#CAPAM2019

16th Annual Capital Market Conference

'BUILDING A $5 TRILLION ECONOMY : ROLE OF CAPITAL MARKET'

The Experts' Voice

A compendium of articles

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Foreword

In alignment with the Government's vision of becoming a $5 trillion economy by 2024, FICCI's 16th Capital Market Conference - CAPAM 2019 - focuses attention on the role of capital market in realising this ambitious target.

While an economic slowdown was being experienced in the last few months, the recent announcements by the Hon'ble Finance Minister to trigger a virtuous cycle of investments, growth and higher employment exhibit the Government's determination to achieve high growth.

With the reduction in corporate tax rates, India now becomes a competitive market in the region with our rates similar to those prevailing in the ASEAN countries. The additional measures such as reversing the enhanced rate of surcharge on FPIs as well as on capital gains arising from sale of equity shares and units of equity funds would revive both domestic and foreign investment and stabilise the flow of funds to the capital market. Industry has greeted these measures with a significant jump in the sensex and translation of the vision of a $5 trillion Indian economy does seem possible.

On this occasion, we are pleased to present CAPAM 2019 Knowledge Paper, 'The Experts' Voice', a compendium of articles contributed by members of FICCI's National Committee on Capital Markets. With a focus on how the Indian capital market could play a catalyst in imparting greater momentum to growth, the articles delve into interventions required to be put in place to ensure deepening of bond market, availability of capital, infrastructure financing, role of mutual funds and improved business confidence. The articles also capture 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 2019 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 FICCI's National Committee on Capital Markets 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

Shilpa Kumar
Co-Chair

Himanshu Kaji
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FICCI Capital Markets Committee

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Multiple disruptions disrupting Capital Markets

Sunil Sanghai, *Chairman, FICCI National Committee on Capital Markets and Founder & CEO, NovaDhruva Capital Pvt. Ltd.*

One of the things that fascinated me as I took my first step into investment banking in 1992 was the uncertainty of the capital markets. The volatility that the market thrives on apart, the environment then was continuously changing. In my very initial years in this exciting profession, I witnessed multiple transformational events – be it the advent of SEBI, the infamous Harshad Mehta scam, the Asian crisis, the dot-com bubble or the computerization and online trading of the stock trading, there was never a dull moment

With time, the Indian capital markets have matured significantly. Today, it is the sixth largest market globally in terms of market capitalization. It follows, and often leads, the global standards of most matured markets and has one of the best integrated technology platforms, be it for trading or the payment system. And even though in terms of complexity it is second to none, the Indian capital market has been operating seamlessly. But the volatile nature of the market, fundamental to its existence, continues and may be is more pronounced in recent times due to global factors. Very often, when the market reacts the way it does, we find that reasons for the reaction are in other markets – not local – or due to some seemingly unconnected developments

Going forward, I see 3 Specific Global Trends, or Rather Disruptions, that would Continue to Bear upon the Market

- **Disruption No 1 – The Tech Revolution**
  - The first disruptor being 'Technology' – and not in the way the operations of the market will change with advent of artificial intelligence, blockchain, robotics process, etc. It has to do with the way businesses across the different sectors are being disrupted with new technologies. When I moved to Bombay 35 years back, we had enrolled for a fixed line phone connection with a wait period of 30 years. Now, by just one phone call or over an app, in less than 3 mins one can get a mobile phone, a landline and high-speed broadband with television connectivity. Similarly banking which was truly intimidating then with its brick and mortar format, is today on our fingertips
  - From buying movie and train tickets in black through agent to booking them online, from an all-day cooking ritual at home for guests to Swiggying food, from making a trek on traffic jammed roads to buy a Ganpati for Ganesh Chaturthi to Amazoning it – sector after sector is witnessing a revolution because of disruptive technologies. Electric vehicles, different options of mobility like Uber and Ola, and improvement in the public transport infrastructures have altered the business models of the automobile industry, including that of the small garages. OYO has made it easy and affordable for people



stay in the hotel while traveling than staying with their friends and relatives. Convergence of telecom, technology and media has provided a complete makeover to all three industries. No sector today is untouched by the technology revolution. As a result, people across big and smaller cities are going through a lifestyle transformation

- After the Agricultural Revolution and the Industrial Revolution, the Technology Revolution is permanently altering the way Homo sapiens live, consume, interact, travel and every other part of their life. The incessantly evolving business models can risk the very survival of hitherto established companies or conventional sectors. We have seen the decimation of traditional music and camera industries. Outsourcing of services has become a way of life, be it our house, kitchen, vehicle, wardrobe, office premises, computer system or communication. 3D printing is knocking at the doors of manufacturing industry. And we can just go on and on. The Technology Revolution is here to stay and will clearly impact the corporate valuations, the business models and risks, and therefore the capital markets

- The other impact of technology on businesses can be assessed from the new vulnerabilities that it exposes businesses to. The cyber security breaches apart, the recent attack on Saudi Aramco's refineries through drones underlines the infinite security risks technology poses to corporates

- **Disruption No 2 – Nationalism or Localization**

  - The second most disruptive phenomenon we are witnessing in the recent past is 'Nationalism or Localization', a global volte-face on globalization. At the start of the economic liberalization in 1991, India had followed the world in decisively embracing globalization. Back then, the world was moving in the direction of globalization – both technologically as well as commercially. The immense interest that Thomas Friedman's famous book "The World is Flat" generated, was reflective of how globalization had caught the imagination of all corporate and political gurus. Most countries believed in free trade, open boundaries and free movement of goods, services and people. India started receiving all time high foreign direct investment, foreign companies set up offshore operations in India, and our foreign currency reserve only went skywards. Global trade became a norm

  - However, in the last several months, political rhetoric in some of the developed countries and large economies has changed noticeably. Voices of nationalism and protectionism have started making headlines. Tariff and trade wars are in the open. Free movement of capital and trade is once again conspicuously constricted. It has been a remarkably sudden and substantial change that the world has to deal with which has grave and far-reaching long-term impact on the capital markets

- **Disruption No 3 – The Rise of Intellectual Capital vs. Financial Capital and Permits**

  - Traditionally, setting up new businesses and large businesses required large financial capital and permits. Post-independence, India had adopted the policy of controlled economy. At one stage we converted a number of private enterprises into national assets - be it banks, coal mines and some others. Licenses/ Permits were required to be obtained to start any new business. Foreign investment needed a series of approvals. There was a complete control on foreign trade and foreign investment

  - Part of this dynamics changed post the economic liberalization, though the government control was still very pronounced. In the 90s and early

2000, businesses started investing directly into capacity expansion. This unprecedented expansion required significant infusion of financial capital, some of which came through leverage of the existing cashflows, assets and the shareholding of the businesses. A bank lent to a viable project and if investment was being made in hard assets in the form of plant and machinery. But today, business dynamics has totally turned this on its head - intellectual capital is taking centerstage

- Unprecedented business models are now first conceptualized using intellectual capital, set-up with negligible financial capital and rarely with any leverage. Then they automatically attract a slew of investors. Hard assets are no longer a pre-requisite to raise financial capital. Valuations are no more about profits, but about ideas. Licensing, permits and approvals are no more about being somebody with connects in power corridors. Young entrepreneurs have started building businesses as start-ups which are growing and creating significant value. Companies with soft assets and intellectual property today form part of the top market cap companies around the world and in India. The BSE Sensex in 1988 had 20 industrial category companies out of the total 30. Today, only 6 out of 30 belongs to this category

- With the hitherto unseen focus on corporate governance, an extension of this trend is emerging in India - the advent of professionally managed companies supported by professional pool of capital. The new norms around the board compositions, independent directors and related party transactions, has tilted the equations in



favor of professional management as against promoter run businesses. We have seen buy-out funds investing around USD 26bn already and they own and run 160 companies across the different sectors. Additionally, businesses are being incubated by Private Equities

- The power of knowledge economy is for all to see - while it took more than 60 years for an automobile or an airline industry to reach a 50mn user base, a Pokemon Go achieved it in 19 days! With 87% of India's population already possessing mobile phones, the intellectual capital is only gaining more power. Knowledge economy is changing the world. As per the latest study, India has 31 unicorns, and the start-ups have raised more than USD 50bn of capital since 2014

- Our capital markets, going forward, will be shaped by the new realities. The above disruptions are already exerting influence. This will only be more pronounced as we step further into the future. Our capital markets will have to take cognizance of these ever-evolving trends and future business models, and continuously assess the impact of these on business risks, valuations and viability of businesses. ■

Economic revival through Capital Markets – What do we need to do?

Himanshu Kaji, *FICCI National Committee on Capital Markets and Executive Director & Group COO, Edelweiss Financial Services Limited*

Last one year has been a challenging phase for the economy. Growth has slowed down, multiple sectors including financial services have been severely impacted, sales and profitability has been going down, availability of credit continues to be a challenge and there is a general environment of uncertainty and risk aversion in the economy. There are talks of job losses numbering in lakhs and with the global economy also facing its own slew of challenges, it is a difficult market environment that we face today in India.

Capital markets are strongly coupled with the economic environment - naturally, the market slowdown has had a concurrent effect on capital markets as well. FPIs have been pulling back money from the economy in the wake of a moderation in growth outlook and domestic investments, which have seen strong SIP traction, have also slowed down to some extent. In the first half of August alone, FPIs sold equity worth more than INR 10,000 cr while only buying about INR 2,000 cr - a net outflow of more than INR 8,000 cr. This was after net selling of ~INR 3,000 cr in July across equity and debt markets. Part of this has also been precipitated by global factors like tariff wars between China and USA and the ongoing tensions between USA and Iran. On the debt side, while G-sec yields are in control, the spread for corporate bonds is trending at much higher levels than the 10-year average, a clear indication of the risk aversion in the economy today. It wouldn't be amiss to say that it is a time of uncertainty for capital markets as well. However, capital markets also play a key role in helping manage such a downturn and potentially, coming out of it.

Bond Market Reforms

The government and the regulator have done a good job in the recent past of making the capital markets more and more streamlined through a variety of reforms. On the equity markets side, barring a few small issues, the reforms have largely been progressive and have helped drive the growth of equity capital markets in India. However, the bond market still needs a strong push, considering India's bond market still lags behind most other large economies.

Bond markets play a key role, especially in times like these in an economy like India. In times of distress, especially, it is difficult to raise capital in the equity markets. Equity markets, by nature, have a significant component of retail participation. The current upheaval means that not only retail participation is volatile, it is also, quite often, based on incomplete availability of information, which could mar investment decisions. In addition, equity funding, already a pricey form of capital raising becomes even more expensive during such times.

Raising capital market in the bond market, on the other hand, is a different construct altogether. Not only is this cheaper (comparatively!), it is also dominated by large institutional buyers who generally are able to better underwrite the risk in the debt instrument than a retail investor in the equity market. This ensures that good companies continue to do get funded even in challenging times and are able to continue growing. However, for this to happen proactively, needs a further deepening of the bond markets in India. While some measures have been

taken, initiatives like removing certain restrictions around FPI debt investment, a real-time bond market amongst others can help drive the growth of bond markets in India.

Trust and Transparency

While the market slowdown is a reality, the accompanying risk aversion is as much an outcome of the slowdown as of a trust deficit. So while some participants have ample liquidity, there is not enough dissemination that is happening due to a trust deficit that has come about due to some recent corporate events. This has, however, impacted the ability of other organizations, even with sound financials, to raise funding in the market. While constant and clear communication from the government and regulator will help, part of the blame lies with capital markets as well.

Even today, there isn't enough transparency in capital markets. Information availability and dissemination is not uniform across all market participants and as a result, there can often be small periods of information asymmetry. Such an environment discourages the larger population from utilising household savings to investible surplus. An online real-time portal for debt markets, in this sense, would be of great help. A growing economy like India still continues to hold a large part of its retail net worth in the form of savings and not investments. Being able to unlock this vast pool of household wealth can help quickly recover from any future market slowdowns.





MSMEs in Capital Markets

Today, there are 63 million MSMEs across various industries that employ more than 111 million people and produce more than 8,000 products. In addition, they contribute nearly one-third to the GDP of the country. MSMEs are the building blocks to the large corporates of tomorrow. In fact, they are the cornerstones which usually form the base for economic activity in a country – especially in a nation's transition from a developing country to a developed one.

Traditionally, equity capital for MSMEs has largely been under-utilised. As a result, most of the growth capital for MSMEs is in the form of debt which can severely hamper growth in situations like what exist today with a crunch in liquidity. Recent changes in listing norms have helped improve, to some extent, the number of MSMEs listing in the market. However, the post-listing scenario still leaves much to be desired. In particular, the liquidity for investors in these IPOs is a big concern. Less than 50% of the companies listed since the inception of the exchanges are being actively traded on the two premier exchanges in India. This is because the minimum trading lot on the SME boards is INR 1 lakh. This is a very high quantum, even as the minimum subscription size is also around the same. As a result, secondary trades are few and far between, reducing the overall desirability of these stocks, until and unless they have the wherewithal to move to the main board.

This floor of 1 lakh could therefore need a re-think. However, it must be accompanied by a few more measures to make the reduction in the floor possible.

Part of the reason why norms for SME investment continue to be rigid is the inability of retail investors to be able to understand the risks involved. There is therefore a need for investor education as well. In parallel, some investors have been spooked by frauds and financial irregularities in certain listed SME companies. A provision to protect interests of such investors might also help alleviate such fears.

It is documented in multiple forums that capital markets play a key role in the economy. However, it is often assumed that in times of distress, capital markets follow the economic movements and have limited wherewithal to influence the same. That



assumption is not entirely accurate. There are several avenues, where, with the right steps in the right direction, capital markets can play a key role in ensuring not only a pick-up during slowdown, but preventing a slowdown in the first place itself. Many of these initiatives are in the works and it is hoped that in due course they will help create a new direction for capital markets in India. ■

Selling less while raising more

Amit Tandon, *Managing Director, Institutional Investor Advisory Services India Limited (IIAS)*

Whether the government wants to raise more money by selling PSU's in whole or part or whether it wants to retain them to serve some other purpose, these need to be run efficiently. It needs to ask itself three questions. First if there is clarity regarding the objectives in running PSU's. This will help determine those it will keep and those it should sell down. Second, for those it has chosen to run, it should ask if the current Ministry-PSU linkage the best structure to ensure PSU's function efficiently. And three, where it has decided to sell-down, is the divestment giving the government most bang for its bucks.

