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The background of the cover features a world map with a focus on the Indian subcontinent. In the foreground, there is a 3D bar chart with blue bars and a thick green line graph that trends upwards from left to right, symbolizing economic growth and financial performance.

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ABOUT FICCI

Established in 1927, FICCI is the largest and oldest apex business organisation in India. Its history is closely interwoven with India's struggle for independence and its subsequent emergence as one of the most rapidly growing economies globally. FICCI plays a leading role in policy debates that are at the forefront of social, economic and political change. Through its 400 professionals, FICCI is active in 39 sectors of the economy. FICCI's stand on policy issues is sought out by think tanks, governments and academia. Its publications are widely read for their in-depth research and policy prescriptions. FICCI has joint business councils with 79 countries around the world.

A non-government, not-for-profit organisation, FICCI is the voice of India's business and industry. FICCI has direct membership from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 83,000 companies from regional chambers of commerce.

FICCI works closely with the government on policy issues, enhancing efficiency, competitiveness and expanding business opportunities for industry through a range of specialised services and global linkages. It also provides a platform for sector specific consensus building and networking.

Partnerships with countries across the world carry forward our initiatives in inclusive development, which encompass health, education, livelihood, governance, skill development, etc. FICCI serves as the first port of call for Indian industry and the international business community.

PREFACE



Financial Sector is the backbone of the economy and it is indeed critical to nurture the growth of this important sector in order to ensure sustained growth rate. When the Indian economy was liberalized in the year 1991, a road map was also set forth for financial sector reforms. Since then based on the recommendations of two Narasimham Committee reports, Malhotra Committee report on Insurance sector reforms etc., Indian financial sector has witnessed several important reforms of course in a calibrated and cautious manner which has helped strengthen financial markets in India.

FICCI has been in the forefront of Reforms process and has worked tirelessly with Industry, Government, regulators and other stakeholders to facilitate dialogue to enable suitable policy changes critical for the growth of Financial Sector in India. Through its various forums and research work FICCI keeps regular track of the business and policy issues and works with the government in policy implementation and in developing road map for future course of development.

With a view to have a regular forum of debate on several critical issues related to Indian financial sector, FICCI has decided to publish bi – monthly Journal on various contemporary aspects of Financial Sector. The Journal would include articles highlighting various facets of the subject from various industry experts, a section on Policy updates related to Indian financial sector, an update on the economy and information on FICCI's banking and Finance sector related activities.

This Inaugural issue will focus on Corporate Bond Market which needs to be activated urgently to facilitate growth ambitions of India Inc. as also for the economy to build much needed Infrastructure and attain double digit GDP growth.

We also thank our partner MCX for extending their support to help achieve our endeavor.

We do look forward to views and suggestions from the readers to help us improvise the content of the Journal and make it more relevant and informative.


Dr Anil Mitra
Secretary-General
FICCI

Corporate bond market in India: Pushing the envelope

FICCI Banking and Finance Team



This article on the progress made on the debt market front in India, particularly corporate debt, is not the first one and not the last one either, however, despite the right noises made at various forum debt market in India has been a virtual non-starter. While, clear focus since the beginning helped equity markets in getting off to a flyer, debt market in India got intertwined in the rules, regulations and by-laws of regulators, various states and ministries.

The kind of astronomical growth and sophistication we have achieved in the equity markets is truly world class. This also shows that when we have the willingness to do things, we do it in the most competitive and transparent manner and have achieved global benchmarks. But that's all we have! All these years we have continued to live with FII inflows, which by its very nature are very volatile. The pain when the FIIs

retreat, lasts much longer, as against the pleasure one derives in welcoming them. Though the dependence has reduced over the period of time, we today have a very large and liquid forex OTC spot and derivatives market and a very large Government securities market.

What we don't have as yet: in terms of market segments, is an active secondary market in corporate bonds. While the government is putting the requisite infrastructure in place, it's the initial dilly-dallying in reforms in debt market that led to a delayed start, while equity zoomed away with all attention. What we are witnessing right now in the bond market, especially in the corporate bond is a 'late movement' in cricket parlance, as steadily the building blocks are being put in place.

A strong government securities market is often cited as precursor to a healthy corporate bond market and

that is where FICCI believes that steps in the right direction will bear rich dividends. The following extract from a Working Paper of OECD is a testimony to this fact:

“...Well functioning government securities markets give public support to private fixed-income market (both cash and derivatives) in the form of pricing benchmark, while they also provide a tool for interest rate risk management.

