off adverse consequences of financial instability, including high inflation. In fact, even if CPI were currently low within such a context, one might still call for high headline interest rates.

To that extent, perhaps additional context needs to be set by paying close attention to indicators alongside CPI – such as INR & the external sector, employment, banking & corporate health, fiscal health, asset markets, and trends in savings and investments.

Likewise, there is an argument to be made for considering responses outside of a single policy interest rate, to optimise overall macroeconomic stability. These could include focusing on the shape of the yield curve (rather than a single short term policy rate), and considering macro-prudential measures.

## Other Macroeconomic Indicators besides CPI

First, we need a reliable measure of payroll, employment and underemployment in our country. With so much of our socio-economic future

dependent on job creation, this is a key metric for all policy makers, including the MPC.

Second, as the RBI repeatedly points out, the health of our banking system, with its capital constraints, stressed assets, and tepid credit off take needs to be addressed. Our economy needs fresh investments both to de-bottleneck supply, and to create sustainable jobs. To this end we need a realistic assessment of how much additional capital is needed for the banking system, and how this need can be plugged.

Third, INR bears watching. The past year, including the carry from interest rate differentials, INR has strengthened by over 10% against the USD and other currencies. Given that despite our underemployed workforce, we import manufactured goods from around the world, a stronger INR is not good news for our domestic producers. In the first four months of FY18, our average monthly trade deficit risen to $13B, almost double of the same period last year.

Yet, since the beginning of this year, RBI's spot FX reserves have grown by $33B and outright forward FX purchases by another estimated $20B. This $53B increment cannot be explained by our Current Account and FDI inflows. Instead, this appears to indicate rising complacency, with exporters covering more of their exposures, while importers/ borrowers in foreign currency/ FPI debt investors leave currency exposures open.

Fourth, State Government finances and the possible impact on our overall fiscal situation bear watching. Currently, all state governments are clubbed together largely into one credit risk bucket by the market, and bank market valuation norms for State Government bonds may not be accurate. The natural market mechanism to reward states that manage their finances well, may not work under these circumstances.

Fifth, recent strength in our equity markets is backed by increased domestic flows, even as corporate earnings struggle to keep pace. This increase in domestic liquidity could at least in part be due to the



reduction in post-tax returns from banking fixed deposits. Increased savings into equity financial assets are of course welcome, but the growth should calibrate to the capacity of markets to absorb them. Increased flow of savings into equity markets might also reduce long-tenor customer deposits with the banking system, which could exacerbate the liquidity gap mismatch that the banking system carries.

Lastly, the global context is a curious mix of high uncertainty, but low market volatility. There is no shortage of geopolitical and economic events that could shake the global economy. However, backed by a wall of liquidity, and possibly the long-term reduction in commodity and energy prices, global equity and bond markets have remained resilient.

## Policy Response

(a) Our banking and INR context described above call for lower short-term interest rates. As a natural response to a slow economy in the short run, lower rates would perhaps reduce India Inc. costs, encourage domestic spending, and help banks bridge some of their large capital requirements. Narrower interest rate differentials against other major currencies should also help encourage hedging of FX exposures.

On the other hand, prospects for the fiscal deficit, movement of savings away from long-term fixed deposits into equities, and global uncertainty, all call for stable to even higher long-term interest rates.

A steeper yield curve fits into all the above. RBI has the means to achieve such a steeper yield curve. The current wall of surplus liquidity could be used to reduce short term rates, perhaps by making banks deploy their surplus funds at a lower RBI LAF reverse repo rate. Simultaneously, the MPC could reiterate that there is uncertainty around the future trajectory of macroeconomic variables and therefore, longer term rates. The RBI should also stand ready to use OMO window, to sell long tenor bonds in the market, should longer end yields fall sharply. In addition, the borrowing program of the state and central government could be tweaked to increase duration, if longer end yields were to drop.

(b) Specifically on the capital requirement for banks, alongside ensuring there is adequate provision cover on non-performing assets, we should address areas where banking capital and liquidity requirements are high compared to global standards. As examples (i) Liquidity Coverage Ratio (LCR) currently adds to already existing Statutory Liquidity Ratio (SLR) holdings of banks (ii) RBI currently does not yet recognise bilateral netting of derivatives for exposure purposes (iii) RBI's Basel III Credit Value Adjustment (CVA) norms are more onerous than global norms. Each of this can be brought down at least to global standards, helping reduce liquidity and capital burden of banks.

(c) Stressed banking assets need addressing, and this calls for innovative solutions. The legal route being pursued needs to be supported by a strong commercial resolution framework as well. Experiences of jurisdictions such as Malaysia post the Asian crisis bear study.

(d) RBI should resist continued overvaluation of INR, particularly one fostered by a build-up of unhedged currency exposures. RBI has about $20B of net outright forward purchase of USD. Such forward intervention supports higher



forward premia, which incentivises a further build-up in unhedged currency exposures. For sterilisation of INR liquidity from their USD purchases, RBI could consider using the reverse repo window or bond OMO routes, instead of the USDINR forward market.

(e) State Government borrowing costs should be determined more by their individual state of finances, rather than any notion of implicit backstop from RBI. A starting point should be a review of the valuation norms for these, and other government and corporate bonds. The current RBI circular prescribing valuation for State Government bonds at a spread over Central Government bonds should be withdrawn. FBIL and FIMMDA should be charged with devising a more accurate and dynamic valuation process for individual bonds.

(f) Given considerable uncertainty about the future course of markets, even amongst policy makers, participants should be encouraged to consider risk management as deemed appropriate. In this regards, the move to link bank MCLR to a common floating benchmark is very welcome. This will help bring transparency & transmission of rates, besides allowing for meaningful and liquid risk management products to be built around them.

(g) While outside the scope of monetary policy, in the current context of diversion of savings to capital markets, there should be a review of the tax asymmetry between banking fixed deposits, debt mutual fund and equity investments. To start with, the government should consider giving fixed deposits over three years the benefit of indexation for tax computation, akin to debt mutual funds. We do need incentives to encourage long-term customer deposits into banks, to allow the system to fund long term investments better.

## Conclusion

While the MPC is mandated to target inflation using policy interest rates, it does consider a whole set of other data. Public discourse would likewise do well to focus on financial stability as a whole, while considering a variety of tools, outside of the RBI policy rates.



# One Trillion Opportunity in Commercial Paper

***Ashu Suyash,*** *Managing Director and Chief Executive Officer, CRISIL*

The commercial paper(CP) market in India has grown substantially, and provides significant short-term funding to corporates today. CP senable issuers to raise funds directly from investors and hence, depending on the liquidity in the market, can enjoy favourable interest rates compared with bank loans.

CP issuances have almost tripled to Rs. 20.8 lakh crores from Rs 7.3 lakh crore over the three fiscals ended March 31, 2017. As on March 31, 2017, the CP outstanding amounted to ~Rs 4 lakh crore - almost four times as on March 31, 2014.

However, the CP market is almost fully dominated by A1+ rated issuers, despite the Reserve Bank of India (RBI) allowing even A3 rated companies to issue CPs. Only a handful of corporates rated A1 currently issue CPs; most still rely on bank lending for their working capital requirements.

There is need to develop and deepen the market for A1 rated CPs. This would allow corporates to tap funding at lower interest rates, and also enable investors to diversify their portfolio to yield better returns without a substantial increase in the overall portfolio risk.



RBI has also recently announced its directions on CPs on August 10, 2017. As per the directions, issuers with total CP issuance during a calendar year of Rs.1000 crore or more are required to obtain credit rating for issuance of CPs from at least two credit rating agencies. The directions also strengthen disclosure requirements around the use of CP proceeds, and can provide a further fillip to the development of the CP market.

## Market size and returns of A1 rated CPs

Working capital debt of more than 250 companies rated CRISIL A1 exceeds Rs 65,000 crore, which can be potentially issued as CPs. The market for A1 rated CPs could exceed Rs 1 lakh crore if the working capital debt of companies rated by other credit rating agencies is also considered, presenting sizeable investment opportunities.

For perspective on returns investors can expect, the median cost of debt for CRISIL A1 rated companies was ~150 basis points (bps) higher than CRISIL A1+ rated companies during fiscal 2017. That's the potential spread over A1+ rated CPs expected to beavailable to investors.