Raising money from sale of Public Sector Undertakings (PSU's) is now a critical item in meeting fiscal targets. This government has raised Rs 2.71 trillion or 84.3% of the targeted Rs 3.21 trillion since 2014-15, meeting its divestment targets[1] in the last two years. The tenacity with which the government is pursuing this one number is admirable.

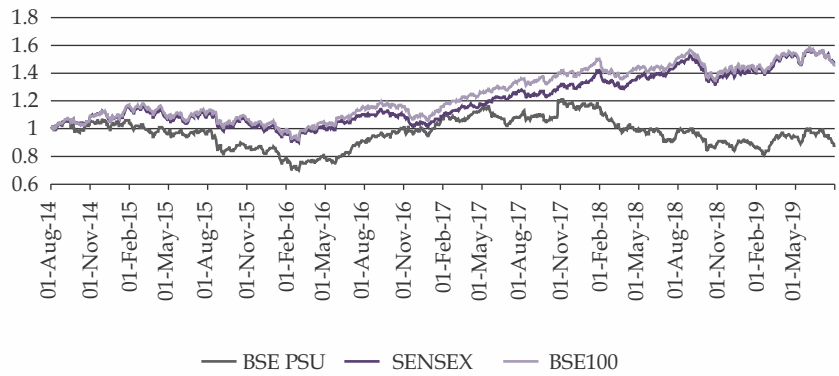
During this period, no route to raise money has been off the table; the government has used buybacks (Oil India, National Hydroelectric Power, IRCON, etc.), offers for sale (NALCO, National Fertiliser, Neyveli Lignite, etc.), piggybacking on PSU IPO's (Cochin Shipyard, GIC, New India, etc.), off-market transactions (HPCL-ONGC), strategic divestment (PFC-REC, Dredging Corporation), sale of SUUTI shares, sale through ETF's (CPSE ETF and Bharat 22) and even sale of enemy shares. Nor is any amount too small; the Dredging Corporation of India employees brought in Rs 9.3 million through an OFS.

Despite the impressive amounts gathered from there sale, there are infirmities that ail the public sector. These come in the way of a more robust fund-raise. Some alternate sets of data point to this.

One, the trailing BSE PSU Index (Exhibit 1). Rs 100 invested in the PSU index five years ago in August 2014 would return Rs 88.0 today. A similar amount invested in the BSE SENSEX would have returned Rs 146.7 and in the BSE100 Rs 147.0.

Two, this is reflected in the price performance of PSU ETF's. The CPSE ETF, which tracks 11 Central PSU's has raised Rs 48,500 crores. And Bharat-22, its dizygotic twin, with 19 public sector companies and

Exhibit 1: BSE PSU vs SENSEX vs BSE 100



Source: BSE; data upto 31 July

[1] *https://dipam.gov.in/disinvestment-till-now/2502*

Exhibit 2: PSU ETF Returns

CPSE ETF	YTD	1-Month	3-Month	1-Year	3-Year	5-Year
Fund	3.90	-9.18	-7.26	-2.17	5.14	0.10
Category	4.04	-4.18	-2.97	1.68	4.96	2.89
Rank within Category	2	3	3	3	2	3
Number of funds in category	3	3	3	3	3	3

BHARAT 22	YTD	1-Month	3-Month	1-Year	3-Year	5-Year
Fund	1.28	-4.81	-3.87	7.54	-	-
S&P BSE Bharat 22 TRI	1.33	-4.82	-3.89	7.59	-	-
Category	3.57	-1.87	-3.03	3.53	-	-
Rank within Category	80	106	81	5	-	-
Number of funds in category	100	107	106	94	-	-

Source: Value Research; data as on 2 Aug 2019

three SUUTI shares - Axis Bank, ITC and Larsen & Toubro, has garnered Rs 26,400 crores. Their performance lags as seen in Exhibit 2.

Three, governance is no longer an amorphous idea; it can now be measured on the IFC-BSE-IiAS Corporate Governance Scorecard.[2] Excluding banks there are 16 PSU's in the BSE-100 index. Their average and median score out of 100 is 52.3. Our research shows companies that scored above 60 had a median return of 39% over two years, (7% over one), while those with lower scores, generated a 3% return (negative 16%). This is a pointer that poor governance lies at the heart of middling performance.

Whether the government wants to raise more money by selling PSU's in whole or part or whether it wants to retain them to serve some other purpose, these still need to be run efficiently. It needs to ask itself three questions. First if there is clarity regarding the objectives in running PSU's. This will help determine those it will keep and those it is happy to sell down. Running PSU's is a legitimate desire of the government, but they need to be run efficiently. Second, for those it is running, it needs to ask, is the current Ministry-PSU linkage the best structure to ensure PSU's function efficiently. And three, where it has decided to sell-down, is the divestment giving the government most bang for its bucks.

There is limited clarity regarding the objectives and purpose. Oscillating between achieving the greatest good for the greatest number versus running a profitable business, muddles decision-making at the PSU level and confuses investors. It is perfectly legitimate to have national political level objective (development of a backward region), but these should be separated from those that control national resources (ONGC, Coal India), or building national champions (SBI). The government is better served pursuing just one goal. With clearer commercial focus and tighter financial discipline, the treasury can hope for a steady steam of dividends and of realizing a fair price from the sale of shares and even entire businesses. This money is then available for its broader (social) objectives. The alternative of running a febrile business which consistently needs funds to be injected, does not serve the divestment agenda.

Oversight of a PSU is a small part of a Ministry's responsibilities. Shortish tenures leave bureaucrats insufficient time read the industry trends, let alone understand business nuances. An added downside is a very short institutional memory. Responsibilities towards the company give the appearance of being



[2] *https://docs.wixstatic.com/ugd/09d5d3_eef64afe13ab41cfa9b0df292b439470.pdf*

chores and need safe decisions: why else will PSU boards be dominated by former bureaucrats [3] – which compound the problem of limited skills and to a less robust board oversight. Then there is the mistaken belief in Delhi that SEBI's rules apply only to the private sector. Consequently, PSU's generally weigh in favour of their parent ministry; conversely market discipline is frequently breached. And while market discipline may not ensure business success, but its absence will ensure failure. Suffice to say, the ministries have exhibited extremely uninspiring stewardship over our PSU's.

There are ownership models that address the challenges that plague Indian PSU's. They address governance issues and structures, a path towards gradual disengagement from non-core investments, beneficial asset monetization and generating returns for the state. Temasek (Singapore), Khazanah (Malaysia), Solidium (Finland), Forsta AP-fonden (Sweden), ADIA and Mubadala (Abu Dhabi, UAE), are some successful models. All of them involve at the core, putting in place a governance structure where ownership shifts from individual ministries to a government holding company or a fund and furthering their governments agenda. Parenthetically, the report of the Committee to Review Governance of Boards of Banks in India aka the PJ Nayak Committee[4] had a similar recommendation for government owned banks. Such structures will bring the desired focus, accountability, specialization and sense of ownership to the task at hand. These are some examples of successful transitions and structures importantly within the 'state', that we should consider emulating.

Finally, divestment is a specialized job. Deciding between IPO's, offers for sales, follow- on offerings, bulk deals, QIP's is not an easy task. Add to this the complexity of deciding which company is ripe for



sale. Will selling HPCL to ONGC be more value accretive than merging the two and then selling the combined entity? Should the general insurance companies be merged, and shares in the holding company be sold or should one sell shares in the operating business? Different market cycles will give a different answer. Unfortunately, the decision is likely to be driven by the fear of the Central Bureau of Investigation or the Vigilance Commissioner, rather than what markets dictate. Even when selling, the 'holdco' structure has its strengths.

This shift, even if begun today, will bear fruit in the medium to long-term. Meanwhile there is undoubted fiscal pressure to raise funds. There are assets including BALCO and Hindustan Zinc, that can be sold immediately - to Vedanta or even the public. Shareholding with SUUTI can also be monetized relatively quickly. These and other such ideas will serve for the short-term. For the long-term unless we bring about transformative change, the pipes will choke. ■

A modified version of this article appeared in Business Standard on 30 August 2019.

[3] *https://www.iiasadvisory.com/single-post/2018/09/17/For-want-of-a-nail*
[4] *https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/BCF090514FR.pdf*

Unlocking growth capital of Indian households

Ashutosh Bishnoi, *Managing Director & CEO, Mahindra Mutual Fund*

Strap: Domestic savers can play a key role in capital formation, but that can only happen if we can align interests of all stakeholders with those of the households / investors.

India's economy is going through a rough patch. To an extent, the pinch is being felt because more sharply because of being a capital-starved country. As a nation our industrial investments have little room for error. Therefore, staying power to see itself through a cyclical downturn causes a lot of pain in terms of failures, job losses, bankruptcy etc. Private capital is limited and unlike the developed economies, printing more money is not a viable option for a developing country like India.

So, where do we create capital from? Globally, there are enough examples to suggest that capital requirements of an economy can be met by household savings. There are also several examples that underscore fiscal risks a developing nation has to bear when it chooses to print more money to meet its capital needs. Latin America, Zimbabwe etc are recent cases in point. So, this is not really an option.

Governments in India have tried to find ways in which household savings can be channelised towards capital formation. In developed markets like US and Europe, household savings are significant contributors to capital creation as a large part of household's allocation is oriented towards capital market-linked investment products. For example, in the US and Europe, approximately 50-60% of household contribute investments in the capital market-linked products issued via the organized open ended fund industry. In India, this ratio is just 5%-6%. This shows the gap or the extent to which the household savings in India could be capitalised, if incentives are correctly aligned.

In India, weaning away household savers from the lure of physical assets has not been easy. In the last few years, the sentiments seem to have shifted in favour of financial products, which was also seen in the mutual fund industry given the robust flows we saw during this period. However, investing in a capital market product is not yet a compelling proposition in India, like it is in the West. In several cases, it remains a 'push' product.

No man's land

Today, the household saver is facing a strange dilemma. Both physical and financial assets have disappointed the investors. The real-estate segment is going through its own set of challenges. Lack of liquidity and the high-cost of investing in real-estate has been a major dampener on investor sentiments. Further, lot of investments are still stuck, so there is a sense of being trapped. Traditional buyers of gold are finding it difficult to engage with that asset class as it is already trading at record highs.

Financial markets – which were doing fine till four years back – have suddenly caused a great deal of investor nervousness in the last eight months.



Investors are not just concerned about mutual fund products or unit-linked insurance plans, but also worried about their investments in bonds. There has been constant flow of negative news around corporate bonds. Whether it is from a non-banking financial company or a manufacturing entity, corporate bonds have led to grave concerns for retail investors.

So, what can be done to get household savers on board when the confidence-levels are perhaps at their lowest point? And yet, more households have witnessed the fastest rise in incomes over the last two decades.

Getting on same page

Whenever markets are bad, the demand for advice rises significantly. It would be fair to say that the movement of financial markets and demand for advice are inversely co-related. Investors want to desperately know what should they do with their investments, and how they should plan to spend their higher incomes so that they can meet their future financial liabilities. Should they change their allocations or stand by their investments?

This is a critical time for financial investors, but it is also a good time to edify the existing systems so that the interests of industry and intermediaries are aligned to those of the investors. There is nothing like a rough patch in the markets to put spotlight on the cracks in the system and seal them. This can also go a long way in making investors more comfortable when engaging with financial products, especially during tough times.

We can look at how systems in West have evolved in increasing the comfort-levels of households when investing in capital market-linked products.

In 1995, a committee commissioned by US SEC and chaired by the then Merrill Lynch Chairman Daniel Tully proposed several changes to deal with potential conflicts of interests in the distribution / brokerage industry. One of its several proposals, which were accepted by all fund houses then, was that the commission should be the equalised all the fund



products in the same fund category, irrespective of the fund house. So, commission payouts on all hybrid aggressive products, for instance, would be the same across fund houses. This meant that there was no real incentive for any intermediary to sell product of one fund house over another. So, distributing a product would only help the distributor's business, if the investor's long-term goals are met by a suitable product. In India too, the regulator constantly attempts to see that fairness is brought into the manner in which costs are charged to fund investors, and paid to distributors.

Intermediaries - whether advisors or distributors – have also played an important role in facilitating Indian household savers' participation into capital markets. However, we still need to clearly define the roles, responsibilities and liabilities that intermediaries need to bear when dealing with a client. This is still a nebulous area. As manufacturers and asset managers, we also need to ensure that the mutual fund industry's interests are not in any way working against those of the investors.

In the past and even recently, the Securities and Exchange Board of India (sebi) has demonstrated its pro-activeness in protecting the interests of investors at almost every phase of the financial markets. Sebi's role remains key in ensuring that investors repose their faith in the systems.

Reaching out

For several reasons cited above, intermediaries will play a critical role in developing capital markets and hand-holding investors during difficult times. Distributors are partners in growth and not just a channel that brings in incremental customers. For mutual fund industry, it is imperative to sit down with distributors and frame incentive structures that are beneficial for long-term growth of all the stakeholders.

The mutual fund industry will have a key role to play in development of the capital markets. The industry is targeting Rs 100 trillion of asset base over the next decade. This would be a four-fold jump from the current asset base of close to Rs 25 trillion. This won't be possible without efforts of the intermediaries.

Almost all industry participants acknowledge the importance of distributors -- especially IFAs -- in deepening penetration of mutual funds. However, there is acute shortage of distributors, especially in smaller cities, where they are perhaps needed the most. According to a study conducted Amfi and BCG, there are only 230 AMFI egistered number / million



households in beyond the top-15 cities. Even in the top-15 locations, the numbers are not that encouraging. There are just 4,300 ARNs for every million households and the national average is 437 / million household.