For these reasons, the development of a well functioning government bond market will often precede, and very much facilitate, the development of a private-sector corporate bond market...”

(New Strategies for emerging Domestic and Sovereign Bond markets, Working Paper No.260, OECD Development Centre,)

Debt market-crying need of the hour

If it's about sustaining the 10 per cent growth for China, we in India are looking for the answer to how to touch the double-digit growth. The answer is pretty straightforward and is not as dubious as the number crunching done by China. India has a "massive" need for capital to catch China's growth rate and fully benefit from a global shift in economic power to emerging markets, said Prof. Nouriel Roubini, better known as 'Dr. Doom' of New York University, who also predicted the financial crisis. "China has been a hare and India a tortoise but growth is accelerating in India." "There is a massive need for both human and physical capital," prophesized Roubini at a conference organized by Edelweiss Capital in Mumbai on March 31, 2010.

As an alternate source of funding, debt market has an important role to play. While the public-sector debt market is fairly liquid, constituting approximately 35 per cent of GDP, the stock of listed non-public sector debt is an abysmal 2 per cent of the GDP (Goldman Sachs, 2007). This is far below the depth of the equity market capitalisation placed almost at 100 per cent of GDP. Even emerging countries such as Malaysia, Korea, and China have a higher percentage of corporate bonds to GDP.

Consequently, there is a tendency to adopt lopsided structures in the form of over-reliance on equity. While the government uses tax revenues and PSUs surplus to fund infrastructure, a large percentage of capital requirements in the private sector too are met through equity and bank finance.

Of the total expenditure of the Eleventh Plan (2007-12), nearly 52 per cent is likely to be financed through internal accrual/equity primarily appropriating the internal and extrabudgetary resources of the PSUs. For private sector, the share of debt is relatively less at 30 per cent. Of the total debt requirement at Rs. 9,88,035 crore (USD 247.01 billion), the actual availability during the Eleventh Plan period is estimated to be around 83.5 per cent. More than half of the total estimated resource flows are likely to come from bank credit, while close to 15 per cent is estimated to come from external commercial borrowings. The resource flow from pension/insurance companies, which is potentially a high source of long term debt, is expected to provide resources by less than 7 per cent.

Here one needs to understand that bank credit is not the answers to all funding requirements. The credit extended by commercial banks is also restricted through exposure norms. Say for example infrastructure, finance requirements

cannot be filled by banks alone but would have to be met by financing from long term debt finance. Infrastructure financing brings additional risks in view of their long term nature and is not good for the banks from an asset-liability management perspective to increase their exposure excessively.

Participants in FICCI's committee on Corporate Finance and Capital Market, which met in August and November last year, respectively, spoke unequivocally about the need to correct this lop-sided balance sheets arising out of a lack of a long term sources of funding i.e. debt and diversity of fund sources, which in turn impairs their rating as banks find them over-leveraged. In an urgent need to diversify availability of financial resources from sources other than Banks the committee emphasized the need for the development of the Corporate Bond market.

Following the recommendations of the High Level Expert Committee on Corporate Bonds and Securitisation (chairman: Dr. R H Patil), hailed as the "Bible of Debt market" numerous



steps have been taken both on the primary issuance side as well as to smoothen the secondary market trading process for corporate bonds. However, if foreign investment remains substantially underutilized even after permitting up to a limit of USD 15 billion, there is something somewhere going wrong in the debt market space.

The committee highlighted the following issues that the regulators should further push for having a vibrant bond market:-

- ❖ Non-existence of a standardized trading platform and a central clearing house.
- ❖ Stamp duty is complex and variable between locations leading to increased cost of stamp duty. The stamp duty for a typical debt issuance is 0.25% of the total issue size. In addition, the taxes are non-uniform across the states. The level and complexity of stamp duty also encourages an arbitrage-based approach and hence, the investment decisions by the investors at times are purely driven by tax considerations.
- ❖ The total issuance is highly fragmented because of the dominance of private placements.
- ❖ The number of participants in the market is relatively small and there is little diversity of view, and hence little incentive to trade.