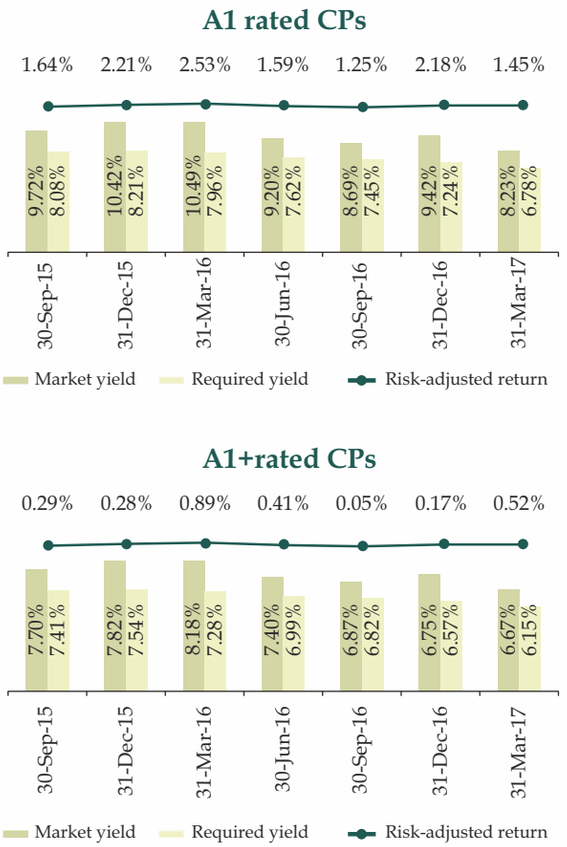
## Risk- Return Arbitrage

Risk-adjusted return is the excess return offered by a portfolio over the required yield to cover expected and unexpected losses, including default risk. A1 rated CPs can yield risk-adjusted returns of ~100bps or more in excess of that available on A1+ rated CPs (Chart 1).

Higher risk-adjusted returns underscore adequate compensation for the credit risk and present a

significant opportunity for investors to increase their portfolio returns while maintaining risk levels within manageable limits. However, the benefits of risk adjusted returns can be reaped only in a portfolio with adequate diversification.

### Chart 1: Risk-adjusted returns of CRISIL A1 and A1+ rated CPs show a vast differential




Market yield represents average yield on commercial papers outstanding, maturing within four months (120 days). The yield is computed based on the credit risk premium over 91-day treasury bill rate.

## Track record of CRISIL A1 rated papers

Such ratings are typically assigned to companies rated in the CRISIL A category on the long-term scale, which is an investment grade rating with adequate degree of safety in terms of timely servicing of financial obligations.



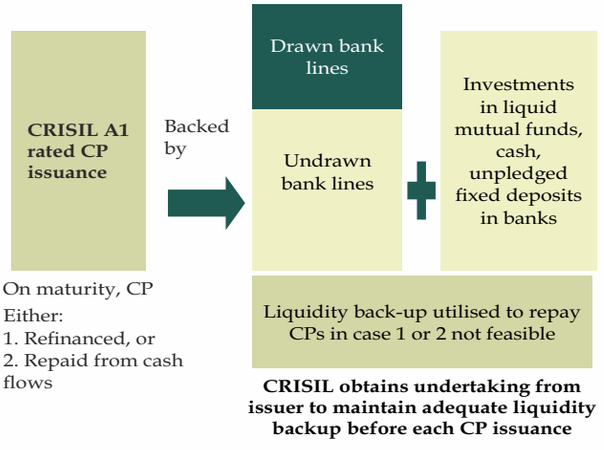
In the decade through 2016, only 0.59% of CRISIL A1 ratings defaulted within a year. The one-year stability rate was 86.44% and one-year upgrade rate was 6.47%, indicating ~93% of CRISIL A1 ratings remained at the same rating or were upgraded to CRISIL A1+ within a year.

As an additional safety feature, CRISIL insists that issuers of CRISIL A1 rated CPs maintain adequate liquidity backup to be able to tide over temporary liquidity mismatches when refinancing is difficult.

CRISIL's stipulation of a liquidity backup is beneficial to both the issuer and the investors. Liquidity backup ensures that investors in the CP will be repaid in time and that the issuer can use the support of the credit lines from the banking system to over come temporary cash flow mismatches.

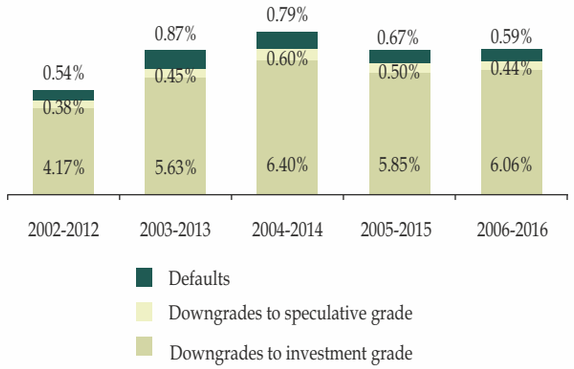
In the past decade, majority of CRISIL A1 ratings that were downgraded remained in the investment grade

### Chart 2: Liquidity backup can take many routes



post the downgrade. Liquidity backup helps prevent defaults due to such minor shifts in credit quality as bankers may not revoke the facility used as backup in these cases (Chart 3).The benefit of liquidity backup is reflected in the fact that only one CRISIL A1 rated CP has defaulted in the past decade.

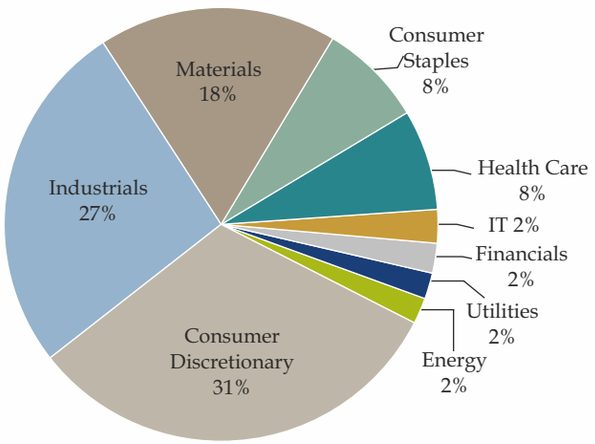
### Chart 3: One-year downgrade rates of CRISIL A1 ratings buttress case for investment




## Win-Win for Issuers and Investors

Apart from the returns upside without significant risk, there are also potential portfolio diversification benefits. CRISIL A1 rated entities offer a range of investment options across sectors(Chart 4). Also, ~50% of CRISIL A1 rated entities belong to strong

### Chart4: Sectoral composition of CRISIL A1 rated companies shows scope for diversification







corporate groups, and enjoy significant support, which can provide additional comfort to investors.

As for cost savings compared with bank credit, issuers of CPs can potentially reduce their funding costs by more than 100 bps by meeting their funding requirements from the CP market, instead of traditional bank lines. The issuance cost of CPs is ~0.3% of the amount raised, which is marginal compared with the interest rate reduction of ~1.5% that may be available to issuers.

## In Summary…

With A1+ rated CPs being the norm, it is time the market is expanded to include A1 as a means to optimize cost for issuers and at the same time extend a measured means of enhancing returns. It is indeed time for investments to pick up in A1 rated CPs, considering the huge market potential and higher returns, even after adjusting for credit risks.

The presence of liquidity backup on CRISIL A1 rated CPs can provide additional comfort to investors. The development of the CP market for A1 rated CPs would also allow issuers to reap significant cost-savings vis-à-vis bank credit, and diversify their funding sources.

# Taking Infrastructure Investment Trusts to the next level

***Harsh Shah**, Chief Financial Officer, IndiGrid*

SEBI notified the Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014 (the "InvIT Regulations") which introduced an additional mode of infrastructure financing through Infrastructure Investment Trusts ("InvITs"). InvITs provide an avenue for long-term financing of infrastructure projects. InvITs are structured as trusts that can help de-lever infrastructure project developers and enable them to undertake new projects to fulfil the infrastructure needs of India. Further, InvITs provide investors the opportunity to hold a portfolio of operating infrastructure assets for a reasonable risk-adjusted yield, with a potential for growth if the portfolio include a percentage of projects that are under-construction.

The InvIT Regulations were followed by certain taxation related benefits that were granted to InvITs and/ or investors of InvITs, including exemptions related to dividend distribution tax, in the 2016 Union Budget. Further, in the same year SEBI eased the InvIT Regulations allowing investment in two-level structures (special purpose vehicle), removing the limit of number of sponsors, rationalizing the requirements under related party transactions and reducing the minimum holding of sponsor. This led to two successful initial public offers ("IPO") in 2017. Presently, three sponsors have filed applications for registration/ have received registration of InvITs and propose to undertake either an IPO or a private placement of their units.