These numbers need to grow exponentially over the next few years so that investors across India have enough touch-points to access the capital markets. And equally for the capital markets to attract the much needed capital. ■

India's journey towards a $5tn economy: Readying the Debt Capital Markets

Jujhar Singh, *Managing Director, Global Head HY & Head - Financial Markets India, Standard Chartered Bank*

The NDA government has set itself the admirable task of achieving a nominal GDP of $5 tn by FY 2024, nearly Rs. 350 tn at present exchange rates - a near doubling from the Rs. 190 tn economy at the beginning of its second innings.

One could argue that our Debt Capital Markets would need to similarly double from the present Corporate Debt outstanding of Rs. 31 tn, 16% of GDP, to Rs. 56 tn or even higher. As we advance in size & sophistication in an increasingly complex and interlinked world an ever-higher share of Corporate Bonds to GDP would be an imperative, moving closer to markets such as China, 19%, South Korea, 74%, Malaysia 44% and of course the US which is at 123% of GDP[1].

Indeed, an estimate published by CRISIL in its 2018 Yearbook on the Indian Debt Market pins the total projected bond supply by FY23 to be Rs. 55 to 60 tn, i.e. 16 to 17% of a Rs. 350 tn economy. We would err on the side of caution and suggest market participants such as ourselves should work towards preparing a Debt Market which constitutes 20% of GDP. Implying Rs. 70 tn of Corporate Debt outstanding at the end of FY 24, more than 2x of the current number.

Table 1: India Nominal GDP & O/S Corp Bonds (Rs. tn)[2]

	Nominal GDP	O/S Corp Bonds	As % GDP
FY 14	112	15	13
FY 19	190	31	16
FY 24	350	60 - 70	17 - 20

Led by the guidance from a number of expert Committees, such as the Expert Committee on Corporate Bonds and Securitisation (R. H. Patil, 2005), Committee on Making Mumbai an International Financial Centre (Percy Mistry, 2007), Committee on Financial Sector Reforms (Dr. Raghuram Rajan, 2009) and most recently the Working Group on Development of Corporate Bond Market in India (HR Khan, 2016), our regulators have undertaken multiple market reforms & restructuring - providing an environment where the Corporate Bond market has doubled between FY14 & FY19, with burgeoning Mutual Fund (MF) and Foreign Portfolio Investor (FPI) participation.

The journey though is far from complete. An analysis of Non-Financial firms in the 2019 RBI Bulletin concludes debt market concentration is limited to large established firms. For smaller firms, lacking a high credit rating and economies of scale, banks and non-bank/non-market sources continue to remain the primary source of financing, segments which have shown volatility and possible contagion risks considering prompt corrective action (PCA) and non-banking financial company (NBFC) liquidity issues.

Table 2: Sources of Debt for Non-financial Firms Across Size Categories (End-March 2018)[3]

Size Classes*	Banks & FI	Debentures, Bonds, CPs	FCY borrowing	Other non-bank non-market
Decile 1	43.9	28.5	15.2	1.7
Decile 2	55.6	26.8	5.5	4.9
Decile 3	79.1	5.2	4.7	4.9
Decile 4	72.1	2.8	4.1	13.6
Decile 5	70.4	2.3	0.8	10.5
Decile 6	81	-	-	11.7
Decile 7	38.4	2.1	-	37.2
Decile 8	85.1	-	-	14.7
Decile 9	51.2	-	-	15.4

*Size is defined in the Prowess database as the three-year average of the total income and total assets of a company. Decile 1 consists of largest among the sample.

[1] *Crisil-Assocham Report (January 2018) and IMF Private Debt Database, SCB projection*
[2] *SEBI Outstanding Corporate Bonds Data, CRISIL & SCB analysis*
[3] *India's Corporate Bond Market: Issues in Market Microstructure Shromona Ganguly, RBI Bulletin Author's calculation based on data obtained from Prowess, CMIE.*

Further analysis shows a mono chrome market[4] - Sector-wise, primary issuance data shows finance & infrastructure companies together accounted for 90-92% of total cumulative value of bonds outstanding during 2017-19. The majority of bonds issued were in 2-5 year tenor category (~56 %) and AAA rated papers accounted for more than half of total amount outstanding in the primary segment during the last two years.

Secondary markets too exhibited similar sector and rating-wise composition with finance and infrastructure companies constituting around 80% of the total traded value and highest rated bonds

Table 3: Availability of long-term debt[5]

	Ratio of long-term to short-term corporate and government bonds issuance Percent, 2015		
Financial depth of outstanding government and corporate bond market Percent, 2015		Short term–oriented, 1–3 years (Ratio <100%)	Long term–oriented, >10 years (Ratio >100%)
	Deep (>100%)	Australia Singapore Germany US Malaysia Brazil ④	France United Kingdom Japan South Korea ⑤
	Shallow (>25%)	China **India** South Africa ②	Pakistan Philippines Thailand Russia Chile ③
	Very shallow (<25%)	Indonesia Vietnam ①	

Coordinated Portfolio Investment Survey (CPIS); IMF; World Bank (O Quintile)

accounting for a similar share of secondary market trading. The top 25 traded bonds accounted for about a third of total traded volume.

In times of tightening market liquidity, as witnessed in the last year, secondary volumes have determined pricing in primary markets too as market participants value the ability to get a price on their paper above all else, leading to a significant divergence in yields between high rated and other bonds, and at times for names within the similar rating/sector itself. In the primary issuances tracked, coupon rates for the private companies were higher as compared to the public ones, implying risk perception and investor preference for relatively safer asset class.

Before diving into the what and the how, consider the EU, which is nearly the same size of North America, yet its Corporate bond market is a third in size. The same results into EU borrowers increased dependency on banks for meeting its financing requirements. However, increasing dependency on bank market leads to an overall slower recovery from financial system disruptions, as bank credit takes a lot longer than capital markets to recover even as they are faced with ever increasing requirements to retain additional capital, liquidity. The EU banks also use a lot less securitisation than their US counterparts, the market for European securitised assets is a fifth of that of America.

The gap between European and American markets can be explained by the lack of private pension, lack of huge endowments etc but the most basic difference is twofold – first European savers prefer parking their funds with banks and second borrowers prefer financing via traditional bank route and not tapping capital market products compared to their US counterparts.

Considering above, we may group the imperatives for market development into four key areas –

I. Make Capital Markets the preferred destination for borrowers

II. Develop source of liquidity both in primary via new investor pools & in secondary via efficient secondary market liquidity mechanisms

III. Supportive institutional framework

IV. Integrating into Global Markets

I. Making Debt Markets the first port of call

Making Debt Capital Markets the first stop for fund raising would require streamlining issuance

[4] *RBI Bulletin 2019, Shromona Ganguly. SEBI*

[5] *Mc Kinsey: Deepening capital markets in emerging economies, Banking & Finance April 2017*

processes and procedures, operationally smoother and reduced issuance costs, formulating and executing economic & regulatory policies that encourage corporates to tap into capital markets.

Operationalising the 2018-19 Budget announcement mandating large corporates to raise 25% of their incremental funding from the bond markets will go a long way towards developing corporate bond markets in India. In addition to above, large exposure regulation by RBI would further lead to issuances from multiple new issuers. These are ideal mechanisms from a supply side perspective and in order to maximise the potential of this requires us to address demand side issues also. Aligning gaps in regulations and harmonising prudential norms laid down by the IRDA and PFRDA could provide significant impetus from demand perspective. Further efficient & clear communication of these policies via debt issuer education programmes would assist in further awareness around alternative financing market vis-à-vis bank loans.

Apart from rationalising the stamp duty on corporate bonds across states which we saw in the recent finance bill, we should consider other markets, where tax incentives on corporate bonds have attracted additional issuers. As per CRISIL research[6] issuers still feel the Electronic Bidding Process (EBP) requires streamlining, simultaneous issue of bonds should be allowed and EBP reduces the role of arrangers which may not be desirable in the Indian context where they match issuer and investor needs.



Promoting capital markets for financing infrastructure could be a powerful lever to develop markets further and can be assisted by mandating and creating specialised Infrastructure Financing Platforms which would exclusively look at both borrowing and lending through market instruments only.

InvITs and REITs were a step in the right direction of developing products for specialised funding needs in the infrastructure and real estate space. However by limiting them only to mutual fund investors, we miss out on deep liquidity from investors such as insurance companies and Provident Funds which would positively look at such long dated annuity instruments to match their long term liability profile. Further, FPIs while permitted to invest in InvIT/REIT units are not allowed to invest in their debt securities. External Commercial Borrowing (ECB) regulations too should be amended to allow offshore investors to participate in the debt offering of InvITs / REITs and the banking regulations could be amended to allow on-lending as a bankable end use for InvITs/REITs.

Securitisation, Pass through Certificates (PTCs) too are ideal financing instruments for maintaining efficient capitalisation in sectors such are NBFCs and Banks. FPIs, one of the key investor segments which understand securitisation structures, are unable to participate in this product owing to withholding tax (WHT) payable, resulting in the instrument being economically unfeasible. We believe extending WHT as applicable on Non-Convertible Debentures (NCDs) will be well received by FPIs. Also, it will be beneficial to allow trusts to re-deploy surplus funds received by way of prepayment into fresh assets so that FPIs are able to hedge their currency risks without worrying about break costs, this may need changes to taxation mechanism of trusts.

[6] *Issuers survey finding roundtable feedback, CRISIL Yearbook on the India Debt Market, 2018*

Similarly, the development of sector specific credit enhancement entities, can make such bodies the nodal agency for encouraging and educating issuers for their sector in addition to providing credit enhancement, this may be considered not just for infrastructure and housing, as the 'Credit Guarantee Enhancement Corporation' is envisaged to be but also specialised pockets such as education, renewables etc. to enable better debt flow into those segments.

Another factor which could be issuer friendly, can be the creation of liquid and 'hedge-able' benchmarks basis which issuances can be considered, bringing a linkage between macro movements and issuer costs and will give issuers and investors avenues to hedge interest rate risks.

As with all benchmarks a universal one will have a greater chance of being successful. However, necessary safeguards need to be built to avoid manipulation of the benchmark settings.

II. Develop source of liquidity in primary (new investor pools) & secondary markets (efficient market liquidity mechanisms)

The demand for corporate bonds is largely confined to the institutions, with retail accounting for only 3% of issuances[7]. Even among institutions, Insurance & Pension names, which are considered the buy and hold category, are constrained by prudential norms for investment requiring them to hold a maximum of 25% of their portfolio in sub AA rated bonds. For such names Government securities constituted almost half of the total investment for life insurance and 36% of the investment by the general, health and re-insurance companies. In contrast, investment in other securities constituted less than 5% of total investment of these companies (IRDAI, 2016-17). Banks too prefer loans to bonds, as loans can be carried to their balance sheets without being marked to market (CFSR, 2008).

As the largest Buy and trade segment, the MF industry played an important role in developing primary and secondary markets.

Assets under management (AUM) of short term debt funds, which are the largest investors in the corporate debt segment, increased at a rapid pace with corporate bonds and Commercial Papers (CPs) accounting for close to 77% compared to 6% of their total funds in Government Bonds (Source: SEBI), this segment is expected to grow at a CAGR of 15%[8] in the next few years despite setbacks in 2018-19. MFs also represent a diverse set of holding with bonds issued by real estate, NBFCs and Public Sector Undertakings (PSUs) constitute about 1%, 19% and 23%, respectively, the "other" category being close to 57%.

As highlighted in the RBI bulletin we have been referring to, the predominance of private placements implies that all the characteristics of a well-developed market does not exist, and prevailing conditions reflect an information intensive relationship-lending market in which investors act like banks in collecting information pertaining to the borrower, which is not publicly available (James and Smith, 2000).

In this context one should consider targeted education programs to potential retail investors emphasising longer-term investments and their advantages relative to term deposits, as well as the Capital Markets' ability to provide attractive and safe long-term investment opportunities. High minimum ticket sizes for bonds (many starting at Rs. 1 Mio) constrain the pool of such potential investors, who have a limited number of products available to them. The protection of retail investors from any form of mis-selling is paramount, therefore as an alternative to direct exposure, financial institutions should be empowered to create new products around the packaging and distribution of bonds to retail investors, as innovation in such offerings should be an ideal first step to woo retail investors.

While formulating policies to protect such investors it is key to note that America has one of the highest retail capital-market participation rates in the world even as its regulations lay massive emphasis on creating a level playing field, and one of the highest levels of disclosure.

[7] *RBI Bulletin January 2019 – India's Corporate Bond Market: Issues in market Micro Structure*
[8] *Crisil Yearbook on the India Debt Market, 2018*

The overarching theme we should consider during this process is that each investor segment is presently confined to few players who have been in existence for the past 10-15 years, compared to large investor networks in other capital markets. Prudently conceived incentives around tax, distribution incentives, etc could be possible avenues for attracting new players and developing newer pools.

Defined-contribution from public and private pension funds are critical to longer-term capital market development. The policies adopted by Chile and Singapore are often cited as examples in this area. To encourage their participation in corporate bond market, policy-makers should enable the pension funds to develop a longer-term mindset by changing the evaluation criteria to longer-term targets. Incentive needs to be created for insurance companies, to bring them in as longer tenor investors into capital markets beyond the AAA rated paper.

Both publicly owned and private banks are the largest segment punching well below its weight in this market. Besides the fundamental issues around loans not being mark to market, a World Economic Forum white paper on Accelerating Capital Markets Development in Emerging Economies bring attention to - historical separations between corporate banking and treasury teams preventing quick communication and coordination required for bank-wide use of lending limits across lending products and the nimbleness needed for quick short-term investment decisions required for corporate bonds, and advises banks should strive to break down such internal isolation[9].