- ❖ Retail participation remains low due to lack of knowledge and understanding of bonds as an asset class.
- ❖ Life insurance companies and pension funds, which have incentives in investing for longer tenor, are governed by strict investment norms.
- ❖ Lack of risk management/hedging products, the interest rate derivative market is not well developed due to existing regulations. There is a need for the introduction of a CDS market to hedge/manage the credit risk.

Authorities have set the ball rolling...

The Reserve bank of India did its bit by allowing participants to undertake repos in corporate bonds, recently. This is a momentous leap that would add much warranted liquidity in the corporate bond market. Only listed corporate debt securities, which are rated "AA" or above by a rating agency is eligible for repo. To contain leverage, a minimum haircut of 25 per cent has been stipulated and selling of borrowed securities under repo has not been allowed during the period of repo.

The mechanism of doing a repo in G-Sec and corporate bond is quite different and it comes with a few caveats. Repos in corporate bonds carry considerable risks that get



amplified in the light of the state of the underlying cash market in corporate bonds. In normal times, the repo borrowing is cheap and rollover is easy whereas during periods of financial stress, the rollover becomes difficult, leading to a liquidity crisis. The risk of the illiquidity of the underlying asset leading to the drying up of repo markets is accentuated during periods of financial crisis.¹

How to keep the ball rolling...

Liquidity is a function of diverse investors base and instruments being traded; while repo has been permitted in corporate bond, the issuer market is still highly rated large corporates and you just cannot go beneath triple A, it is not easy for a double A company to go for a long tenure bond. So, creating a niche

market that goes beneath the large high rated ones is a forgone ask.

Need for integrated trading and settlement

In equity the global standards have already been reached as there is novation (albeit without a legal basis) and settlement under DVP III. Currently, the settlement of transactions relating to G-Secs, Market Repo, CBLO, FX-spot and forward are settled on guaranteed basis through CCIL.

In the case of corporate bond, DVP III settlement system whereby you are able to at least net off the payment obligations across various trades for counterparties should be used once the market matures. Hence a central clearing counterparty backed payment and settlement system for the clearing of a corporate bond contracts is a highly desirable.

We have taken the first step, which is the DVP-I. This basically means that the settlement is happening on a trade-by-trade basis. If we are able to reach to that stage for corporate bonds as well, it will create a higher level of efficiency for the corporate bond market and reduce daylight risk – a variant of settlement risk, when a party faces possible loss between the time a settlement payment is made and a corresponding payment is received (usually in another currency) on the same business day.

Tax incentives

From the issuer point of view, corporates currently find it easier to tap retail funds through the fixed deposit market or even equity markets; it costs them significantly lesser amount of time and money to tap. There is no reason why this market should not be available through an instrument-the corporate bond, in a format that is easily tradable and passable in terms of title to that particular bond from one retail holder to the other.

The point here is about how do you incentivize the retail investor to invest into this format vis-à-vis any other format because from a risk perspective, the investor is still taking the same risk, which is where in our opinion a tax advantage or a tax arbitrage would be a adequate incentive. The tax free or the tax arbitrage bonds from some of the public sector undertakings (PSUs) and financial institutions have actually seen a lot of healthy retail demand and which is why there is no reason why this cannot extend into the corporate space.

Awareness among investors

Retail debt market would take time to develop and it would require great deal of efforts in educating investors about the advantages of investing in debt instruments. But a start has to be made in this direction. Retail investors in India prefer to invest



mainly in instruments with relative safety, though by doing so they compromise on the liquidity front. To mitigate this problem and with a view to encourage wider retail participation, trading was introduced in government securities for retail investors on stock exchanges in 2003, which has failed to pick up.

As far as investments in debt instruments with private firms are concerned, investors, by and large, are not aware of the role and responsibilities of a debenture trustee. Suitable education programs, including advertisements, should be launched about the role and responsibilities of debenture trustees. SEBI should issue suitable guidelines for providing wide dissemination of information/reports including compliance reports filed by companies and debenture trustees, defaults if any and all other relevant information that are required to be brought to the knowledge of the investors.

Lack of risk management/hedging

Credit derivatives, in themselves, are a good risk management tools helping the investors to transfer/hedge their credit risk. Such ability to hive off unwanted credit risk encourages investors to hold bonds which otherwise they would have not been inclined to hold, thus enhancing the liquidity in the markets. The problem, however, arises when the products do not remain what they are originally intended to be. If these products disconnect themselves from the real sector and start behaving as standalone products, they could set a perfect stage for perverse incentives to set in, as we have observed in the recent times.