Despite a strong conceptual, regulatory and governance framework for InvITs, the listings of InvITs have not matched expectations. In order to




realize the true potential of InvITs there is a need to take steps to increase their market depth, provide financing flexibility to optimize the return to unit holders and stipulate a longstanding legal framework.

## *Increasing liquidity and market depth of InvITs:*

1. **Provide clarity to mutual funds to participate in InvITs:** Mutual funds are one of the largest source of professionally managed capital in India today. InvITs provide a unique opportunity for mutual funds to earn superior risk adjusted returns over a long period. However, there is a lack of clarity amongst the mutual funds regarding the classification of InvIT units in their schemes and requisite approvals from SEBI. This is significantly hampering the participation of mutual funds in InvITs thereby reducing the liquidity and depth of this new financial instrument.

   SEBI should consider organizing a round table (along with prospective sponsors of InvITs) with the Association of Mutual Funds in India and representatives of all major mutual funds to

deliberate the challenges faced in participating in InvITs. Once these concerns are clearly laid out, SEBI will need to address them, including by providing a simplified approval mechanism for mutual funds to invest in InvITs.

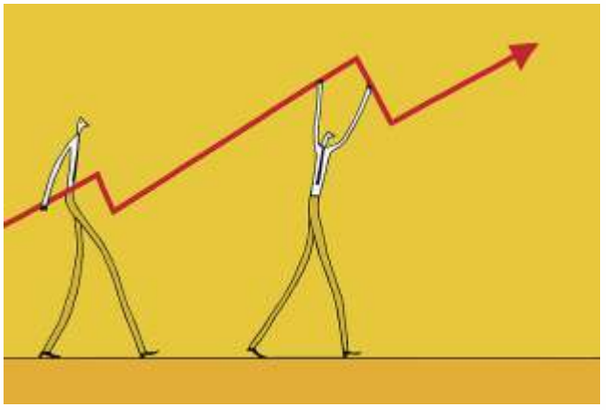
2. **Enhance the investment limit for insurance companies:** Currently, Insurance Regulatory and Development Authority of India ("IRDAI") allows insurance companies to invest not more than 3% of its respective fund size or not more than 5% of the units issued by a single InvIT, whichever is lower. On the other hand, SEBI allows a mutual fund to invest not more than 5% of its respective fund size or not more than 10% of the units issued by a single InvIT, whichever is lower.

   The fundamental proposition of InvITs is to offer stable cash flows from underlying infrastructure assets which is better suited for long-term investors like insurance companies. The current low limit restricts the ability of insurance companies in playing a more active role in a product that matches their long-term risk-return profile. A higher participation by insurance companies will add to liquidity and market depth for InvITs.

   IRDAI should increase the maximum investment limit for insurance companies in InvITs to at least the same level as permissible by SEBI for mutual funds.

3. **Tap provident funds:** The Pension Fund Regulatory and Development Authority ("PFRDA") that administers the National Pension System ("NPS") has approved investments in InvITs. However, the much larger Employees' Provident Fund Organization ("EPFO") that administers the larger social security schemes has not yet approved or provided guidelines for investment in InvITs.

   InvITs provide a stable and long term investment opportunity for provident funds to match their pension payment obligations. EPFO needs to diversify its investments to include InvITs by laying down clear guidelines.



4. **Stimulus to Banks to participate in InvITs:** The Reserve Bank of India ("RBI") norms on capital market exposure by banks limits their ability to meaningfully participate in InvITs. Currently, the banks cannot invest in more than 10% of the unit capital of an InvIT.

   Considering the stable and conservative nature of InvITs, the capital market exposure norms should be relaxed further and the banks should be permitted to invest in a higher percentage of an InvIT's unitholding.

5. **Attracting retail investors:** InvITs offer stable and long-term yield owing to the robust regulations developed by SEBI regarding the quality of eligible infrastructure assets and governance. At present, a large section of retail investors are not able to participate in the InvIT offering due to the minimum investment amount of INR 10 lacs in an IPO. Further, post listing of the units of InvIT, the minimum prescribed trading lot is INR 5 lacs, which reduces the liquidity for unitholders to trade. These limitations restrict retail investors in investing and trading in InvITs.

   SEBI should consider reducing the minimum investment amount by retail investor at the time of

an IPO to increase the participation of retail investors. Correspondingly, SEBI should also reduce the minimum trading lot for InvITs.

### *Providing financing flexibility to InvITs:*

1. **Optimize capital structure of InvITs:** In general, revenue generating infrastructure assets are levered beyond 70% considering the de-risked nature of cash flows and higher credit ratings. Existing regulations allow InvITs to leverage up to a maximum of 49% of asset value. An optimal capital structure would reduce the cost of capital for InvITs thereby providing a higher returns to investors.

   SEBI should allow up to 70% of leverage at consolidated level if the credit rating of the InvIT and the instrument is AAA. In any case, the leverage beyond 25% will need unitholder approval to ensure unitholder interests are safeguarded.

2. **Issue of unlisted or listed debt securities by InvITs:** The Trusts Act, which is the governing legislation for trusts (including the InvITs), does not provide any legal framework for issue of securities by InvITs. Accordingly, the issue of securities by InvITs is governed by the InvIT Regulations, which provide a framework only for issuing units. Hence, InvITs are not able to issue debt securities thereby blocking an important source of debt capital. This is especially important in relation to financing acquisition of assets by InvITs in the future.

   Appropriate changes should be made to enable InvITs to issue debt securities by amending the regulatory framework.

### *Longstanding legal framework:*

1. **Post-listing obligations:** The Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (the "Takeover Regulations"), Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 (the "Insider Trading Regulations") and Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 are applicable to companies with listed equity and debt securities. However, there is ambiguity over the applicability of these regulations to InvITs. This has created uncertainty for currently listed, and prospective, InvITs and their respective sponsors. Moreover, due to the uniqueness and peculiarity of the organizational structure of InvITs (being trusts), the extant Takeover Regulations and Insider Trading Regulations cannot be applied to InvITs without suitable modifications. SEBI needs to issue appropriate guidelines to remove this ambiguity.

2. **Preferential allotment of units by InvITs:** Whilst the InvIT Regulations allow InvITs to raise further capital (post-listing) through preferential allotment of units, the operational guidelines for such preferential allotment of units have neither been covered under the InvIT Regulations, nor any circulars/ notifications for that have been issued by SEBI.

   The important aspects for which legal framework is required include, provisions related to pricing of units, lock-in requirement, disclosure norms and offer documents. It is important for InvITs to have



the ability to raise further capital for future acquisition of assets, which is not only beneficial for unitholders of such InvITs in terms of distributable cash flows and yields, but also to ensure that InvITs are perpetual vehicles. This aspect becomes even in more pertinent in view of a cap of 49% (of the relevant InvIT's assets) on leverage.

We believe that these changes will increase the attractiveness of InvITs and provide more impetus to infrastructure financing in India. It would be a big opportunity loss if a financial instrument with so much potential does not achieve its purpose to spur the desperately needed infrastructure development required to drive India's GDP growth.



# Listing Start-ups

***Monal Mukherjee,*** *Partner, Shardul Amarchand Mangaldas & Co*

India is a growing service economy, home to thousands of start-ups, in need of funds for future growth. Initial public offerings **("IPOs")** are a way of channeling large public investments into a company, while providing an exit opportunity to investors including angel investors and venture capital funds **("VCFs")**.

Among other differentiators from companies that access the IPO route, start-ups particularly in the technology space may be characterized by not having promoters in the conventional sense, but rather entrepreneurial founders and financial investors who are keen to take a successful business venture public, handing over the reins to professional managers, then moving on to the next opportunity.

However, early-stage companies face a number of challenges in accessing the capital market, including due to strict disclosure and post-listing compliance requirements.

The Securities and Exchange Board of India **("SEBI")** instituted the Institutional Trading Platform **("ITP")**, pursuant to the SEBI board meeting dated June 25, 2013, to allow easier listing and trading of start-ups and Small and Medium Enterprises **("SMEs")**. SEBI introduced this platform on October 8, 2013, inserting Chapter X-C through an amendment in the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 **("SEBI ICDR Regulations")**, relaxing many of the stringent rules governing main market listings.

Although retail investors are excluded from this forum, to safeguard smaller investors from the higher risk associated with equity investment in emerging companies, SEBI contemplated that companies listing on the ITP could migrate to the main board, subject to



certain requirements, at which time retail investors could become shareholders in these companies.