Banks and primary dealers can also fulfil the role of market making which is largely absent beyond the quasi sovereign/high grade space. Incentives like funding/tax incentives & a clear regulatory push can be considered for making this attractive to banks. Further by pricing loan risk in line with where a



similar or the same market instrument would price, would be essential to both pricing loan risk appropriately and giving corporate bonds an even ground.

Market participants cannot hedge appropriately without certain products, including derivatives, bond exchange traded funds, asset-backed securities and real estate investment trusts. While some of these products are in place, they have not grown and are considered unsuccessful. Credit Default Swaps (CDS) for instance which are essential and prevalent in every developed market is yet to take off in India. The inability of counter-parties to net their positions, requiring both parties to provide for capital on a gross basis has made the product inefficient, further investors are not allowed to write protection making the market one sided.

Corporate Bond Repos too while initiated by the RBI in 2010, hasn't been as supportive as expected, initially due to the un-availability of guaranteed settlement and an electronic dealing platform, and subsequently due to only AAA category papers being accepted as collateral and the absence of Tri-party Repos. – we expect the regulator and the government to focus on this area as alluded to in the recent FM statements. A possible counter to the illiquidity of non-AAA papers in such initial Repo trades, if allowed, could be allowing lending against basket of securities with higher loan to value (LTV) cover.

[9] *World Economic Forum, Accelerating Capital Markets Development in Emerging Economies, Country Case Studies, May 2016*

III. Supportive institutional framework

The Insolvency and Bankruptcy Code (IBC), 2016, has gone a long way in supporting investor confidence in the corporate bond market.

The 2016-17 Union Budget announcement of setting up of Credit Enhancement Fund could enable infrastructure companies, which represent large pools of funding demand, access the corporate bond market, complemented by the large exposure framework laid down by the Reserve Bank.

In the context of risk perception, the role of credit rating agencies (CRAs) in disseminating information on the issuers of corporate bonds remains critical and is in need to continual strengthening and monitoring. SEBI in November 2016, enhanced standards for the credit rating agencies and is presently mulling strengthening norms for disclosures to such agencies and plugging any gaps in regulations caused by providers of financial information i.e. Banks being under the ambit of the RBI, will go a long way in boosting confidence.

Electronic Platforms: Bond trading is largely conducted over-the-counter by phone, though single-dealer platforms already exist, albeit with poor liquidity. The development of an electronic platform with wide participation from local / foreign dealers would help with market-making and allow for better price discovery in the market. Trading remains constrained as corporate bonds are settled through clearing corporations of exchanges on a DVP-I basis (without settlement guarantee). Moving to DVP-III settlement (i.e. netting of both cash and securities obligations) could increase trading activity but is difficult to implement. Clearing corporation management standards mean that settlement cannot be guaranteed in the absence of robust credit ratings processes. Moreover, settlement guarantee funds are inadequate to take care of extreme risks.



IV. Integrating with Global Markets

There are great benefits to opening domestic markets to foreigners and allowing local investors to place money abroad. Such measures would help diversify capital and investments, expose the market to globally accepted practices, and, as a result, accelerate the growth of capital markets. However, one must consider concerns around volatile inflows and outflows

Lastly, further strengthening hedging mechanisms (sizeable forward markets beyond one year) would also enable foreign investment. Hedging mechanisms would enable foreigners to properly mitigate the interest rate and foreign exchange risks arising from investments in the Indian markets.

While the regulators and the Government have ably guided the opening of Debt Capital Markets to offshore investors, it is worth keeping in mind some basic principles which we believe lead to the best outcome. The communication of a clear roadmap or set of principles for opening capital markets, implementing a tax regime aligned with financial development objectives & at a later stage positioning to be included in global indices and portfolios. These would further increase exposures in global portfolios and project oneself as a robust financial centre.

The known unknown

On a parting note - While debt capital markets have come a long way in India, it is yet to see the upheaval brought about by technology, big data and AI which are revolutionising transportation, supply chains and even closer to home retail finance, is yet to make significant inroads. Markets still depend on individual connection when it comes to institutional investors, feel and intuition when it comes to pricing with a human being required for intermediation and information. All of this can and has to change and requires increased permeation of technology some which are yet to be conceived, but many which might already be available to us. ■

Resources & suggested reading:

- RBI Bulletin January 2019, India's Corporate Bond Market: Issues in Market Microstructure
- CRISIL yearbook on the Indian debt markets, 2018
- Mc Kinsey & Company, Deepening capital markets in emerging economies, Banking & Finance, April 2017
- BIS, Committee on the Global Financial System, CGFS Papers No 62 Establishing viable capital markets
- WEF, Accelerating Capital Markets Development in Emerging Economies Country Case Studies

Sustainable Investing: Need of the hour

Navneet Munot, *ED & CIO – SBI Funds Management Private Limited*

Mutual funds are trustee of people's money and owe a fiduciary duty, first to their investors and then to the community at large. It can be best served, not by trying to maximise short-term profitability, but by ensuring optimisation of long-term return and risks.

As part of our fiduciary responsibility, value system and risk management strategy, it is our core belief that a business, run in best interests of all stakeholders seldom fails to create a lasting value for its investors. ESG investing is an approach where apart from financial considerations, one looks at Environmental footprint, Social impact and Governance factors (ESG) of the investee companies. Companies focussing on triple bottom line (People, Planet and Profits) deliver sustained returns over a long period and hence, we integrated ESG factors in the investment decision making process a few years ago.

Environmental risks are bound to gain prominence in India. As per WHO, India inhabits 14 of 20 most polluted cities of the world. It ranks amongst the top three nations to see the highest number of deaths from air-pollution. The country is fast pacing towards water stress zone. As per a NITI Aayog study, 40 cities are likely to face drinking water shortages over the next decade. There are serious concerns about soil degradation in India and increased oceanic acidity world over. Rising inequality, with poor literacy and human development index in a democratic society has the potential to creates risks for businesses as well.

Even as India is growing faster than most other economies, it is still a US$ 2000 per-capita country and is yet to catch up meaningfully in the income ladder. In the process, the resource intensity of consumption is bound to rise. If history is any guide, ignoring the sustainability aspect can be damaging. China serves as a classic example. While high growth facilitated dramatic increase in consumption levels, it led to a rapid degradation of the eco-system, choking pollution and rising social tensions. Eventually, their policy makers had to shut thousands of manufacturing plants too rapidly.

Some of the policy developments in India too, such as Delhi's experiment with odd-even cars, move towards BS-VI compliance and now Electric vehicles, plastic ban in Maharashtra, plant closures in Karnataka around Bellandur lake were in response to rising pollution. We witnessed social backlash, leading to a copper plant closure in Tamil Nadu, SC's ban on liquor sales on highway and cancellation of coal blocks allocation (with adverse impact on mining and power companies). On the governance front, multiple instances of auditor resignations, excessive leverage, questionable 'related party transactions' and accounting issues have recently come to the fore. Such issues may remain unattended for years. But once brought to the surface, it erodes the economic value of the businesses at one go. To sum, investors can ignore ESG issues at their own peril.





Look at it another way: equity fund returns are largely a function of the beta (market return) and the alpha that fund manager generates above the market. Market return, in long term, is dependent on the economy. Long-term sustainable growth of the economy comes only when businesses focus on sustainability. So, when large fund houses start focusing on ESG, it signals the companies to integrate sustainability in their business practices, which in turn creates long term win-win for all.

Globally, large pension funds started putting pressure on fund managers to adopt ESG in their fund strategy. In India, we as a large fund manager are taking up this mantle, without necessarily waiting for our investors to ask us to do so.

Further, there is growing global evidence of better risk adjusted performance of ESG strategies, which is also contributing to the rapid growth in their AUM. Even in India, the NIFTY 100 ESG index has outperformed NIFTY 100 index across time periods.

It has been challenging for us to implement the framework due to inadequate data availability. However, regulatory requirement of sustainability reporting now applicable to Top 500 companies has helped. Over time, policy nudge combined with better data and analytics will facilitate a more systematic approach.

As part of ESG framework, we look at around 50 parameters across the Governance, Environmental & Social aspects, with the emphasis being in that sequence. These include energy and water consumption, carbon emissions, use of renewable energy, waste management, long term impact of companies products and business on environment and society, supply chain, relationship with workers, government and local community, composition and quality of board of directors, related party transactions, accounting quality, executive compensation, minority shareholder protection etc. The relative importance of these parameters differs across sectors.

Advocacy is a critical part of responsible investing strategy and we work with several institutions to sensitize Indian Companies as well as Investors on the importance of ESG compliance for their long-term success. SEBI has also stipulated that mutual funds should play an active role in ensuring better corporate governance. Over and above exercising the voting rights, we actively engage with our investee companies on ESG related matters.

The best preparation for tomorrow is doing your best today. Asset managers should pull up their values-based socks as the need to invest with an eye on environmental, social and governance issues will only get stronger. ■

Focus on Infrastructure and Manufacturing to achieve the $5 trillion mark

R Govindan, *Executive Vice President-Corporate Finance & Risk Management, L&T Ltd.*

Soon after the speech of our honorable PM, on the Independence Day, when he put worth his vision of a USD 5 trillion economy, the critics are busy doing the math and talking about how the targets are unrealistic; pointing on how India would have to grow at 9% real rate (which is 2.5% higher than the current real growth rate of 6.5%) to achieve the USD 5 trillion mark by Mar 2025. We should be not illusioned by all this and should focus on the essence of what he was trying to say i.e. India should look at growing faster than what it is currently, and it can very well do so. It was just a symbolic milestone that he put forth for the country to target.

We need to see what needs to be done to increase our growth rate, so, let us take a look at the basics – that is the four engines of growth (C + I + G + NX).

Of the 4, a lot of impetus has historically been on the first engine - Consumption, but that seems to be fading. Contrary to what might appeal to us a general norm, consumption is more an after effect of the other three engines and it cannot be functioning in a silo, driving growth on its own, for a prolonged period.

What this implies is that we need to focus on the second engine – Investments. Domestic investments or savings as it is more commonly referred to, has been falling from 37% of GDP in FY08 to 31% in FY18. This drop is mainly driven by the fall in household savings from 23% to 17%. The reason for this drastic drop is a shift in the consumption pattern of households, who are consuming more and saving less, which can be attributed to changing lifestyles, perhaps an adaptation of some of the more prevalent mentality of the Western economies. The other part contributing to investment is the foreign capital. This has been a special focus area for the Government and a lot has been done on reviving the FDI flows, from easing rules for overseas single-brand stores to permitting FDI through the automatic route in contract manufacturing, coal mining, etc. This definitely has an impact and there was a visible boost in the first quarter inflows at USD 16 billion vs USD 12 billion for the same period last year, but this still seems too little to move the needle.

We should also be wary of the fact that just opening the entry gates wouldn't solve the complete problem. Terms of trade, compliance and regulatory structure are some other issues bothering the foreign enterprise. Government would have to fix them, in letter and spirit.

The third and arguably the most debated growth engine is Government expenditure. This has always



been a much-loved topic for the critics and opinion writers – how the government has been using the food bill to park the additional 1.4% deficit thereby achieving the 3.3% fiscal target, at least optically. Fiscal discipline is good for an economy, but in times of a slowdown the focus has to shift to growth from fiscal prudence. This fiscal prudence has started affecting various focus areas for the government. If we look at infrastructure for example, the recent rout between the center and NHAI – "Road infrastructure has become financially unviable—PMO Letter to MoRTH" – has been a big setback for the sector. NHAI has so far awarded contracts for a mere 500 kms this year between April and August 2019, against a target of 7,500 kms for the whole FY 2020. After the success of first TOT (Toll-Operate-Transfer), the second one failed to attract investors and the third one (valued at around Rs 5,000 crores) is still in the bidding stage. With the swelling balance sheet and debt of NHAI, HAM projects are no longer aisle. Government is looking at other means of awarding projects, the most probable one being BOT (Build-Operate-Transfer). But BOT, which is currently on the negative list of public sector banks, has its own shortcomings, which is a whole topic for discussion in itself.

Government not only needs to contribute more to boost infrastructure, but also needs to give the special impetus in the form of regulatory / policy support. Some of the steps that may be urgently needed to boost infrastructure projects under the PPP model are as follows: (1) financing risks have to be shared between government & private, (2) government needs to bid out projects on fixed annuity-based models, rather than passing on all the revenue risks to the private sector, (3) fast-track dispute resolution mechanisms, (4) put an end to renegotiations of concession agreements / PPAs, and (5) bring in an eligibility criteria in the form of a minimum ROE for the private sector participant as a pre-requisite for bidding.

That brings us to the last, and the most crucial growth engine – Net Exports, measured in terms of Balance of Trade. In today's era of global trade war and increasing emphasis on localization, it is ironical to talk about increasing our net exports. There is one school of thought which argues that India should benefit from the existing trade war, in the form of shifting of market share from China, the same way that the likes of Vietnam and Thailand have been doing. We have also done some progress here and the results are visible, as seen in the case of companies like Intel and Canon establishing manufacturing set ups in India. But we need to understand that there is an inherent difference in the way China manufacturing functions when compared to India. The resources there are completely controlled by government, and the conditions in which the labor force performs there is something very difficult to match. This is probably the main reason why it is not going to be easy for us just to take up the whole share that is moving away from China.

Recent tax incentives announced by the government will help in boosting growth. This tax sop is a clear savings for corporates, which will provide them head room for fresh capex. At the same time the special incentives provided for new establishments will help attract foreign investments. We have built the required infrastructure, with GST we have sorted the tax structure, and now with the tax revisions we are in line with other global economies. And thus, should become an attractive investment destination.

Apart from manufacturing, we also need to focus on services - our strength. We are a service exporting economy. So, we should be focusing on enhancing the service sector, that will not only create more jobs, but will also give us an edge over other countries. Government is conscious about this and thus has been taking steps to boost sectors like Tourism, medical tourism, education, etc. We should build capabilities such a way that India is known in the world for certain

sectors. For instance: Yoga is now practiced the world over, so, we should think of ways developing our infrastructure for becoming a hub for Wellness / rehabilitation.