Credit derivatives are obviously not the instrument to blame *per se*, it was largely to do with leverage. RBI's working paper² on CDS effectively takes care of all the excesses that the

West has gone through, though, the instrument has not been a non-starter after a series of delays, till date.

For the corporate bond market to be a vibrant and the liquid one, you need the ability to hedge the market and the credit risk. The ability to hedge the market risk is very much there though it is only till the five year point and becomes progressively illiquid beyond that but the ability to strip out the credit risk and transfer that onto someone else is just not there and which is where we do think that some form of credit enhancement or the ability to strip credit risk out would help.

Going forward there is a need to have uniform stamp duty, product standardization, and most importantly gradual removal of restrictions on long-term investors such as insurance companies and pension funds. Articles in the next few pages will highlight these issues in greater details.

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Perspectives on Corporate Bond Market in India

Y M Deosthalee- CFO & Member of the Board, Larsen & Toubro Limited



A well-developed capital market consists of both the equity market and the bond market. In India, equity markets are more popular and far developed than the debt markets. The ratio of equity market capitalization to GDP is around 100%, whereas that of bond market is only around 40%.

US has the largest debt market in the world. It is also the most developed in terms of variety of instruments ranging from Municipal bonds, Treasury bonds, Federal Agency Securities bonds, Mortgage related bonds, Asset-backed bonds to corporate bonds. Among the other countries UK & Japan have a strong corporate debt market and among the developing countries perhaps South Korea has a reasonably well-developed bond market.

The Indian debt market is composed of government bonds and corporate bonds. However, the government

bonds are predominant (constituting 92% of the volume) and they form the liquid component of the bond market. Although we have the largest number of listed companies on the capital market, the share of corporate bonds in GDP is merely 3.3%, compared to 10.6% in China, 41.7 in Japan, 49.3% in Korea among others. Further, close to 80% of corporate bonds comprises privately placed debt of public financial institutions. The secondary market, therefore, has not developed commensurately.

Total corporate bond issuances by Indian companies in 2008 stood at around \$37 billion as against \$185 billion by South Korean companies and \$748 billion by US Companies. Average daily trading volume in the Indian corporate bond market was only around USD 0.25 billion in 2009 (till October) far lower than USD 17 billion in US.

Development of Indian Debt Market

Over the past few years, some significant reforms have been undertaken to develop the bond market and particularly the corporate bond market. The listing requirements for corporate debt have been simplified. Issuers now need to obtain rating from only one credit rating agency unlike earlier. Further, they are permitted to structure debt instruments, and are allowed to do a public issue of below investment grade bonds. One more welcome change was the exemption of TDS on corporate debt instruments issued in demat form and on recognized stock exchanges. As a result of these reforms, the volume in the primary market has increased by almost 150% over the last four years from Rs. 634 billion in FY 06 to Rs. 1,597 billion in FY 09.

Though there has been an increase in the volumes, the trading activity is still negligible in the secondary markets. If we look at the ratio of secondary market volume to primary market volume, the ratio is below 1 indicating very low trading activity in the secondary market.

In a recent move, SEBI has stipulated that all trades in corporate bonds would now be routed through stock exchange platform. This would help in reducing settlement risk and reduce transaction costs. At the same time the exchanges would document the trades, thus creating transparency as well as assist in price discovery. The transparent dissemination of corporate bond prices and quantities traded will also facilitate better participation by market participants. To add liquidity and depth to the market, the RBI has recently released for debate the 'Draft Guidelines on Repo in Corporate Debt Securities'.

Need for an active Corporate Bond Market

A well run and liquid corporate bond market can play a critical role in supporting economic development. There are many other factors driving the need for a robust corporate debt market:

- ❖ The bond markets exhibit a much lower volatility than equities and are vital for the financial stability of an economy.
- ❖ A reasonably well developed bond market could supplement the banking system in meeting the requirements of the corporate sector for long term capital investment and asset creation.
- ❖ Although banks are the largest recipients of savings in the economy, their long-term lending is constrained by the regulations relating to debt issuance and asset-liability management.
- ❖ Huge requirement of financing in infrastructure sector which cannot be met alone by banks / NBFCs.
- ❖ A developed bond market can be an appropriate route of channelizing the savings of the country in capital formation.