Providing an alternative platform for emerging companies to list is a tested concept in the international securities market. The United States, United Kingdom, Hong Kong, Japan, Singapore and China have all provided alternative platforms for emerging companies, with less onerous disclosure and other requirements, compared to main market listings.

The National Stock Exchange of India Limited **("NSE")** and BSE Limited **("BSE")** have both set up ITP platforms. Approximately 20 companies have listed on BSE's ITP platform, whereas around 70 have listed on NSE's ITP platform, so far.

Observing that the ITP had not received the expected response from investors and investee companies, SEBI replaced Chapter X-C of the SEBI ICDR Regulations by an amendment on August 15, 2015. The amended regulations relaxed various eligibility criteria and disclosure requirements for listing on the ITP, and provided the option to list on the ITP with or without a public offer. Various enabling amendments

to other SEBI regulations, including on takeovers, listing, delisting and Alternate Investment Funds **("AIFs")** were also notified.

However, since the further relaxation of the ITP framework was announced by SEBI in 2015, there have been no start-up listings, and none of the companies listed on the ITP have migrated to the main board.

Certain start-ups, such as Infibeam Incorporation Limited and Quick Heal Technologies Limited, both of which went public in 2016, directly listed on the main market, irrespective of stricter disclosure and other requirements applicable to the main market listings. While this option exists and the current market environment is encouraging, the majority of early stage companies in India still find a main market listing challenging.

Others, such as MakeMyTrip Limited and Yatra Online Inc., have in the past externalized their capital raising initiatives and listed on foreign bourses rather than on the Indian stock exchanges. Many companies continue to explore capital raising avenues overseas, including through offshore holding companies and special purpose vehicles. While certain sectors see better valuations overseas and globalization allows such companies to tap a deeper pool of capital overseas, this trend is of concern when it represents the inability of an Indian company to find investor interest and market depth in our own country.

SEBI's Primary Market Advisory Committee **("PMAC")** is the apex advisory body for policy issues relating to the primary market. It has representation from investment banks, credit rating agencies, stock exchanges, academic institutions and investor associations. In 2016, the PMAC, chaired by Mr. T.V. Mohandas Pai, recommended to SEBI that alternate listing of start-ups be discarded and these companies be provided with a platform to list on the main market, with relaxed regulations. Further, in June 2017, it was reported that SEBI may be contemplating the removal of the lock-in requirement in its entirety.

On July 29, 2016, SEBI issued a discussion paper to review the ITP framework, based partially on the



recommendations of the PMAC and further discussions with various stakeholders. SEBI's focus on encouraging emerging companies in the technology space to utilize the ITP is illustrated by the proposal to rename Chapter X-C of the SEBI ICDR Regulations from 'Listing on Institutional Trading Platform' to 'High-tech Start-up & other new business Platform'.

## Among other things, SEBI proposed the following measures:

- Relaxation of the eligibility requirement for a minimum prior holding level by Qualified Institutional Buyers **("QIBs")** in the pre-issue capital of companies seeking to list on the ITP, to also include prior shareholding of other categories of institutional investors (including family trusts with a net worth exceeding ₹ 500 crores, and certain entities registered with or regulated by SEBI, the Reserve Bank of India, or the appropriate overseas regulator), albeit not registered as QIBs.
- A uniform eligibility requirement of a pre-issue institutional shareholding level of at least 25% across all sectors, instead of the existing differential requirement of at least 25% in technology related companies and at least 50% in other companies.
- Deletion of the eligibility requirement that no person, individually or collectively with persons acting in concert, shall hold 25% or more of the post-issue capital.
- Relaxation of the requirement to allocate at least 75% of the net offer to public institutional investors and the remaining portion of not more than 25% to

non-institutional investors **("NIIs")**, to instead allocate at least 50% to institutional investors and the remaining portion of not more than 50% to NIIs.

- Increase of the cap on discretionary allotment to individual institutional investors from 10% to 25% of issue size.
- New provision for compulsory market making for a minimum period of three years for an issue size of less than ₹100 crores.
- A uniform period for lock-in of pre-issue capital across all categories of shareholders, for six months from the date of allotment in case of listing pursuant to public issue or date of listing in case of listing without public issue, instead of limited exemptions to the existing six-month rule, for shares arising out of employee stock option schemes and held by VCF/AIF Category I/FVCI in case of listing pursuant to an IPO.
- Reduction of the minimum trading lot from ` 10 lakhs to ₹5 lakhs.

While it appears from this discussion paper that SEBI is not immediately working towards dismantling the ITP framework in favour of relaxed main board listing requirements for start-ups, or exemption from lock-in requirements for start-ups, it is reported in the media that various stakeholders have reiterated those recommendations and made several related recommendations, including tax breaks for start-up listings, and crowd-funding in India, pursuant to a framework similar to the US Jumpstart our Business Startups Act, passed in 2012.

We stand at across roads today. In line with the agility associated with start-ups themselves, whatever policy and regulatory changes to the extant ITP and related framework SEBI may announce could be regarded as further course correction by our market regulator towards the same objective as before, namely, to boost listing and trading of start- ups in India. In the interim, companies continue to look offshore for capital raising opportunities, or to evaluate private equity options.

Many others are considering main market listings in



India. To this last category, SEBI's policy and regulatory moves towards increased transparency and efficiency in the main market provide a ray of hope. Recently announced SEBI reforms in cludeeasing of access norms for FPIs, extension of lock-in exemptions to Category-II AIFs as well, continuing reduction in the listing time line from T+6 eventually to T+2, and enhancing investor engagement through social and digital media, including e-IPOs.

In addition, in an effort to address concerns regarding poor price discovery and overvaluation, SEBI constituted the Committee on Fair Market Conduct in August 2017, under the chairmanship of Mr. T.K. Viswanathan, former Law Secretary, to recommend amendments to the SEBI (Prohibition of Insider Trading) Regulations, 2015 and SEBI (Prohibition of Fraudulent & Unfair Trade Practices Relating to Security Market) Regulations, 2003. This committee is man datedto suggest short and medium term measures to improve surveillance of markets and anti-fraud enforcement. These recommendations, once notified, may affect price discovery and liquidity for start-up listings, and the Indian capital market as a whole.

Although it may seem daunting to navigate the complexities of accessing the public market, there are compelling reasons for any emerging company as well as its shareholders to explore onshore as well as offshore listing options. The right intermediaries and advisors can help identify the most effective route and unlock the benefits to taking a company public, and the opportunities for growth post listing.

# MFs emerge as Force-Multiplier in Capital Markets

***Sundeep Sikka,*** *Executive Director & Chief Executive Officer, Reliance Nippon Life Asset Management*

Increasing participation of retail investors through systematic investment plans (SIPs), flood of pension money, adoption of technology by the players and a rising realization among the investing public that mutual funds are an ideal wealth creation opportunity have helped the Rs 20 lakh crore MF industry achieve critical mass. Along the way, mutual funds have acted as a force-multiplier in capital markets. With big inflows coming via equity, debt and hybrid products regularly, MFs play a huge role in stabilizing and supporting capital markets. This has not only made the profile of capital markets better, but also reduced volatility.

## Equity markets driver

Traditionally, the Indian equity market has been driven by foreigners. However, the overseas hot money subject Indian markets to great uncertainty. This has started to change of late. Big fund-houses, with hugely experienced teams and top-class systems, have been able to attract investors, whose investments have been deployed in Indian markets.



Stabilizing agent for stocks -The strong influx of sticky, long-term money in equity mutual funds from systematic investments by retail investors is changing the face of Indian capital markets. For instance, when FIIs sold Rs 146 billion worth of equities in FY16,mutual funds bought a whopping Rs 661 billion.

Strong and robust inflows from equity and equity linked products have led to MFs becoming an important factor in Indian equity space. Mutual funds' share of the equity market capitalization in India has nearly doubled from just2.9% at the end of March 2014 to 5.5% as of March2017.

Over Rs 4,000 crore of SIP money is coming into Indian markets every month. This has changed the behavior of Indian markets, because investors are soaking up any choppiness.

Pure equity funds, and tax-saving funds earlier shouldered a bulk of inflows into equity markets. However, hybrid funds, popularly known as balanced funds, have emerged as new favorites. With balanced funds seeing a sharp spurt in investor interest in recent years, net inflows have been positive on a sustained basis in the 34 months through March 2017.