Only focusing on existing sectors will not give us the required pace, we would also have to develop at least 10 sectors which are going to be big in the next 2-3 decades. All the developed nations have done it by building capabilities in some regions, China in manufacturing, US in Internet and technology, France / Germany in technology. That leads us to the core of all this – Innovation and research. If we really need to grow and develop, we would have to seriously focus on research. This should be the next big agenda on the governments to do list. The private sector now is not able to spend on research and development. The government should undertake serious, large, long term research projects, will not happen by just promoting universities. We will have to set up



institutions / organizations whose core activity would be to focus on long term research. I would like to conclude by quoting the example of Internet – currently which is affecting the life of almost every person on the planet, was an outcome of a contract awarded by U.S. Department of Defense. ■

The need to resuscitate NBFCs, gripped by the liquidity squeeze

Rajat Bahl, *Chief Analytical Officer & Head - Financial Institutions, Brickwork Ratings*
Anita Shetty, *Research Editor, Brickwork Ratings*

Non-banking financial companies (NBFCs) which are commonly referred to as shadow banks in India play a significant role in financing both businesses and retail loans. After banks, NBFCs are the most preferred route to fund the financial needs. They cater particularly in areas where commercial banks have limited penetration. They offer the diverse financial needs of segments like Microfinance, Small and Medium Enterprises (SMEs), Real Estate, Automobiles, Affordable Housing sectors etc.

Even as their importance grows, recent developments in the domestic financial markets have brought the focus on the NBFCs (including housing finance companies) with regard to their exposures, quality of assets and asset-liability mismatches (ALM). Since September 2018, (post IL&FS crisis) there has been a liquidity squeeze in the market. NBFCs, including HFCs, came under severe liquidity stress following a series of defaults by the group companies of IL&FS.

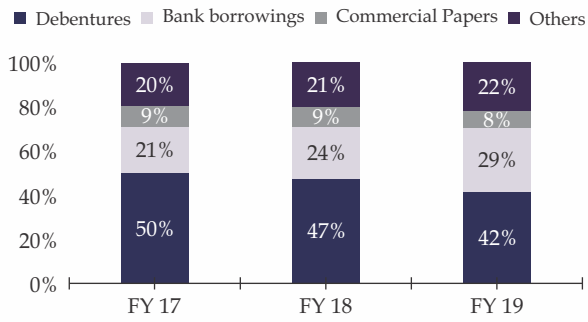
The contribution of NBFCs in disbursing credit accounts for nearly one fourth of the amount disbursed by banks. Industries (Large, medium and small) commercial real estate, consumer durables and vehicle and auto loans are the major ones who borrow from NBFCs. As per estimates of the flow of resources to the commercial sector in 2018-19, the non-bank share in credit was at 26.6% of the aggregate domestic sources, reported by the RBI's Financial Stability Report, June 2019.



NBFCs market borrowing via NCDs reduced

NBFC sector is undergoing challenging times since mid-2018. The liquidity stress in NBFCs experienced recently was due to an increase in funding costs and due to difficulties in market access in some cases. Better performing NBFCs with strong fundamentals were able to manage their liquidity even though their funding costs moved with market sentiments and risk perceptions.

NBFCs - Borrowing Profile

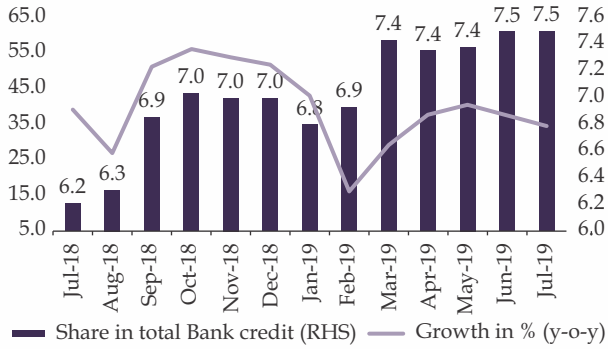


Source: RBI, BWR Research

Raising funds particularly through debentures has become costlier. Debentures which constitute nearly 50% of NBFCs borrowing profile in 2017-18, came down to 42% in 2018-19. However, this gap is somewhat fulfilled by borrowings through banks. After the initial hiccups, banks have started lending money to NBFCs, and banks' overall exposure to

NBFCs also increased. Banks outstanding credit to NBFCs has grown from Rs 3,910 bn in March 2017 to Rs 6,412 bn in March 2019. The recent data by RBI on Deployment of Banks credit by major sectors reveal that the deployment of funds by NBFCs increased by 35% (y-o-y) as on July 19, 2019 (see chart below).

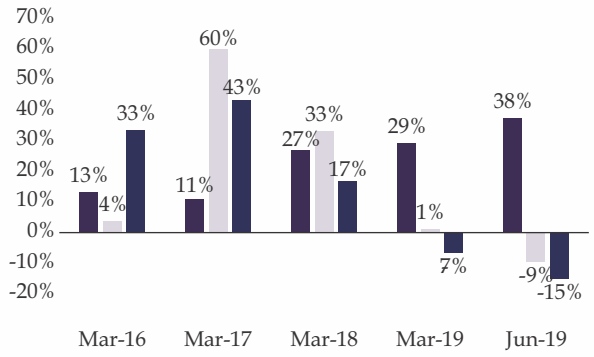
Bank credit to NBFCs (Growth and share)



Source: RBI, BWR Research

Apart from banks, Mutual Funds are the largest net providers of funds to the financial system including NBFCs. Recent events related to fixed maturity plans (FMPs) and post IL&FS, the Mutual Funds have become selective in investments. Mutual Funds investments in NBFCs show a falling trend in CPs/ debentures. After 33% and 17% increase, respectively in FY 2017-18, Mutual Funds' investments in CPs increased by a mere 1% over the previous year and that of debentures shrank by 6.7% during 2018-19. The trend continued in 2019-20 as well (Chart below).

NBFCs - Sourcing of Funds (Growth y-o-y)



Source: RBI, BWR Research

Credit disbursals by NBFCs

The liquidity stress faced by NBFCs is expected to result in lesser deployment of funds to major sectors who are dependent on NBFCs funding. Borrowings from banks still constituted the largest source of funding for industries. NBFCs and HFCs are among the largest borrowers of funds from the financial system. A substantial part of this funding comes from banks.

The credit disbursals by NBFCs started shrinking significantly as per the available data from some large NBFCs. *"Credit disbursals by NBFCs continued to slide despite regulatory measures to boost credit to the sector. Loan sanctions plunged 28% in the quarter to June, almost a year after the liquidity squeeze that followed the unexpected default by Infrastructure Leasing & Financial Services (IL&FS). NBFC sanctions fell to Rs 1.79 lakh crore at the end of June versus Rs 2.49 lakh crore at the end of March. On a year-on-year comparison, the fall in sanctions was steeper at 30%. Non-bank lenders had sanctioned loans worth Rs 2.57 lakh crore in June last year, which rose to Rs 2.76 lakh crore at the end of September, the month IL&FS collapsed. It slid to Rs 2.2 lakh crore at the end of December – a drop of nearly 20% from September levels", data compiled by credit bureau CRIF High Mark showed.*

Confidence boosting measures/initiatives

To restore confidence and provide easy flow of credit, government and regulators announced quite a few measures. In Budget 2019-20, the government made an announcement that "NBFCs that are fundamentally sound should continue to get funding from banks and mutual funds without being unduly risk averse. For purchase of high-rated pooled assets of financially sound NBFCs, amounting to a total of Rs 1 lakh crore during the current financial year, Government also provide one time six months' partial credit guarantee to Public Sector Banks for first loss of up to 10%. In order to enable the banks to implement this announcement and deal with the NBFCs/HFCs issue effectively, the RBI announced to provide required liquidity backstop to the banks against their

excess G-sec holdings. A circular in this regard also issued recently. Further, the government also proposed for strengthening the regulatory authority of RBI over NBFCs to be placed in the Finance Bill, and steps to allow all NBFCs to directly participate on the TReDS platform and considered to allow NBFCs to raise funds in public issues and to done away with the requirement of creating a Debenture Redemption Reserve. The proposed transfer of regulatory authority of HFCs from NHB to RBI came into effect in August 12, 2019, with HFCs being treated as one of the categories of NBFCs for regulatory purposes.

In line with these measures, the RBI also announced quite a few measures, and the likely impact of these measures are listed below:

- In order to boost credit to the needy segment of borrowers, RBI has announced that bank credit to registered NBFCs (other than MFIs) for on-lending will be eligible for classification as priority sector under respective categories subject to the following conditions:
  - Agriculture: On-lending by NBFCs for 'Term lending' component under Agriculture will be allowed up to Rs 10 lakh per borrower.
  - Micro & Small enterprises: On-lending by NBFC will be allowed up to Rs 20 lakh per borrower.
  - Housing: Enhancement of the existing limits for on-lending by HFCs vide para 10.5 of our Master Direction on Priority Sector lending, from ₹ 10 lakh per borrower to ₹ 20 lakh per borrower.
  - Bank credit to NBFCs for On-Lending will be allowed up to a limit of five percent of individual bank's total priority sector lending on an ongoing basis.

The measure of allowing priority sector tag to bank loans extended to registered NBFCs for financing agriculture, MSMEs, and homebuyers within specified limits can increase the credit flow to NBFCs serving these segments to some extent.

- Earlier banks' exposures to a single NBFC was restricted to 15% of their eligible capital base. However, based on the risk perception, a bank's exposure to a single NBFC (excluding gold loan companies) is enhanced to 20% of that bank's eligible capital base. Banks' exposures to a group of connected NBFCs or group of connected counterparties having NBFCs in the group was restricted to 25% of their Tier I Capital under exceptional circumstances.

Increasing the lending exposure limit to NBFCs to 20% per borrower and providing priority sector status to loans given to NBFCs lending to agriculture, micro and small enterprises (MSEs), and Housing is a definite step towards improving the credit environment in the country in the long run. The focus has been on increased lending to NBFCs as they play a significant role in financing segments like Microfinance, Small to Medium Enterprises (SMEs), Real Estate, Affordable Housing sectors, which form the backbone of the economy. However, the raising of exposure limit to NBFCs may not provide much of aid to the NBFC sector in the short term as the currently available 15% is also not fully utilized, given the risk aversion of banks towards NBFCs at the moment.

- Extension of the relaxation on the guidelines to NBFCs on securitisation transactions till December 31, 2019.

The relaxation of asset securitisation norms by RBI in November 2018 has helped ease the liquidity issues to some extent and the total securitisation volumes have almost doubled to Rs 1.4 trillion in 2018-19 from previous year. Extension of the relaxation on the guidelines further help NBFCs liquidity position.

- To frontload the Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR) scheduled to increase by 0.5% each in August and December 2019 and permit banks to reckon with immediate

effect the increase in FALLCR of 1.0% of the bank's NDTL, to the extent of incremental outstanding credit to NBFCs and Housing Finance Companies (HFCs) over and above the amount of credit to NBFCs/HFCs outstanding on their books as on date, which will enable the banks to avail additional liquidity of Rs 1,34,000 crores.

- Risk Weights for exposures to NBFCs: The exposures to all NBFCs, excluding Core Investment Companies (CICs), will be risk weighted as per the ratings assigned by the rating agencies registered with SEBI and accredited by the RBI, in a manner similar to that of corporates.

These measures provide a good cushion against any liquidity squeeze in the economy and addresses viability concerns in the medium term particularly when many mutual funds are averse to invest in the segment.

Conclusion

It is said that 'crisis is the mother of reforms', and scams or frauds have their uses; they make the stakeholders wake up to the need for more vigorous regulation, control and supervision. Hence the government should use this opportunity to reform NBFC sector as they have been successful in filling the gap in offering credit to retail customers particularly in underserved and unbanked areas. Their commendable contribution towards the government's agenda of financial inclusion also can not to be ignored. Though the banking sector would always be the most important sector with respect to access of credit, because of its credibility in supporting manufacturing, infrastructural development, the role played by NBFCs in providing credit to major sectors of the economy also assumes significance.

Recent measures announced by RBI and Government have somewhat eased the pain faced by NBFCs by helping ease the credit flow to the sector. his will also relieve the borrowers with low cost funding. Reinvigorating confidence and ensuring financial access to fuel growth is an important step in sustaining consumption demand as well as capital formation. The greater resilience and adaptability have put the NBFC sector as preferred mode of funding for many hence, this sector needs to be nurtured appropriately like banks. Given the systemic spillovers entailed by the sector, and the importance of non-banking financial intermediation specifically with regard to certain sectors that are traditionally disadvantaged in accessing bank credit, non-banking financial intermediation is more relevant than ever before. Fiscal year has begun on a cautiously optimistic note which provide a glimpse into deleveraging which has happened with the rise in retention of good quality assets in the books. ■



Role of Capital Markets in building a $5 trillion economy

Sundeep Sikka, *Executive Director & CEO, Reliance Nippon Life Asset Management Limited*

Economic growth in a modern economy hinges on an efficient and effective financial sector that pools domestic savings and mobilizes capital for productive projects. Absence of effective capital market could leave most productive projects which carry developmental agenda unexploited. Capital market connects the monetary sector with the real sector and therefore facilitates growth in the real sector and economic development.

India has amongst the highest Savings Rate in the World. India's Domestic Savings Rate is above 30% of GDP (FY '18. Source: CEIC, RBI), with the Household Savings Rate above 17%. It is imperative that these Savings are effectively channelized to aid productive growth. Capital markets play the important role of providing surplus capital generated through savings to areas that require capital for growth.