What needs to be done?

While there have been some important steps in corporate bond market development, a lot needs to be done. Some of the issues which need to be addressed are as under:

- ❖ International experience shows that Institutional investors play a key role in the market. It is

believed that foreign participation in these markets wherein the ceiling has been raised to \$15 billion annually gets impacted due to the imposition of the withholding tax of 20%. A rationalisation or removal of this tax could attract more inflows. Analysts say a similar measure by South Korea in May 2009 has already helped it in attracting more foreign funds. Net purchases of Korean bonds by foreign investors rose to 9.5 trillion won (\$7.7 billion) in June, from 3 trillion won in May.

- ❖ Another hurdle is the Stamp Duty, which is high, typically 0.375% and on an ad-valorem basis. There is no volume discount and it varies across states, issuers, and investors.
- ❖ There is also a need for Market Makers in the corporate debt segment. Otherwise the issues of price discovery and liquidity would not be realistically addressed. The risk of default for



corporate paper too can be mitigated to some extent by the market makers. This does not call for the creation of new institutions to add to the existing plethora. Since India already has an established system of Primary Dealers, it should be possible to utilise the same for good corporate paper. As a pilot project some PSU debt paper could be assigned to the existing PDs for market making. Once this gets established the list could be expanded. Needless to say, the PDs would require some fund back-up for this activity.

- ❖ A bigger issue for corporate debt would be credit risk or the risk of default. This is apparently one of the main concerns of foreign investors. We need to evolve a system as it exists in the equity market, wherein the exchange clearing houses and depositories guarantee the settlement. Although there are indirect mechanisms such as credit default swaps for the same, it could be suggested that the existing depositories could extend their operations to include some good PSU paper at the outset and cover the credit risk to kick start this market segment. The scheme could be expanded depending on this experience.

- ❖ The investment guidelines for the provident and pension funds need to be rationalized and they should be allowed to invest on the basis of rating rather than in terms of category of issuers. This may encourage these funds to invest in high quality corporate bonds.
- ❖ Measures should be taken to encourage public offers and encourage retail participation. The extent of retail interest was evident in recent issues by Tata Capital, L&T Finance, Shriram Transport Finance.

In this context, it is required that a roadmap should be drawn for development of the corporate debt market in India that would acknowledge the current structure of the market and address the above mentioned issues and problems. For the complete development of a deep and liquid corporate bond market, steps should be taken to create not only an enabling mechanism to encourage primary issuance of debt but also create an environment that would increase secondary market activity.

Going Forward

India meets many of the pre-conditions which are required for the development of a corporate bond market. It has a legal framework in place to provide for regulatory oversight & investor protection. It has the required infrastructure in place and has world class stock exchanges for trading, clearing & settlement systems. Over and above, there is a need of long-term funding for infrastructure development and corporate growth.



Corporate bond market in India: unlocking the potential

N S Kannan, Executive Director and CFO, ICICI Bank



Overview

A well-developed capital market comprises deep and liquid equity and bond markets. While the equity capital market in India has grown manifold aided by progressive reforms, world-class infrastructure and a wide range of market participants, the corporate bond market in India is still relatively underdeveloped. Currently, most Indian corporates rely on bank loans for their debt funding requirements. This has not only led to concentration of credit risks within the banking system, but has also discouraged most companies from accessing debt capital markets. The recent global credit crisis and the cyclical investor interest in equity primary issues have highlighted the need to develop a vibrant domestic debt capital market, as an alternative funding source.

Corporate India's growth potential can be fully realized only if we can assure adequate access to affordable capital. A robust corporate bond market can play an important role in providing the much-needed alternative source of funding to the private sector, including for critical infrastructure projects. This would not only result in increased efficiency in channelizing the country's savings to spur capital formation, but would also reduce financing costs for corporates, improve transparency in pricing of credit risk, and increase the efficiency of domestic capital markets as a whole.