Pension money -Another major trend that has lifted the position of MFs in Indian equities space is the advent of passive investments. Traditionally these chunks of money went into fixed return assets, but things have started changing with the Employees' Provident Fund Organisation (EPFO), the biggest retirement manager in the country allocating a portion of its incremental inflows into equity ETFs.

EPFO started with allocating 5% of its incremental inflow of around Rs 1 lakh crore in FY16 to equities, before expanding this to 10% in FY17, and now plans

to use up its full quota allowed, which is 15%. This has boosted the assets of equity ETFs by almost seven times since August 2015 (when EPFO started its investment) to Rs 429 billion as of March 2017.

## Date with debt

On debt markets side too, mutual funds have participated in a big way. Fixed income investment forms a significant part of any portfolio since it carries a lesser risk compared with equity. Long-term debt funds tend to benefit more during periods of interest rate decline, while short-term debt funds fare better during periods of rising interest rates. Additionally, debt funds provide tax benefit in the form of indexation for holding period of more than three years. Initiatives by bigger fund-houses such as creating awareness, connecting with investors, providing easy to understand facilities have gone a long way in bringing investors to the fixed-income MF side.

Win-win for everybody - The rising participation of debt MFs in debt markets has been a win-win for both industry participants and investors. Debt issuers benefit from being able to get stable funding at low costs. Investors receive secure and predictable cash flows with higher returns compared with plain-vanilla bank fixed deposits. In the long run, this will offers out-sized economic benefits to the country as a whole, and will turn out to be growth-conducive. It becomes especially important for funding the government's ambitious infrastructure agenda, which is estimated to require Rs 43 trillion in the five fiscals up to 2020.

Rising share in debt issuances -The Indian mutual fund industry remains slanted towards debt-oriented mutual funds including liquid funds. These products account for over 61% of the total assets as of March 2017.

With deeper penetration, MFs' share of debt capital markets have grown. According to data, mutual funds' share of domestic debt market issuances in the past five years has gone up to 10.4% as of March 2017. Four year back i.e. March 2013, this share was 8%.



Clearly, this indicates how mutual funds' debt holdings increasingly started accounting for more of country's total debt issuance.

GSecs, corporate & PSU debt -The falling interest rate scenario, growing participation of retail investors and popularity of debt MFs has contributed to stupendous growth in debt markets. According to Sebi data, mutual funds at the end of March 2017 put in Rs 1.2 lakh crore alone in government securities. In March 2014, this amount was less than Rs 40,000 crore. In the commercial paper side, mutual funds have invested over Rs 2.5 lakh crore. This amount was less than Rs 80,000 crore four years back.

Mutual funds have also contributed to supporting corporate debt and PSU debt. Companies floating non-convertible debentures, bonds and other debt instruments have seen good uptake from mutual funds. Put together, MFs have invested over Rs 5 lakh crore at the end of FY17 in corporate and PSU debt instruments compared to less than Rs 1.9 lakh crore in FY14.

## Global window

Indian mutual fund companies have also done their bit when it comes to providing a global platform for investments. This works in both ways - One, Indian investors can invest in global markets and securities in a bid to diversify their portfolio. Two, foreign investors can also invest in Indian capital markets, be it debt or equity, to take advantage of the growth in the world's fastest growing major economy.

From India to global - Global miners, agriculture firms, technology titans and assets classes like real estate and gold are interesting opportunities. Markets like the U.S. and Japan in Asia are attractive. With Indian mutual funds in tie-up with global providers, investors from India now invest in those capital markets without worrying about tax issues, currency conversion challenges and local stock market expertise. In this route, global capital markets also receive long-term Indian investments in a structured and seamless manner. The Indian products act as feeding channels to a larger global product.

From global to India - Sebi in 2016 provided easy entry to the foreign fund managers keen to enter India. For global investment companies wanting to have 'India play', mutual funds provide the best suited platform to carry out investments. Top fund houses registered as a Portfolio Manager are permitted to manage portfolios of its clients. In addition to this, such managers render advisory services to offshore clients. By giving incisive advice to pooled assets including offshore funds, insurance funds, provident funds and pension funds, top mutual funds provide a major bridge for overseas money looking for local roads into India.

Thus, mutual funds in India play a very important role in terms of contribution to capital markets local as well as global. By becoming an investment vehicle of choice for the masses and the niche, the day is not far when mutual funds will democratize capital markets with huge growth and deepening contribution.

Happy investing!

# Easing Regulatory Barriers to Investment in India

***Varsha Purandare**, MD & CEO, SBI Capital Markets Ltd.*

## Introduction

In the current global environment, where capital is scarce and there are countries competing for attracting the same capital, it is important for every nation to become an investor-friendly destination. The first step toward this objective is to do away with multiple procedures, rules, regulations, red tape et cetera and bring more transparency and clarity in policies.

## India as an Investment Hub: Strengths and Challenges

Factors that make India an attractive, investor-friendly destination include the government's policies on the liberalization of most sectors for foreign investment, growing opportunities across sectors, skilled human resource, cost-effective production facilities and strong domestic demand.

The enabling environment to bring new people into the financial system is very strong in India but there are a host of regulatory challenges that prevent Investment/ Doing business in India.

The biggest challenge that most Investors/ Companies face is the Indian governance framework, which is intertwined between the Central and State structures. Any sort of investment has to face several complex bureaucratic procedures and comply with both state & central rules and regulations. Moreover, duties and levies undergo frequent revisions during the Annual Central and State budget exercise. These factors are the major reasons why many Foreign Companies/ Investors indicate 'dealing with regulations and procedures' as one of the major challenges.

Over 200 foreign portfolio investors (FPIs), who have




exposure to India's financial markets, say that the cost of trading is high compared to other emerging markets, in a latest PwC India report. A significant majority of the FPIs also view India's current regulatory and tax environment still challenging, compared to other markets. There have been issues on retrospective taxation in the past, which have negatively impacted the image of the country as an investment destination.

The following are the greatest challenges that hinder investment in India:

- A reactionary approach to legislation
- Unpredictable bureaucracy and volatility in laws
- Corporate laws and Foreign Exchange Controls
- Lack of Transparency
- Tax Ambiguity

Despite initiating various schemes to ease regulatory policies, India still does not seem to be a uniform market. Each of its 29 states has its own rules on land purchase, employment, tax and the environment. State-level reforms supersede national law creating

ambiguity & complexities for Investors in the nation.

## Government Initiatives to ease Regulatory Barriers:

India has already marked its presence as one of the fastest growing economies of the world. It has been ranked among the top 10 attractive destinations for inbound investments. Since 1991, the regulatory environment in terms of foreign investment has been consistently eased to make it investor-friendly.

The GoI has run some important initiatives like Make in India, Smart Cities, Digital India, PMJDY etc to mobilize funds/investment in the nation.

Some key government reforms to increase investment prospects are highlighted below:

- Easing of FDI limits in several high value added sectors such as telecom, retail, defense, construction and railways
- Reforms in the labor market, including a single window labor compliance process for industries, more user-friendly provident fund facilities, and a new inspection scheme
- Encouragement to advanced manufacturing by The Department of Industrial Policy and Promotion (DIPP) to deregulating a large number of products such as defense items, from the purview of industrial licensing
- Push for import substitution by encouraging local manufacturing of up to 181 imported products
- Creation of an Investor Facilitation Cell in 'Invest India' to guide, assist and handhold investors during the entire life-cycle of the business
- Replacement of multiple indirect form of taxes by GST Regime
- New bankruptcy law, providing for simple and time-bound insolvency process



## Recommended Steps To Enhance Investment

1. **Increasing equity exposure of pension fund- expedite regulatory clearance:** Currently, the pension funds under PFRDA are allowed to invest up to 15% of the corpus into stock market. The Pension Fund Regulatory and Development Authority of India (PFRDA) has sought approval of finance ministry to raise the limit of government employees' pension funds in the stock market up to 50%. The same is awaiting the clearance of Finance ministry.

   The authority manages about Rs 1.70 trillion of funds belonging to 1.5 crore subscribers who come from government and non-government sectors. Of this 85 per cent are government subscribers

2. **Increasing equity exposure of provident fund:** EPFO started investing in stocks in August 2015. In 2015-16, it invested 5% of the annual incremental corpus in equities and in 2016-17, 10% which was further increased to 15% in FY 2017-18. EPFO has an annual incremental corpus of more than Rs1.2 trillion and 15% of that will be at least Rs18,000 crore. Suggest this limit to be further enhanced to 50% as proposed for pension fund. The EPFO is not picking valuable stocks itself for the retirement fund corpus. Rather, it is relying on the broader

market. The investment of EPFO in the stock market is through the Sensex and Nifty ETF. Suggest to allow EPFO to directly invest in the equity shares.