Role of Capital Markets

Capital market is defined as the market where medium and long-term finance can be raised. Capital market offers a variety of financial instruments that enable economic agents to pool, price and exchange risk. Through assets with attractive yields, liquidity and risk characteristics, it encourages saving in financial form. This is very essential for government and other institutions in need of long term funds. Capital market is a network of specialized financial institutions, series of mechanism, processes and infrastructure that, in various ways facilitate the bringing together of suppliers and users of medium to long term capital for investment in economic developmental project. Capital market increases the proportion of long-term savings (pensions, funeral covers, etc.) that is channeled to long-term investment. Capital market enables contractual savings industry (pension and provident funds, insurance companies, medical aid schemes, mutual funds, etc.) to mobilize long-term savings from small individual household and channel them into long-term investments. It fulfills the transfer function of current purchasing power, in monetary form, from surplus sectors to deficit sectors, in exchange for reimbursing a greater purchasing power in future. In this way, capital market enables corporations to raise capital/funds to finance their investment in real assets.

The contact between agents with deficit of money and the ones with monetary surplus can take place in a direct way (direct financing), but also by the means of any financial intermediation form (indirect financing), situation in which specific operators realize the connection between the real economy and the financial market. In this case, the financial intermediaries could be banks, mutual funds, pension funds, insurance companies or other non-bank financial institutions.

Advantage Capital Markets

Taking into account, the role in the market economy, the capital market occupies an important place, through their specific mechanisms, succeeding to give its contribution to the economic development of the society. Well-developed capital markets will lead to an increase in productivity within the economy leading to more employment, increase in aggregate consumption and hence growth and development. It also helps in diffusing stresses on the banking system by matching long-term investments with long-term capital. It encourages broader ownership of

productive assets by small savers. It enables them to benefit from economic growth, wealth distribution, and provides avenues for investment opportunities that encourage a thrift culture critical in increasing domestic savings and investment ratios that are essential for rapid industrialization.

In addition, the capital market mechanism allows not only an efficient allocation of the financial resources available at a certain moment in an economy – from the market's point of view – but also permits to allot funds according the return and the risk – from the investor's point of view – offering a large variety of financial instruments with different profitableness-risk characteristics, suitable for saving or risk covering. Nowadays, the protection against financial risks becomes a necessity, imposed by the transformations in the global economy, by the accented instability and the financial crisis that affects without discrimination both developed and emerging stock markets.

Capital market also provides equity capital and infrastructure development capital that has strong socio-economic benefits through development of roads, water and sewer systems, housing, energy, telecommunications, public transport, etc. These projects are ideal for financing through capital market via long dated bonds and asset backed securities. Infrastructure development is a necessary condition for long-term sustainable growth and development. In addition, capital market increases the efficiency of capital allocation by ensuring that only projects which are deemed profitable and hence successful attract funds. This will, in turn, improve competitiveness of domestic industries and enhance ability of domestic industries to compete globally, given the current momentum towards global integration. The result will be an increase in domestic productivity which may spill over into an increase in exports and, therefore, economic growth and development.

Moreover, capital market promotes public-private sector partnerships to encourage participation of private sector in productive investments. The need to shift economic development from public to private sector to enhance economic productivity has become inevitable as resources continue to diminish. It assists the public sector to close resource gap, and complement its effort in financing essential socio-economic development, through raising long-term project-based capital. It also attracts foreign portfolio investors who are critical in supplementing the domestic savings levels. It facilitates inflows of foreign financial resources into the domestic economy.

The Indian Context

India does have a fairly vibrant capital market structure. India's stock market is 7th biggest in the world with m-cap of $2.1 trn at the end of 2018. Indian Fixed Income market is estimated to be $1.9 trn, with Government Securities accounting for bulk of the market. Post the market liberalization that began in earnest in 1991, several economic reforms including capital market reforms had been undertaken that have led to steady flows into capital markets. However, for a very large part, we had and continue to have restrictions on foreign ownership of Indian equities and bonds. For instance, aggregate limits on foreign ownership of Indian government bonds have been stringent with foreign investors being allowed to own a maximum of 6% of outstanding government debt. The Reserve Bank of India has been progressively relaxing restrictions, though.



Indian households tend to prefer savings in the physical form. Savings done in the financial form, rather than in physical form, channeled through capital markets have the propensity to be more efficient in transferring capital to the segments which require them. For instance, if the Reserve Bank of India (RBI) were to cut the Repo Rate, the lower interest rate would transmit to the borrowers (Corporates, Home Loan borrowers, etc) by way of lower borrowing cost. However, if the savings were in physical form such as gold, the efficient transmission would not take place.

The following is a break-up of Indian Household Savings. Out of the total household savings, more than 50% is in physical assets. In the US, physical assets are estimated to be 30% whereas financial assets are 70% of the GDP.

Indian Household Balance Sheet in Rs Lakh Crs		% of Total Household Savings
Physical Assets	**180**	**53%**
Real estate	120	35%
Gold	60	18%
Financial Assets	**160**	**47%**
Bank deposits	60	18%
Insurance, EPFO, Small savings,NPS	50	15%
MF equity + Retail equity	30	9%
Cash	20	6%
TOTAL	**340**	100%

Source: Internal estimates

While a lot had been done in the past to develop capital markets, and we have come a long way since, a lot more could be done to further enhance the role of capital markets in building our economy as we move towards the $5 trillion GDP mark.

Way Forward

A well-developed capital market creates a sustainable low-cost distribution mechanism for multiple financial products and services across the country. It increases mobilization of savings and therefore improves efficiency and volume of investments, economic growth and development. There is a lot of empirical research linking capital market development and economic growth suggesting that capital market enhances economic growth and development. Countries with well-developed capital markets experience higher economic growth than countries without.

Capital markets offer a superior alternative to loan markets given the advantages like Better ability to absorb and distribute risk, Lower intermediation costs, Heterogeneity of players, Flexibility to address diverse capital structures & required solutions, ability to absorb overseas flows etc. Hence it's critical to deepen the bond markets, some of the enablers could be as under:

1) A functional corporate bond repo market: Increase both quantum as well as risk appetite for corporate bonds.

2) Promote specialized vehicles for credit risk insurance: Think out of box specialized CDS solutions from the AIF / High Yield / Private equity players.

3) Risk Management / Investment Management in Buy & Hold Entities: Compulsory outsourcing of investment activities of long term investors who don't have dedicated and sophisticated Fund Management teams.



4) Uniform Valuations & Accounting: Across banks, insurance and AMCs, across loan and bond products.

5) Move from predominant fixed rate markets to predominant floating rate markets, have much deeper but separate swap markets for interest rate risk hedging.

6) Continuously improve upon, information transparency, quality of ratings, debt resolution & liquidation processes

Capital Markets encourage higher quality of governance leading to more organized businesses which in turn leads to multiple benefits like better tax compliance, environment awareness etc. In this regard one of the enablers could be to reduce the multitude of taxes like Securities Transaction Tax (STT), Dividend Distribution Tax (DDT), Long Term Capital Gains (LTCG) etc. and simplify the structure.

In consequence, the public authorities must notice the importance of the capital market in the national economy and, on the other hand, to make the efforts for insuring the necessary framework for the normal functioning of its specific mechanisms. ■

A vibrant bond market for India's march towards a USD 5 trillion economy

Vikram Limaye, *MD & CEO, National Stock Exchange of India Ltd.*

India's aspiration to transform into a USD 5 trillion economy by 2025 will require a series of measures and constructive participation from corporate India. The infrastructure requirement to support sustainable economic growth needs efficient, transparent and competitive sources of funding. Banks are on a clean-up and consolidation drive that augur well in the long-term, but has constrained credit flow in the current scenario. Moreover banks alone without contribution from other long term institutional funding cannot be the largest contributors to corporate funding requirements. Consequently, over the short-term, lending to the industry has witnessed a decline. Given the stress in the banking system, the corporate bond market needs to play a much bigger role in helping to realize this ambition of a USD 5 trillion economy by 2025.

Corporate bond markets need to pick-up pace to bridge the funding gap. They provide issuers with many advantages, including better pricing over a period of time, longer term funding and access to a broader investor base. Bond issuances should form a more significant component of incremental funding for corporate balance sheets.

Analysing the Role of Bond Markets around the Globe

Bonds are an essential source of external finance in advanced economies. In developing economies like China and Malaysia, for instance, the size of the local currency corporate bond market as a percentage of the gross domestic product (GDP) is around 53 and 58% respectively. By contrast, India's corporate bond market is only 24% of its GDP. It is to be noted that the primary issuance of corporate debt in India has witnessed a significant increase over the last decade. In June 2010, outstanding corporate bonds in the country stood at INR 7.94 lakh crore. In June 2019, the figure has expanded to INR 30.63 lakh crores. These figures imply that bond issuances have grown at a robust compound annual growth rate (CAGR) of 9%. Additionally, the amount of outstanding corporate bonds stands at around 30% of outstanding bank credit as of March 2019. In the last few years bond markets have contributed more to incremental credit to corporate India. However, despite the impressive growth of the segment, the fact remains that its quantum is small in relation to the size of the Indian economy. By extension, the instrument has much higher potential to contribute to India's USD 5 trillion dream.

Coordinated Regulations

India's bond markets are divided from a point of view of trading venue, settlement mechanism and infrastructure and regulation between RBI and SEBI. RBI regulates the government bond market with 80 per cent of trading online at NDS-OM (the Negotiated Dealing System – Order Matching Platform) and Clearing Corporation of India takes care of settlement



for government bonds. The Government bond market has a relatively liquid yield curve compared to the corporate bond yield curve. Additionally, RBI manages money markets that cater to short term requirements of corporate India through commercial papers which is an over the counter (OTC) market with settlement through clearing corporations of exchanges. Similarly, SEBI regulates the corporate bond market which is again an OTC market with reporting and settlement through clearing corporations of exchanges. Derivatives are again regulated by RBI and SEBI. Further, insurance, mutual funds and pension / provident fund regulators mandate the structure of participation in these markets for their respective constituents. Often times one section of the market is permitted to participate in a product while another is not. While specific differences depending on the constituents may be prescribed, a more coordinated approach to fixed income markets could lead to better outcomes. Also a principle based approach to regulation as against what exists currently may provide more flexibility and ability for different market participants and institutional capital to help grow bond markets.

Exchanges Role in Bond Markets

In the last few years, regulators have taken several constructive steps in increasing participation in bond markets, facilitating access and providing re-financing. Exchanges have launched products and services which given time are likely to increase reach, efficiency and transparency in the bond markets.

a. Non-Competitive Bidding (NCB): This facility of the exchange provides an opportunity to retail investors to participate in central government bond auctions. Government bonds provide a safer investment option to retail investors and for government, retail investment provides a new source of funding. Further, the Reserve Bank of India recently announced that stock exchanges would be allowed to offer State Development Loans (SDL) under NCB.

b. Electronic Bidding platform (EBP): Earlier private placements in corporate bonds were bilateral negotiations where a lot of potential investors couldn't participate due to lack of information. Now with the EBP facility offered by exchanges, all investors get an equal opportunity to participate in corporate bond issuances in a transparent manner.

c. Tri-Party Repo: In order to meet the short term funding requirements, corporate bonds can be kept as collateral to raise funding wherein settlement guarantee is provided by the clearing corporations of exchanges.

d. Online Trading Platform for corporate bonds: Exchanges have also offered online, anonymous, order matching platform and multilateral trading platform to facilitate corporate bond trading.

e. Interest Rate Derivatives (IRD): To hedge against the uncertain movement in the interest rates, investors have a product to trade and hedge.

Other regulatory changes like ISIN consolidation, mandatory issuances through EBP for total issuances of more than Rs. 200 crores in a year, clarity on day count conventions, disclosures of cash flows in term sheet are likely to yield good results.

However, auxiliary facilitations are still required like easing regulatory restrictions for mutual funds and insurance companies to participate in IRD, relaxing restrictions on insurance, provident funds to participate in lower rated credits and easing membership related restrictions to participate in Tri-Party Repo for mutual funds to truly realise the potential of these steps to develop the bond market.

Building Domestic Demand for Corporate Bonds

Institutional monies especially long term pools of capital remain largely elusive to corporate bond markets. This savings pool needs to find confidence in the corporate bond market for greater translation of capital raising through this asset class. Though measures such as insolvency and bankruptcy code

have helped, faster resolution of cases will bring greater confidence.

In conclusion, a well-diversified economy with a balanced distribution across bank lending, equities and bond markets, offers many advantages. Firstly, it is less vulnerable to financial crisis. Secondly, it provides the much-needed impetus for growth with stability. Thirdly, better pricing of market, diversifying sources of capital for issuers is beneficial as well for development of credit derivatives market. For investors it brings more avenues to diversify their investment portfolio. Bond markets are critical to India's march towards a USD 5 trillion economy and it



is important that we continue to make meaningful progress over the next couple of years in order to support our growth aspirations. ■

Evolution of investor friendly capital market in India

VS Parthasarathy , *Group CFO, Group CIO and Member of the Group Executive Board*
Mahindra & Mahindra

A few months back, while addressing the chief ministers of the states, Prime Minister Mr. Narendra Modi declared his commitment to turn India into a "$5 trillion economy" by 2024. While many factors have to come together for this dream to become a reality, the chief amongst them would be a vibrant and efficient capital market. An efficient capital market is essential for proper capital allocation across various industries.

India's equity capital market has evolved substantially over the years. Increased market liquidity, a strong economic environment, stable corporate performance and an improved regulatory framework have had a positive effect in attracting investments in the last few years. This is well reflected in the performance of equity benchmark indices—Sensex and Nifty—which have risen by 35% in the last 5 years, notwithstanding the recent slowdown. The evolving regulatory and governance framework in the country has played a huge role in ensuring the attractiveness of securities market for domestic as well as foreign investors. After all, the minority investors expect not only good return on their hard-earned money, but also fairness in the marketplace.

In recent years, the government and regulatory bodies in India have drafted a slew of regulations with this objective in mind. The culture of promotor dominion and hegemony, which was the mainstay of India's corporate landscape is gradually being chipped away. This sea change in values is reflected in the World Bank's Ease of Doing Business Report of 2019, in which India has improved its ranking significantly to be among the top 7 of the 190 economies in 'Protecting minority investors'.