Market characteristics

Traditionally, the bond markets in India have been dominated by sovereign borrowings. While the Government bond (G-sec) market in India has grown exponentially in the last decade primarily due to structural changes introduced by the

Government and the Reserve Bank of India, similar impetus has been lacking in the corporate bond market. The domestic corporate bond market has lagged the G-Sec market in terms of growth due to various reasons including the following:

- ❖ Corporates, due to favorable external environment in the recent past, have availed of cheaper international borrowings through the ECB and FCCB routes. (However, following the global credit crisis, such external funding dried up, leading to increasing interest from corporates in raising funds from domestic market.)
- The lack of efficient market infrastructure has also been a constraint to the growth of the corporate bond market in India. A high level expert committee headed by Dr. R. H. Patil set out a commendable blue-print for development of the corporate bond market and addressed many

policy level and market infrastructure concerns. Many recommendations made in the report such as simplifying disclosure and listing requirements, establishing a trade-reporting platform, abolition of TDS on interest income in corporate bonds have since been implemented. However, implementation of the other recommendations now needs to be expedited and if implemented, these measures will increase the efficiency and participation in the corporate bond market.

The table below depicts the comparative growth of resource mobilisation in the G-sec and corporate bond markets in India.

Resource mobilization in the bond market (Rs. bn)		
Year	Central Government Securities ¹	Corporate Bonds
FY2004	1,215	484
FY2005	800	554
FY2006	1,310	818
FY2007	1,950	938
FY2008	1,560	1,154
FY2009	2,610	1,743
Fy20102	3,250	1,025

1. Dated securities excluding MSS; 2. Data upto October 31, 2009
Source : CCIL, Prime Database

The primary corporate bond market is dominated by high-rated issuers such as banks/term lending institutions (52%) and non-banking finance companies (18%). Fund raising by manufacturing and other service industries through this

market remain relatively small. Though issuances from private sector has increased from 9.7% of the total issuance in FY2006 to 30.1% in FY2009, a majority of Indian firms still view bank finance as the major source of meeting their debt funding requirements. Recently, there had been increased supply from corporates rated AA-/A+. The market appetite for such lower rated corporate issuances is greater for shorter tenors. Also, there had been significant interest in recent public issues from retail investors.

Liquidity in secondary markets is essential for the transparent price discovery of credit risk. The long-term corporate bond market is dominated mostly by long-only investors like insurance companies and pension/provident funds leading to constraints in terms of trading liquidity in the Indian market. Such investments by investors are primarily driven by the mandated regulatory guidelines and the liquidity position of the investors. However, recent data show increasing liquidity in secondary markets and is encouraging for market development. According to SEBI, the total trading volume in the secondary corporate bond market has increased from Rs. 961 bn in FY2008 to Rs. 2,207 bn in FY2010 (upto November 2009), a CAGR of over 50% over the last two years.

Secondary market volumes (Rs. bn)		
Year	Central Government Securities	Corporate Bonds
FY2008	16,547	967
FY2009	21,651	1,487
Fy20101	20,933	2,207

SEBI, CCIL 1. Upto November 30, 2009

Market participants

While insurance companies, provident and pension funds dominate purchase of long-term bonds, mutual funds are mostly active in short to medium term bonds. Banks and primary dealers are active across the maturity spectrum and play a vital role in market making, arranging primary issuances and supporting the secondary market. Corporate treasuries may also invest in short term bonds on a selective basis and other similar instruments to manage liquidity and investment returns. Due to limited public issuance of bonds, retail investors access the corporate bond market primarily through investments in debt/liquid funds offered by asset management companies.

India has a fairly developed equity capital market and a growing



number of listed corporate entities, who can access the bond markets for their funding requirements.

Regulators realize the significance of a vibrant corporate bond market and have in the recent past taken some steps to deepen the same.

Recent initiatives

- ❖ With a view to mitigate counterparty settlement risk, all OTC corporate bond transactions need to be cleared and settled through the NSCCL/ICCL platforms with effect from December 1, 2009.
- ❖ Disclosure requirements have been simplified for listed companies with a view to encourage wider issuer participation, thereby reducing the time to list debt securities.
- ❖ Fill investment limit in domestic corporate bonds has been increased from USD 6 billion to USD 15 billion.
- ❖ RBI's second quarter review of the credit policy in October 2009 has indicated release of final guidelines for corporate bond repos. RBI has already issued draft guidelines in this regard and sought feedback from market participants on the same.
- ❖ Proposed changes to PF guidelines as approved by the Ministry of Finance provide room for greater allocation to bonds issued by private sector.

These measures are expected to result in greater market depth as well as efficiency. However, there still

remain certain measures that could be undertaken for the development of the corporate bond market.