3. **Introduction of innovative products:** Last year (May 5, 2016) The National Stock Exchange (NSE) launched weekly Bank Nifty options contracts. This gave market participants the flexibility to hedge their portfolio or trade at a lower premium. Earlier, the exchange's Bank Nifty futures and options contracts had a monthly expiry. Weekly options contracts would provide traders another option to play with lesser premium and lesser investment compared to monthly options contracts. Suggest extending this to other Nifty products like NIFTY IT, NIFTYMIDCAP, NIFTY INFRASTRUCTURE etc.

4. **Making demat account compulsory for residents:** The number of demat accounts in India is a paltry two per cent of the total population and has not grown at a healthy pace over the years. SEBI needs to simplify the KYC procedure so that opening a Demat account becomes easier for a common man for e.g. AADHAR linked demat accounts. Further, common demat account for holding financial assets would be very useful for investors.



Depositories to work towards offering single demat account which will hold all financial assets including fixed deposits.

5. **Suggested changes in SEBI ICDR Regulations:** To enhance retail participation in the equity markets, SEBI may consider the following:

- Making retail discount mandatory to encourage retail participation
- Insurance company related to the BRLM be allowed to participate in the Anchor Book
- Increase the limit of mandatory allocation to retail investors from 35% to 50% especially in PSU-IPO

# Fusion – A Group CFO & CIO Perspective

***V.S. Parthasarathy***, *Group CFO, Group CIO and*
*Chairman, Mahindra eMarket Ltd. & Member of the Group Executive Board, Mahindra & Mahindra Ltd.*

When we look at the balance sheets of various organizations, the off-repeated quote comes to mind - ***"there is nothing left on the right side, and there is nothing right on the left side"*** and this happens because we are always having a mismatch. Traditionally India has been a bank-led lending, so everything has been dominated by them - whether it is short term money, medium or long term money. All these have led to a huge mismatch and therefore various sectors have long overdue outstanding. The part of the problem is clearly due to the non-performance, however a part can be blamed for the wrong choice of instrument and lack of adequate market bonds or otherwise.

If we look over past decade there have been a number of reports by expert Committees on development of corporate bond markets in India viz. Report of High Level Expert Committee on Corporate Bonds and Securitisation in 2005 (R. H. Patil Committee), Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre in 2007 (Percy Mistry Committee), A Hundred Small Steps [Report of the Committee on Financial Sector Reforms (CFSR)] in 2009 (Dr. Raghuram Rajan Committee), Reports of the City of London, etc. These Committees have examined in detail various aspects related to the development of corporate bond market and have made useful recommendations. Over last decade many of these recommendations have been implemented. A few notable recent developments / initiatives in the Bond market are :

A) RBI proposing to allow listed companies to lend money to banks through repo market mechanism. B) The proposal to allow foreign portfolio investors direct access to bond trading platforms for government and corporate paper to help widen the investor base. C) Further, opening up of global markets for AT1 and Tier-II bonds, beneficial for banks in negative rate condition prevailing globally. D) RBI has also decided to enhance the aggregate limit of partial credit enhancement provided by banks to corporate bonds to 50 per cent of the bond issue size from 20 per cent earlier - This will help build investor confidence, E) New framework for consolidation in debt securities being implemented by SEBI as part of its efforts to deepen the corporate bond market. In order to increase liquidity as well as ensure that an issuer's ability to raise funds through debt securities is not curtailed, Sebi focused on minimising the number of ISINs (International Securities Identification Numbers) and finally F) The Insolvency and Bankruptcy code implemented recently which, given the comparative high risk of default & suboptimal recovery in low rated Corporate Bonds, will in a big way boost confidence of investors and help increase flows in Corporate Bond Market.

While a lot has been done, following factors continue to act as impediments to the growth of Corporate Bond markets, namely A) Dominance of Banks in



lending, B) Risk appetite of investors limited to higher rated Bonds, C) Regulatory arbitrage between loan and bonds and D) virtual absence of retail participation in debt markets.

There is awareness of these impediments and various agencies are working on mitigating, if not eliminating, the impact thereof. Efforts are on to wean the issuers / borrowers from Banks to Bond markets. This will address the dominance of banks & the aspect of regulatory arbitrage. On the aspect of retail participation & risk averse approach, while steps are taken in this regard by an attempt to infuse secondary market liquidity, a lot still needs to be done. Indian investor by nature is risk averse and more tuned to invest in fixed income instruments, yet retail participation in debt market is almost non existent. If we analyse the data points two things stand out - approx. 95% of the issuance fall in the category of private placement. Here both to achieve diversity in funding as well as to increase transparency it is imperative that we have more public issuances and active secondary market, which will then lend liquidity to the common retail investor to enter and exit on need basis and thereby boost his confidence. Retail participation in Corporate Bond Markets is abysmally low at approx. 1/5th of their participation in Equity markets.

While there is all around focus on how to deepen the markets as well as to increase liquidity, I would like to dwell upon the less addressed issue of transparency. Considering that the Indian investor is risk averse this aspect gains all the more importance to ensure that the retail investor keeps investing on a sustained basis.

All that I have written till now was in my capacity as Group CFO, let me now switch guard and supplement my thoughts by leveraging my Group CIO hat. This is the age of Technology & FINTECH, and as we look at our Bond markets and think of transparency the first question that comes to mind is, have we leveraged technology in its true sense and to its right capability - in particular to address the aspect of transparency ?

On each of the elements which are critical for success of Corporate Bond market i.e. Issuers, Investors,



Intermediaries, Infrastructure, Incentives, Instruments and Innovations we have trailed the developments happening across globe. The question now is can we lead or match them on the technology front? Here I would like to dwell upon the potential of Artificial Intelligence (AI) and Machine Learning (ML) and its applicability to Bond markets in building transparency.

Equity Trading leverages a lot on Big data & Analytics. The same is not the case when it comes to Bond Trading. It is exceedingly doubtful given the difference in their respective market transparencies.

Unlike equities traders that use big data to supplement the market's existing market data, corporate bond market participants still struggle so far as to price their bonds accurately using available market data. In absence of confidence on fair price, attracting an investor who is risk averse and looks for assured return is all the more difficult.

The primary aim of AI / ML should not be to do the trading, the aim is to make people have all the information they need at their fingertips. They can get alerts at the time they specify, or get on-demand information through a web portal. AI / ML should further aid making sense of these data points.

First and foremost we should look to digitizing bond origination and issuance. We should strive for end-to-end fully digital bond origination platform that connects all elements of the bond market - corporate and government issuers, dealers and fixed-income

investors. The platform should draw linkage between Issuers, Investors, Intermediaries, Infrastructure, Incentives, Instruments and Innovations such that it exploits full potential to reduce operational and market risk and transaction costs for all counter-parties.

Machine learning algorithms are designed to find patterns where no human can see any. The idea is to develop a continuous analysis engine designed to "monitor information as it's changing, and look for/identify very specific things/trends." The AI / ML platform should act like a credit analyst that will cover corporate information and read the trends.

The question is how can AI / ML be trained / positioned to watch for the things that a credit analyst watches for; so it's looking for things that would affect the risk of the bond. It watches for things that would cause revenue to fall: taxation issues, unemployment problems, lawsuits, changes in executive management, a strike - all these things which would affect a bond and the Corporate's ability to pay. The point is investors need to stay nimble and course-correct as new information becomes available. Leveraging technology to anticipate, read, analyse and interpret data from source is the key.



Non-availability of credit risk transfer mechanism in the corporate bond market works as a deterrent for common investor. Though Credit Default Swaps (CDS) has been introduced in India, there is not enough activity in the market. One of the things that hinders the growth of this market is availability of data in transparent manner which will help in proper pricing of the swaps. Here again AI / ML can play a very critical role both in anticipating & analysing data to provide right pricing.

Various initiatives already in place has helped penetration of Corporate Bonds. As measured by amount outstanding to GDP, Bond market had moved up to 18% in 2016, up moderately from over 10% at the turn of the decade. While this is a reason to feel happy, when we look around the globe and see how the markets have matured we notice we have a long way to go. Since implementation of various reforms, over a period of 5 years, the penetration in the Bond market in major emerging markets ( in terms of outstanding to GDP) is as follows : Brazil which moved up from 12.7% to 26.3%, Russia up from 8.1% to 13.1 % and China increasing from 18.8% to 33.4%.