Enlightening Investors with Meaningful Disclosures

In recent years, SEBI has instituted stronger corporate disclosure norms to facilitate efficient price discovery of securities. Listed entities now must mandatorily disclose material events to bourses within a set timeframe of maximum 24 hours post occurrence of an event.

Resignation of an independent director or an auditor has to be disclosed within a set time frame accompanied by reasons. This comes in the wake of several auditors resigning over lack of adequate information, sending markets into a tailspin. Moreover, mandatory disclosure requirements of significant beneficial ownerships (beyond a certain level of shareholding) and all credit ratings obtained by a company, underscore the enhanced focus on transparency and resolution of information asymmetry.

In Data We Trust

Corporate reporting in India has evolved substantially to disseminate comprehensive and relevant information to all the stakeholders. Gone are the days, when companies were solely judged based on their financial performance. Investors are now increasingly factoring in ESG risks in their evaluation of securities. Top 500 companies are now encouraged to adopt integrated reporting framework in keeping up with the best international practices. Indian regulators have formulated guidelines around this to assist the companies in their reporting. In order to standardise financial reporting across the entities, companies are required to adhere to a uniform accounting standard of IND-AS. In addition to this, all

listed companies must report their audited consolidated financials on a quarterly basis. Explanation of audit qualifications in the audit report and the impact of such must also be reported mandatorily. Besides, the regulations also require companies to put in place robust internal controls over financial reporting (ICFR). In summary, standardised and comprehensible data reporting is gradually evolving in India which would aid the minority investors remain aware of the risks in their companies.

Transforming Boardrooms

With the ownership being quite concentrated in many Indian entities, minority shareholders count on the board of directors to represent their interests. Regulations have been enacted with the aim of enhancing independence of the board and improving its accountability. Some of these regulations include stricter definition of independent directors including explicit prohibition of interlocked directors from serving as independent directors on the board, cap of 2 consecutive terms for independent directors, capping the maximum number directorships on the listed boards at 7 and mandatory participation of at least 1 independent director in board meetings of a listed company. All listed entities must have at least 1 woman independent director on their board. This would lead to diversity of opinions in the board and strengthen its functioning. Additionally, the board, its committee and the directors are subject to annual performance evaluation. Even the re-appointment of an independent director needs to be explicitly based on his/her performance report. Investors are now increasingly holding firms to higher governance standards.

Resolving Conflict of Interest

Related party transactions have remained a concern in the minds of investors. To enhance transparency in corporate practices, many regulations have been formulated in recent times. The definition of related parties has been expanded and made more comprehensive. All related party transactions must be approved by the audit committee. Certain related party transactions require board approval if they are not in ordinary course of business or on arm's length basis. Material related party transactions in certain cases beyond a certain threshold require approval of shareholders. It is mandatory to disclose all related party transactions entered by a Listed Company on a consolidated basis to the Stock Exchanges on a half yearly basis. Market values fairness in dealings and these regulations should make Indian market attractive to invest in.

Reining in Insider Trading

Insider trading practices violate the integrity of markets and the principle of fairness. Incidences of alleged insider trading have cropped up from time to time and threatened to tarnish the image of the capital market. It is not surprising that curbing insider trading has been one of the key focus areas of regulatory bodies. A proper digital audit trail is now required for sharing unpublished price sensitive information (UPSI) within the company in the course of business. Every company must have an appropriate internal policy to investigate any leaks/suspected leaks of UPSI. The CEO/MD of a company are entrusted with the responsibility of putting in place adequative and effective system of internal controls for compliance with insider trading regulations. Apart from this, the audit committee must verify that the systems for internal control are adequate and are operating effectively. These measures should help minority investors develop confidence in the Indian capital market. However, at the same time we must also ensure that these regulations do not make it cumbersome to carry out genuine transactions.

Power to Minority

There has been a growing trend In India towards empowering minority shareholders and affording them a say in corporate decision making. One-way webcast of annual general meetings of top listed entities and mandatory provision of e-voting by all listed companies ensure wider participation and



enable shareholders to exercise their rights as partial owners. Shareholders now also have a say in the appointment of any non-executive director to the board beyond the age of 75 or if there is a disproportionate payment to a Non-Executive Director. Another instance of shareholder empowerment is creation of provision for proxy advisory firms in the law. Proxy advisory firms maintain scrutiny on all corporate matters and offer their unbiased opinions to assist the shareholders in decision making.

Giving Teeth to the Law

Besides improved norms on transparency and disclosures, an efficient legal system is indispensable for development of vibrant capital markets. Formation of dedicated judicial bodies like National Company Law Tribunal (NCLT) and National Financial Reporting Authority (NFRA) is reflective of the evolution of corporate jurisprudence in India. Now Investors have an effective grievance redressal mechanism at their disposal should they feel the need for it.

The Mahindra Way

I often meet people who commend the corporate governance practices in Mahindra, and admittedly this fills me with immense pride. At Mahindra, it is important for us to do things the right way. Good corporate citizenship is one of our core values. We practise the philosophy of 3 Cs--competence, conflict of interest eradication and compliance orientation--to foster an open and transparent culture. We have 10 listed group companies and multiple unlisted subsidiaries / JVs / Associates, but we ensure consistency in governance practices across our entire organisation.

We were one of the earliest adopters of integrated reporting in India. We are one of the few companies in India to conduct an annual ESG call to discuss ESG specific risks with investors. We have also adopted various mechanisms to protect the interest of our shareholders and keep them informed. We publicly disseminate videos of our leaders discussing the vision of our company to keep our shareholders aligned with our strategy. Unsurprisingly, good

governance has helped us win the trust of our stakeholders. As clichéd as it may sound, companies with good governance and integrity are always rewarded, loved and championed.

Final Thoughts

The Occidental philosophy of pursuit of profits as the sole objective has sometimes led to lapses in good corporate conduct. In response, the Eastern principles of balance and harmony are becoming more relevant by the day. At Mahindra, we add 4th P to People, planet and profit, which is Process. We believe that people and planet form the purpose of every business, and profit and governance form the process of doing business.

The change in capital markets across the world mirrors this modern zeitgeist, as political beliefs increasingly lean towards transparency, fairness and empowerment. The response of Indian capital markets to these tectonic shifts in values has informed the aforementioned changes in the overall regulatory framework. This in turn has made investment in Indian capital markets an attractive proposition.

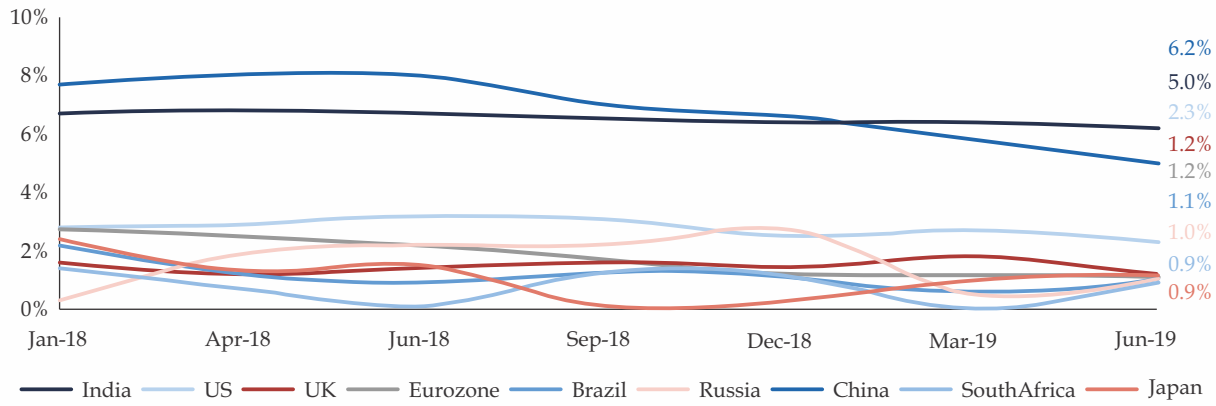
While the progress made so far is impressive, it adds substantially to the cost of compliance. Caution should be exercised in order to ensure that cost of compliance does not start impacting business attractiveness. The tendency to brush all corporates as potential offenders should be avoided at any cost. The system should ensure that honest companies are not unduly penalised in the form of higher transaction cost. Only then, the gains we made in this area are sustainable and lead to expand the investment landscape of India. ■

India: Overview of Macroeconomics and Equity Capital Markets

Presented by NovaDhruva Capital Private Limited

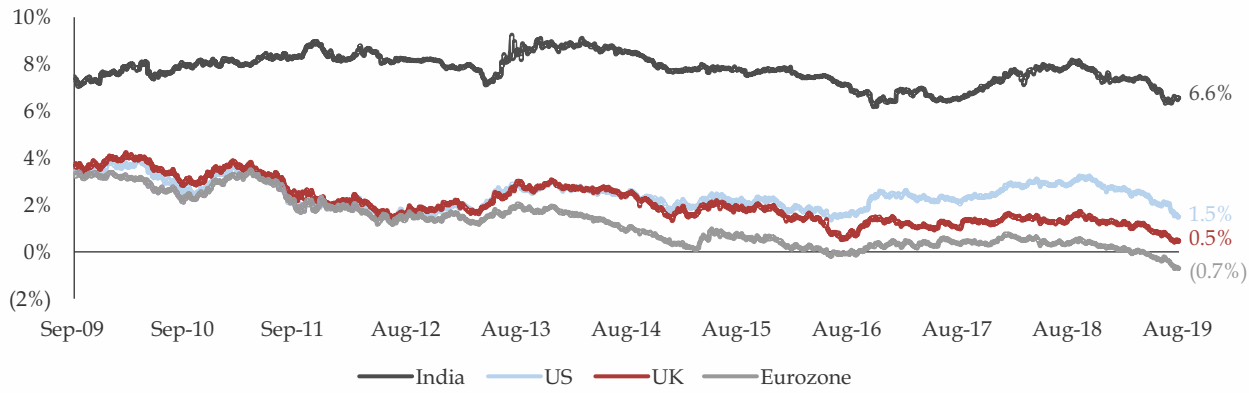
Macroeconomic Trend

Figure 1: Real GDP Growth Rate (Y-o-Y)



Source: *Bloomberg*

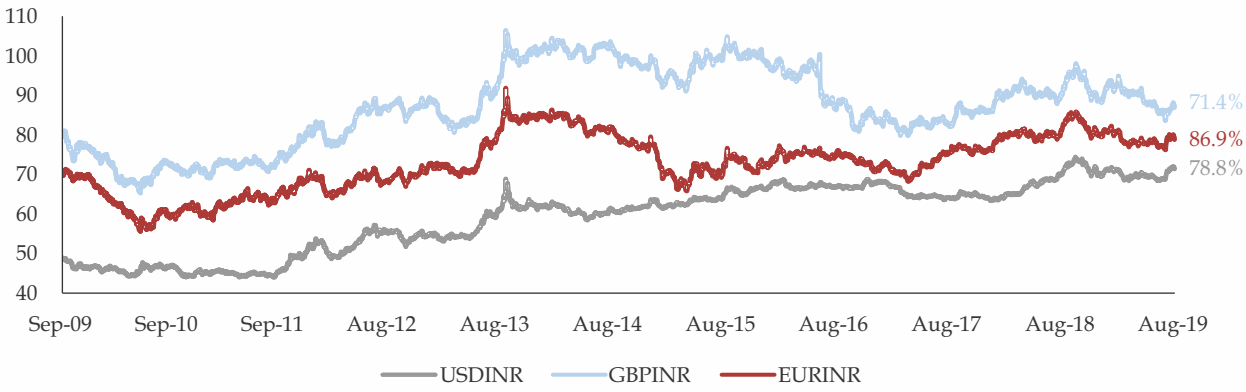
Figure 2: L10Y Generic Bond Yields (till 30th Aug 2019)



Source: *Bloomberg*

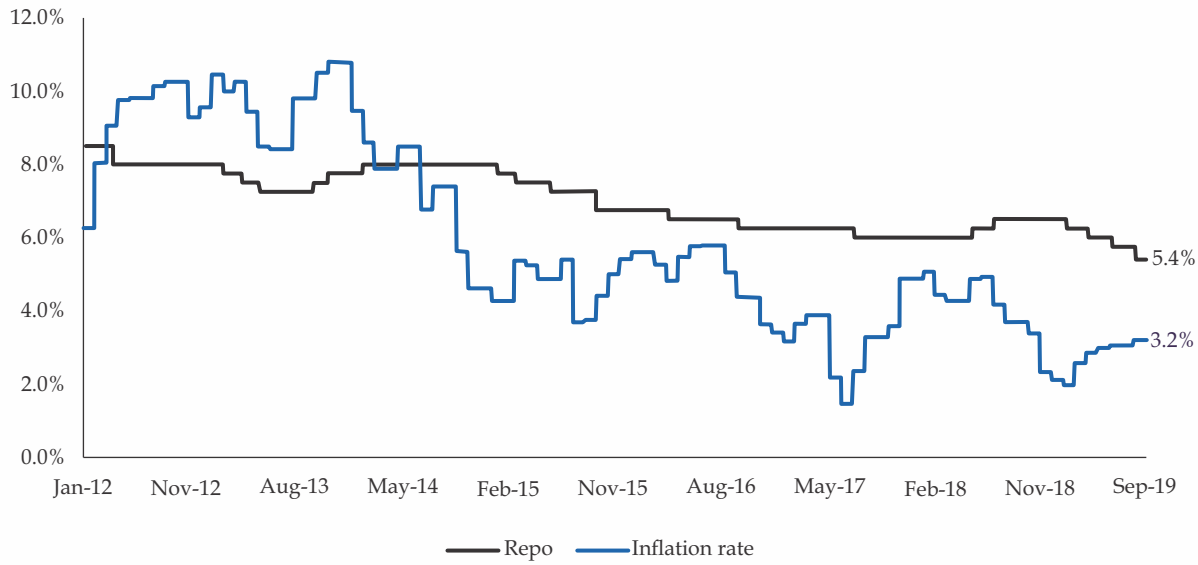
Macroeconomic Trend

Figure 3: L10Y FX Rates (till 30th Aug 2019)