Recommendations for the development of corporate bond market

Market demand/supply

- ❖ Stamp duty reform: Currently, the stamp duty for the creation of security for secured debentures varies from state to state. This creates market distortion for issuance of such debentures, where the creation of security is concentrated only in certain states having favorable stamp duty regime. Also, the stamp duty rates in certain states are quite high, which hinders the growth of corporate bond issuances in those states. To mitigate this, it is recommended to establish a uniform stamp duty across states for issuance of secured debentures. Alternatively, while states may be given the freedom to set stamp duties, a cap on the stamp duty amount can be established.
 - ❖ The proposed changes to PF guidelines provide room for greater allocation to bonds issued by private sector. However, the guidelines are yet to be implemented. Hence, the same are not currently being followed by a large number of Pfs.
 - ❖ Currently, corporate bonds do not qualify for HTM category benefits and such investments have market-to-market implications for banks.
- ❖ In order to incentivize banks, it is recommended to provide HTM category benefits for corporate bonds, which would further encourage investments in corporate bonds by such market participants. This may be done particularly for priority sectors like infrastructure, where there is likely to be a large demand for long tenor, fixed rate funds. While this measure will address the issue of more demand from banks, it may not address the trading liquidity issue.
 - ❖ Introduction of credit derivatives: The absence of credit derivatives lead to concentration of credit risk among few market participants. While RBI had issued draft guidelines in 2007 on the introduction of credit default swaps in India, the final guidelines were postponed. The recent credit policy mentions about the proposed introduction of single-name credit default swaps in India subject to appropriate safeguards. The introduction of credit derivatives would not only enable market participants to hedge credit risk,





but also allow banks and financial institutions to manage their balance sheet better, thereby enhancing market depth.

- ❖ **Withholding tax for FIIs:** While the investment limit in domestic corporate bonds by FIIs has been increased from USD 6 billion to USD 15 billion, the withholding tax acts as a deterrent to most FIIs. As per section 115 AD of the Income-tax Act, 1961, for bonds which are issued by an Indian company and are subscribed by FII's, the income of the FII will attract tax as per Indian Income-tax laws or as per Double Tax Avoidance Agreement (DTAA), whichever is beneficial. However, since some of the FIIs may belong to jurisdictions with which India does not have a DTAA, they would be disincentivised to invest in Indian bonds due to double taxation on income. It is

recommended to repeal withholding tax with a view to encouraging greater participation by FIIs.

- ❖ Most of the large corporate bond issuers currently tap the primary market frequently, leading to multiple outstanding bond series, thereby rendering the older issues illiquid. To enhance liquidity and greater market participation, corporates may be encouraged to reissue more corporate bonds under the same ISIN. Such re-issuance of corporate bonds would ensure increased floating stock in the secondary market, thereby reducing the illiquidity premium on such bonds.

Market infrastructure

- ❖ Currently, different issuers adopt different practices for day count conventions, face value and shut periods for their bond issuances. This leads to confusion among investors due to multiple interpretations. Standardization of such parameters would help in improving secondary market liquidity. Also, the Exchanges would need to ensure adherence to such standard market conventions as mandated by SEBI.
- ❖ SEBI and RBI have recently come out with the guidelines for clearing and settlement of trades in corporate bonds through Clearing Corporations. However, settlement mechanism between the settlement entities will also have to be put in place. It is

important to note that there is no integrated trading and settlement system for corporate bonds (like NDS Order Matching system for G-Secs). Establishment of an integrated trading and settlement system is integral to the development of the corporate bond market.

- ❖ A central body should track and maintain a comprehensive database on primary issues and rating migrations, which is needed for wider dissemination of market information.

Conclusion

A robust domestic corporate bond market can be associated with greater transparency, price discovery, credible rating agencies, a wide range of corporate debt securities, efficient disclosure norms for corporates and a wider range of investors with varied risk profiles. This would not only help create an important alternative funding source in times of disruptions in sources of external financing, but would also reduce the cost of capital for corporates. It would also diversify sources of debt funding for corporates and enable greater transparency in pricing of credit risk. For creating a vibrant and transparent corporate debt market, it is important that appropriate policy reforms are introduced to put in place necessary market infrastructure that facilitate the growth of an active primary and secondary corporate bond market.