The question now is how do we leverage technology effectively. While this is a topic in itself, this is an era of Shared Service Providers and FINTECH players who specialise in AI / ML are the ones to be leveraged for the same. Who owns this or partners this (shared service!) will undoubtedly do a yeomen service to the Bond Markets in India.

There are two things to focus on: - financially sound deep markets from a CFO's perspective and IT enabled new FINTECH service fully in place vis-à-vis analytics and machine learning. All these should give the bond market a lift and we can say ***"bond with the best".***

# Indian Debt Capital Market: The Road Ahead

***Sankar Chakraborti,*** *Chief Executive Officer, SMERA Rating Limited*

## Introduction

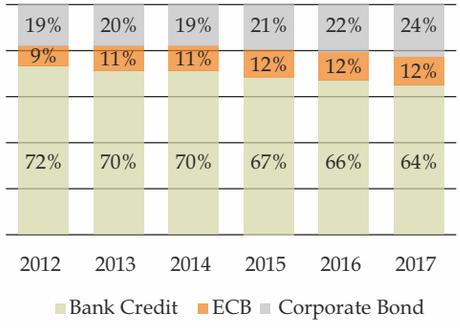
India is among the fastest growing economies currently and going forward, debt capital market will be one of the major drivers of the growth continuum.

Robust infrastructure investment and capital expenditure by the corporate sector are likely to be the major charioteers of the Indian growth story.

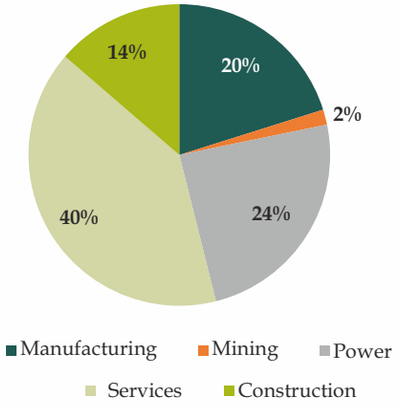
The Public-Sector Banks (PSUs) currently under stress due to the mounting NPAs quarter-on-quarter and Private Sector Banks limiting their exposures to specific industry sectors. Further the conduit of mobilizing money through External Commercial Borrowing and / or Foreign Currency Convertible Bond (FCCB) is also limited to a confined set of borrowers. Hence the fund raising through the debt capital market is expected to see more buoyancy.

Though, there have some advances encompassing the policy, regulatory & infrastructure sphere for these instruments, the paradigm shift has yet not happened in the same and there is a huge opportunity for all the participants in the debt capital universe of India.

**Corporate Debt Mix**




*Source: SMERA Knowledge Centre ; RBI*




*Source: FIMMDA*

## Trends in Indian Corporate Bond Market

Historically, across countries, traditional sources of financing such as banks and financial institutions have been inadequate to stimulate widespread economic growth that is sustainable.

The Indian bond market has grown rapidly over the last few years, however the same is still dominated by the government issuances.

The overall corporate bond market has grown at a CAGR of 16% in the last 10 years standing at INR 6.5 lakh Cr as on March 2017. The incremental growth from FY16 to FY17 was to the tune of INR 3.6 lakh Cr. Of the outstanding issuance of INR 6.5 lakh Cr, 70% was contributed by the financial sector while the remaining flotations was from non-financial sector primarily comprising manufacturing, mining, power, services and construction industry.

Chemicals (21%), metals (15%) and transport (20%) account for more than 50% of the overall bond issuances in the manufacturing sector.

From the power sector bond issuances, DISCOM's accounted for 58% while GENCO's accounted for 42%.

In the services sector, 41% is accounted by road transport infrastructure services companies whereas in the construction sector, 40% is accounted by infrastructure construction companies.

Notwithstanding the gradual shift in the investor's and borrower's appetite towards debt markets in recent times, ***the pace of penetration of corporate bond market has not been very encouraging.*** Although the outstanding value of corporate bonds have doubled over the past five years to INR 6.5 lakh crore in FY2017, India's corporate bond market stands at only around 24% of the total Indian debt market.

While India's GDP as a share of global GDP is 2.99% (Source: IMF), its share of debt market capitalisation is less than 2% of global outstanding. Within this small market, again, government securities reign supreme, with corporate bonds relegated to a minority. The corporate bond market is a fifth of the equity market. The penetration of corporate bonds, as measured by amount outstanding to GDP, was ~20% in FY17, up moderately from over 10% at the turn of this decade.

This contribution seems quite low compared to bank assets (almost 90% of GDP) and equity markets (almost 80% of GDP). The scenario looks weak when comparison is made with other countries, with corporate debt to GDP at ~115% for both USA and UK,

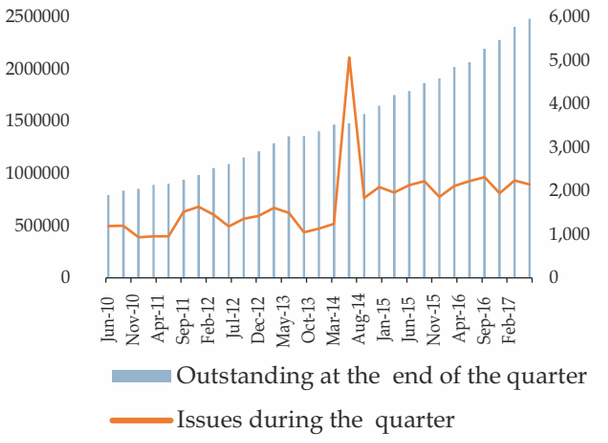
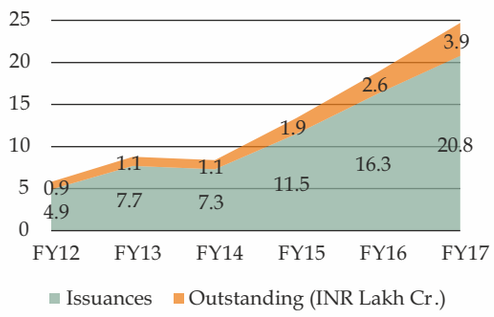



Figure above depicts the cumulative outstanding amount of bonds (in INR Lakh Cr) on quarterly basis on X axis, while the y-axis depicts the number of the bon issuances in the respective quarter
Source: FIMMDA

**CP Issuance & Outstanding Status In India**




*Source: SMERA Knowledge Centre; CMIE*

~80% for South Korea, ~70% for Japan and ~45% for China.

The corporate sector has been gradually moving away from conventional sources of financing like banks. SMERA considers this to be a sign of an increasing maturity of our financial market and expects this trend in disintermediation to continue and expects substantial growth in incremental bond issuance seems unlikely.

## Emergence of Commercial Paper (CP) as an attractive instrument

Working capital requirement is a very important part of financing of companies and even for larger corporates it is a major concern.

The Commercial Paper (CP) is fast becoming an attractive short-term financing instrument that has the potential to be an effective alternative to working capital requirements.

Steep surges in working capital requirement arise out of eventualities such as seasonal bonus payments and

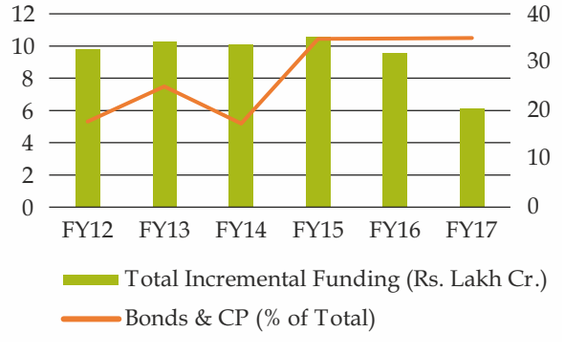


delayed recoveries leading to a sudden funding gap. Traditionally CC was a predominant avenue for funding but the facility remains constrained by its inherent utilization limits and comparatively high interest rates.