Source: *Bloomberg*

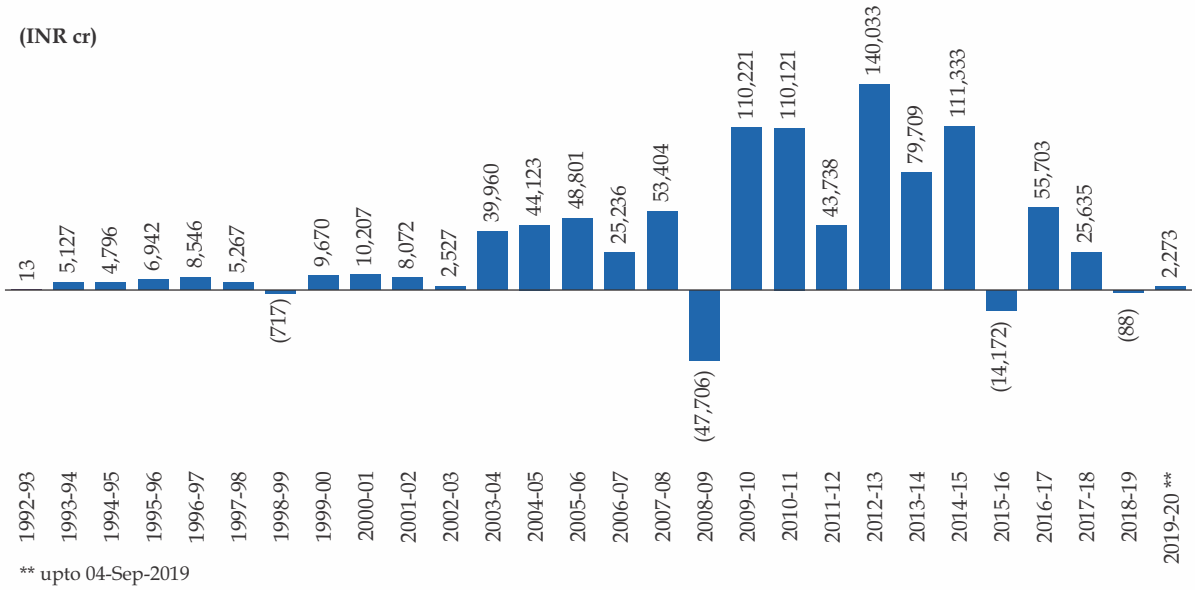
Figure 4: Repo rate and General CPI inflation



Source: *Bloomberg and RBI*

Macroeconomic Trend

Figure 5: FPI investment into Indian Equity Markets

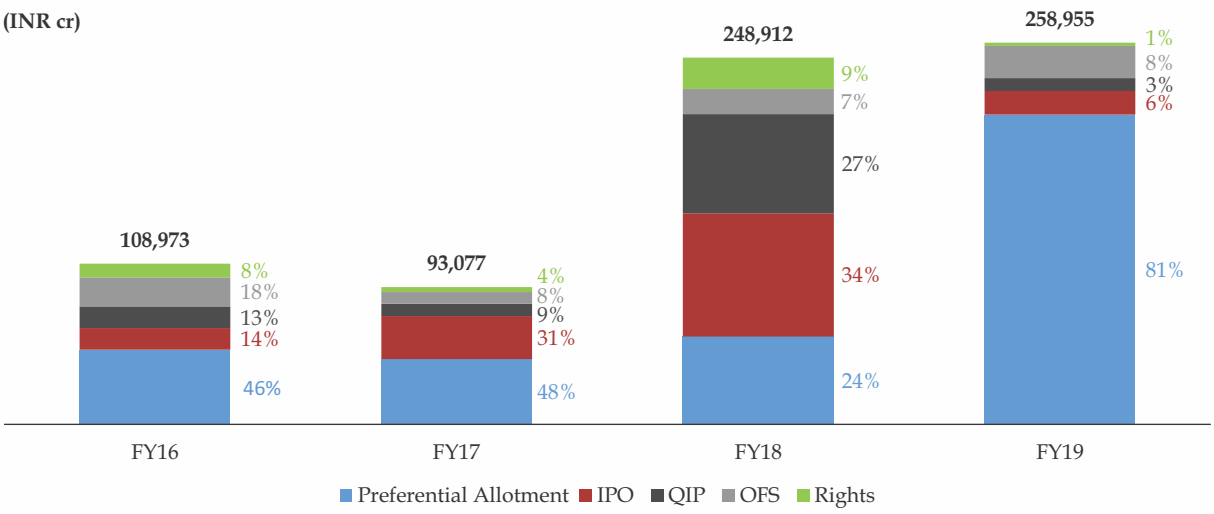


** upto 04-Sep-2019

Source: *NSDL*

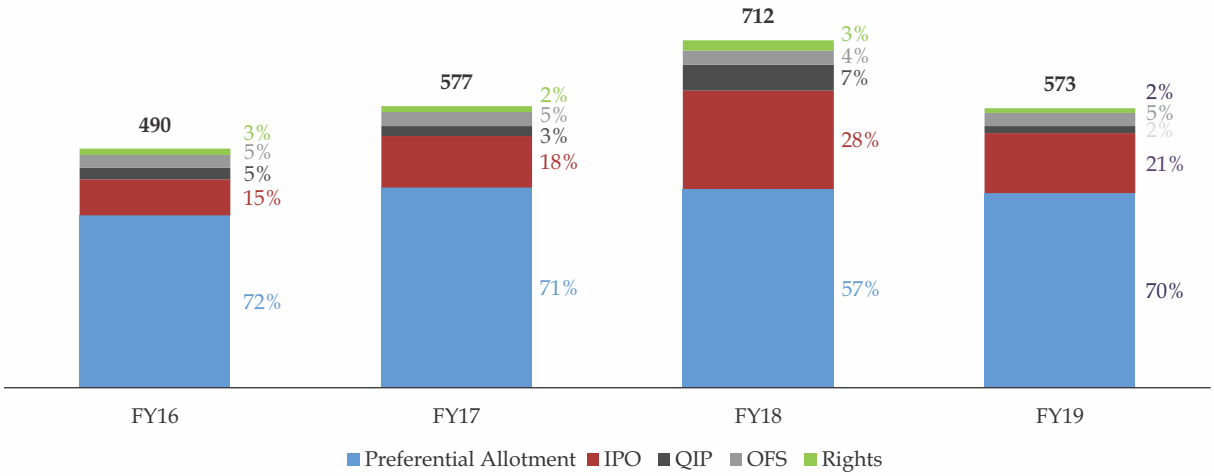
Indian Capital Market

Figure 6: Split by Value of ECM transactions



Source: SEBI

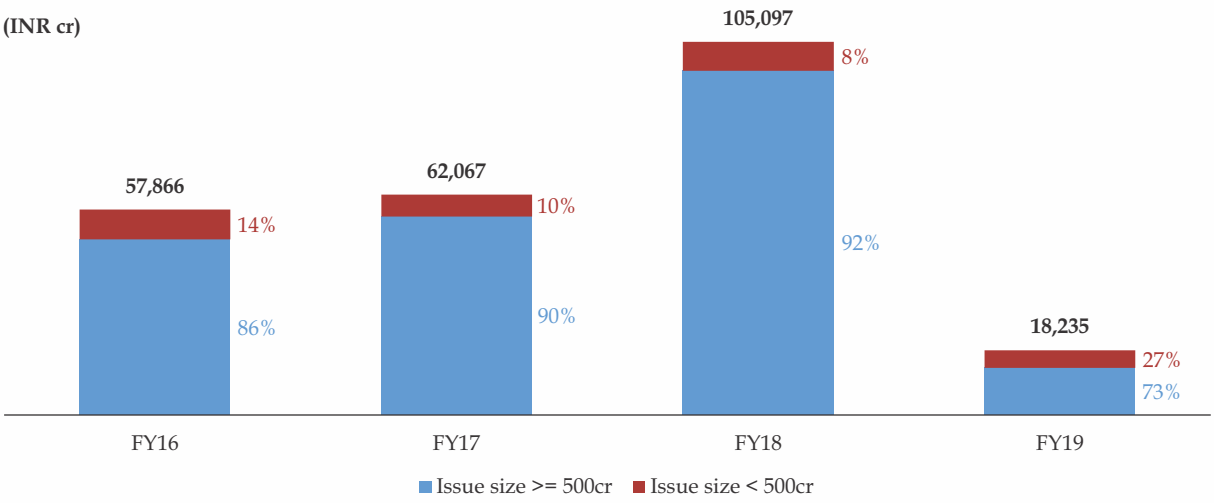
Figure 7: Split by Volume of ECM Transactions



Source: SEBI

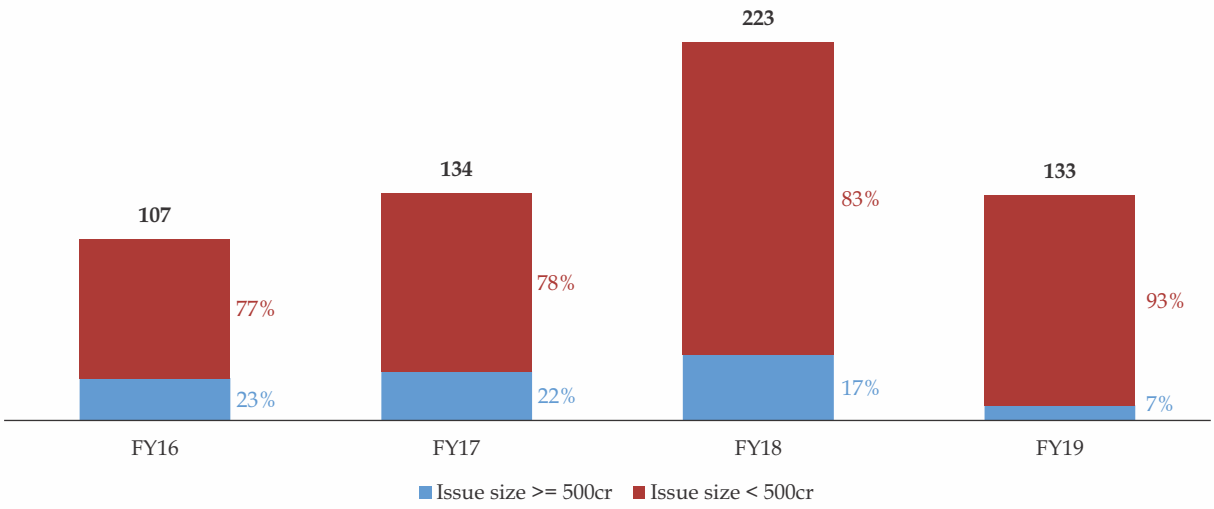
Indian Capital Market

Figure 8: Maximum amount of money raised through big ticket public issue…



Source: SEBI

Figure 9: …However, number of transactions is low for large ticket public issues



Source: SEBI

Initiatives of
FICCI National Committee on Capital Markets

Conference on Institutional Participation in Commodity Derivates Market on 28th February 2019 in Mumbai

FICCI had organised a Conference on Institutional Participation in Commodity Derivatives Market on 28th February 2019 in Mumbai. Based on the deliberations at the Conference, a post-event dossier was submitted to SEBI which included suggestions on policy framework for institutional participation in commodities derivatives market.



(L to R) - Mr Jaspal Bindra, Chairman, FICCI Maharashtra State Council and Executive Chairman, Centrum Group; Mr S K Mohanty, Whole Time Member, SEBI; Mr Mrugank Paranjape, the then MD & CEO, MCX

Interactive Session with Ms Madhabi Puri Buch, Whole Time Member, SEBI on 22nd April 2019 in Mumbai

Committee members at the closed-door interaction with Ms Madhabi Puri Buch, Whole Time Member, SEBI on 22nd April 2019 at Mumbai.

During the interactive session, discussions were held on several matters pertaining to strengthening the primary, secondary and debt market; LODR, delisting regulations, insider trading regulations and other issues pertaining to development of capital market in India.

A detailed representation was submitted for consideration of SEBI on the above issues.



Policy Recommendations

- **Incentivising investment in units of Infrastructure and Real Estate Investment Trust**

A FICCI delegation comprising senior representatives from infrastructure sector and capital market had a meeting with Mr Ajay Tyagi, Chairman, SEBI and Mr Sujit Prasad, Executive Director, SEBI to highlight the issues hindering the growth of InvITs and REITs in India.

Subsequent to the meeting, detailed recommendations were submitted for strengthening of conducive regulatory environment for growth of InvITs and REITs.

- **Suggestions on SEBI (LODR) Regulations - Separation of role of Chairman and CEO/MD**

Based on concerns raised by industry, FICCI has highlighted the challenges in mandatory separation of the roles of Non-Executive Chairperson and Managing Director/Chief Executive Officer for listed companies in its representation to SEBI and the Government.

- **Suggestions on Depositary Interests [DI]**

FICCI has had several discussions with senior officials in Ministry of Finance and SEBI on issuance of DI for raising foreign capital by domestic unlisted companies.

Detailed submissions have been to the Government and Regulator highlighting the advantages of DI, process of issuance etc.

- **Suggestions on Consultation Papers issued by SEBI**

Based on inputs received from committee members, detailed submissions have been made through the year on the following Consultation Papers issued by the Regulator from time to time:

- Issuance of Shares with Differential Voting Rights
- Amendment to the SEBI (PIT) Regulations, 2015 to provision for an Informant Mechanism
- Review of Buy-back of Securities
- Review of Rights Issue Process
- Resignation of Statutory Auditors
- Issues related to Proxy Advisers

Notes

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