To overcome these impediments, over the previous years, the market has begun to tap CP as an alternative and the instrument has since then emerged as an attractive tool for short term and event based working capital requirements. Issuance of CP has grown four times over the past five years from INR 4.9 lakh crore in FY12 to INR 20.8 lakh crore in FY17. The total amount outstanding too has increased by the same proportion, growing from INR 0.9 lakh crore in FY12 to INR 3.9 lakh crore in FY17. The popularity of the instrument has surged incrementally too for highly rated firms, which are bypassing commercial banks. Together with bonds, CPs account for nearly 35% of incremental funding in India as of FY17 as compared to 17.7% in FY12. ***Furthermore, with the recent guidelines of the RBI which states that CP no longer must be necessarily carved out of CC/working capital facilities thereby increasing the utility for the corporates.***

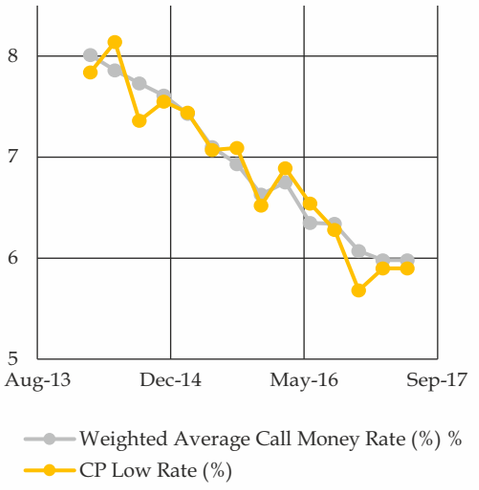
In light of the recent guidelines of the RBI on CPs, SMERA believes that the trend will be further boosted both in reference to annual issuances and outstanding amount. Given the popularity and rising quantum issued, the RBI guidelines have come into force to further guide and strengthen the CP market. ***As per the new rules, issuance of over INR 1,000 crore will be obligated to have two ratings, with the lower rating being taken in case of Credit Rating Agencies (CRAs) differing in their opinions.***

Rising Relevance of CP in Incremental Funding




*Source: SMERA Knowledge Centre; CMIE Bonds & CP % (LHS)*

WACR Vs. CP Yeild (Low Rate)




*Source: SMERA Knowledge Centre; CMIE*

Factors that help CPs to stand out mostly cover the instrument's operational modalities such as:

- Issuance at discount
- No interim interest payments as in the case of CC/ FD
- Multiple rollovers within a year
- And most importantly its non-collateralized nature.

Tradability of the CP, just like any other OTC instrument, also gives it a lot flexibility to both borrowers as well as lenders. This lends a unique inherent liquidity characteristic to the CP. The new guidelines which allows the entities rated A3 and above to issue the CP, will help in broadening the base of CP issuers This condition is however only natural



given the fact that the CP is a non-collateralized/ unsecured money market instrument, which cannot be underwritten and is issued as a promissory note. Investor confidence necessitates that such conditions exist.

Nonetheless, considering the attention on CPs from all quarters, including issuers, borrowers and the RBI, SMERA believes that the instrument is increasingly meeting its purpose by offering a viable substitute to all money market parties.

The attractiveness of the instrument is expected to remain high in the medium to long term given there are no new credible hybrid options available for short term financing.

## Challenges of India Corporate Bond Market

- The corporate bond issuance is dominated by private placements as these account for more than 95% of the total issuance of corporate debt
- Issuances are concentrated in the AA or above rating, largely by public sector entities and financial institutions
- Banks are more eager to advance loans rather than subscribe to bonds issued by the same company
- Majority of the issuances are concentrated in the 2-5 year tenor
- Limited/narrow investor base. Investment mandates of institutional investors such as insurance companies, pension funds and provident funds do not permit large investment in corporate bonds
- Reissuance of bonds has not picked up
- Lack of a functional trading platform with CCP facility like NDS-OM (as available in Government securities market) impedes the growth of the secondary market
- Market for credit risk protection instruments such as CDS is yet to develop
- Insurance companies (the largest participant of bond market) are permitted to hold a maximum of 25% of their portfolio in bonds rated less than AA.



## Opportunities for India Bond Market

RBI has been encouraging large corporates to access the corporate bond market rather than rely on banks as the major source of debt funding. Of late there has been a spate of bond issues to benefit from the low interest rate scenario. SMERA feels that corporate issuances may see some uptick over the near term driven mainly by a low yield scenario. However, long term development of the market will need the required regulatory push through appropriate changes.

## What could be done

The stress in the banking sector along with increased capital requirements under Basel III will force banks to tighten lending. Bond markets could then become pivotal in supporting the diverse financing

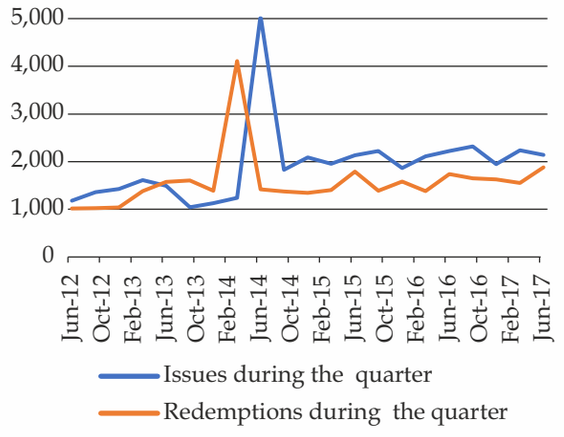



Figure shows that for the first time in Indian bond market, the number of bond issuances have consistently been higher than the redemptions since June 2014.
Source: FIMMDA

requirements of the growing Indian economy. Some of the initiatives that regulators should continue to focus on are:

- Increase awareness among retail investors.
- Develop and promote various such as:
  - Issuance of zero coupon bonds.
  - Popularise fixed income exchange traded funds (ETFs).
- Clarity on taxation issues direct investment in corporate bonds.
- Encourage institutional investors by altering the current investment guidelines for pension and other retirement benefit funds from ownership criteria to ratings based criteria.
- Permit funds to use interest rate swaps, repos and credit default swaps.
- Cap on borrowings of large corporate from banks for capital purpose, thereby providing a boost to the corporate bond and CP market, reducing dependence on financial sector issuances.

## Role of Credit Rating Agencies in strengthening bond market

Credit rating agencies have an important role in providing investors a comprehensive analysis of the risks associated with debt securities issued by corporates. With the policy regulations requiring all bonds to be rated and investors of the Indian bond market impaled towards high rated bonds (generally A and above), there is a pressing need for new ways for providing innovative credit enhancement methods like:

- Partial/full guarantee bonds and credit enhancements (PCE)
- Securitisation of receivables for various infra projects such as Highways, Commercial mortgage backed securities, renewable and non-renewable power projects among others
- Escrow accounts with waterfall mechanisms
- Debt service reserve accounts
- Promoting multi originator securitisation for MFI portfolios
- Securitisation of trade receivables for SMEs in India
- Ring fencing and securitising the cash flows of urban local bodies (ULBs) and thus promoting municipal bonds
- Bond issue under writing by NBFCs

## Debt Capital Market Prospects

The high rated corporates will continue to tap overseas markets to benefit from the low interest rates. The introduction of innovative instruments such as:

- ***Masala Bonds*** (Rupee denominated bonds targeted at overseas investors) will add to diversity of offerings from India Inc.
- 30/50/60 year ***Long Tenure Bond***
- Merger & acquisition ***(M&A) Bond***

The scenario of negative interest rates in major economies is expected to fuel demand for Indian paper in the overseas markets.

On the domestic front, the declining trend in interest rates in traditional options like bank deposits is expected to increase investor appetite for highly rated corporate paper wherein yields would be higher by 75-150 bps.

Nonetheless, even after reforming advancements, the Corporate bond market is still underdeveloped, but likely to grow strongly in the coming years with the recent policy changes and push form the government.

The current Indian banking sector is going through a conundrum where on one hand excess liquidity has been brought into the system post demonetization,



while on the other hand deterioration in the capital structure of banks has led to increased provisioning to be done thereby disrupting the flow of funds and credit from banks being largely available to big private sector companies leads to essentially squeezing small borrowers, SMEs etc. out of the bank lending market. If the domestic corporate bond market becomes vibrant then it could become an attractive source of financing for these large corporations and free up resources of the banks to support smaller companies. A liquid corporate bond market will significantly lower the cost of capital for issuers as well.

Key developments that can ease the challenging journey ahead

- Push from the centre for timely implementation of the bankruptcy code
- Scaling up of existing IDF
- Developing the CDS, Interest rate futures Market
- Setting up of Real Estate Investment Trusts (REITs)
- Asset quality and capitalisation pressures on banking sector is likely to moderate bank credit growth going forward, leading to corporates turning towards corporate bond markets
- With the government's renewed focus on infrastructure growth and clearing up some of the bottlenecks, funding requirement in this sector is likely to grow significantly

With stable currency rates, improving fiscal position of India coupled with stable inflation rates provide the right mix of ingredients to provide the opportunity for the corporate debt market to grow in India.

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