Indian Corporate Bond Market

Tarun Kataria, Head-Global Banking & Markets, India, HSBC



The INR Corporate Bond Market: An Overview

The Indian bond market has historically been dominated by bonds issued by the Government of India (GoI). Traditionally, bank loans have been the primary source of credit for the domestic corporates. Bond issuances have been the exception rather than the primary source of funds, due to the lack of a diverse investor base. Government Bonds on the other hand have enjoyed regulatory benefits including imposition of the Statutory Liquidity Ratio which mandates investments by banking institutions, as well as demand from insurance and pension/ provident funds which are required to invest a certain proportion of their asset base in these.

However, the current decade has seen an increasing issuance volume

and appetite for non-sovereign debt fuelled by strong credit demand from financial institutions and manufacturing as well as the emergence of new classes of investors such as mutual funds and insurance companies.

Certificates of Deposits and Commercial Paper

Along with Treasury Bills (91, 182 and 364 day issues by the Government of India), Commercial Paper and Certificates of Deposits comprise the sub-one-year tenor portion of Indian Debt Market. The exploding consumer and commercial credit off-take (Table 1) in the country has led to a burgeoning requirement for short term credit from banks and financial institutions.

The secondary market for CDs and CPs is primarily a broker-driven market with moderate levels of liquidity. The yields and liquidity in

these instruments are highly influenced by technical factors like short term liquidity in the financial system. Investors in these instruments are typically mutual funds and financial institutions that seek to deploy short-term liquidity or capital.

Corporate Bonds

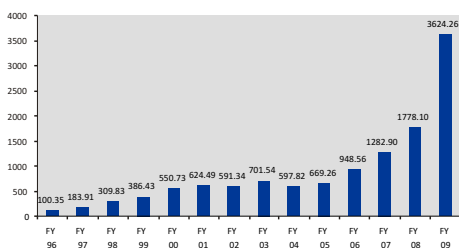
Corporate Bonds can be broadly classified as those issued by:

1. Banking Institutions
2. Non-Banking Financial Institutions (both central and state)
3. Central and State Public Sector Enterprises
4. Corporates (Manufacturing and Others)

SLR is the proportion of Net Deposits and Term Liabilities that banks are required to invest in Government Securities.

The yield and liquidity of the issues vary across the issue categories. . This market is primarily driven by private placements and it is estimated that over 90% of debt issues are placed privately. A major constraint to liquidity in this market has been the absence of a diverse investor and issuer base. The demand is pre-dominantly for highly-rated issues and investors are limited to insurance companies, pension funds and commercial banks. Banks and Insurance companies are limited by restrictions on the amount of investments they are allowed in corporate paper. In spite of these drawbacks, the market has shown significant growth and the issuance volumes have been trending upwards. (Chart 3)

(Chart 3) Corporate Debt Issuance (INR Billion)



Source: Prime Database



Investor Base

The major investors in the rupee debt markets are:

1. Banks and Financial Institutions
2. Insurance Companies
3. Mutual Funds
4. Pension Funds
5. Foreign Institutional Investors (FIIs)

Reforms in the Corporate Bond Market

The evolution of Government securities market has an important bearing on the development of the corporate debt market, though the latter is not yet developed, for reasons stated above. The Government securities market had the benefit of unrelenting support from the Government and the RBI for obvious reasons. On the other hand, the corporate debt market did not enjoy a similar patronage. Some of the reforms in this area are as follows:

1992: Government abolished the ceiling on the interest rate that erstwhile Controller of Capital Issues used to stipulate for issuance of corporate debentures

1994: NSE started trading in debt instruments through its WDM segment. However, WDM has been mostly used as a reporting platform

for the deals on the OTC market. The WDM segment of BSE commenced operations in 2001.

2009: Corporate Bond settlement through NSCCL. This has removed much of the counterparty risk from the system and made the settlement procedure more robust.

2010: Corporate Bond Repo: RBI has announced the permissibility of Corporate Bond Repo between the market participants. The facility is now in process of implementation.

Problems with the Development of the Corporate Bond Market

Corporates - Bank financing versus bond financing: Till the early 1990s, the Indian Corporate sector was sourcing its long term funding requirements - from the so-called development financial institutions (DFIs such as Industrial Development Bank of India (IDBI) and ICICI) and from commercial banks for their short term requirements, working capital requirements. Development of the capital markets facilitated disintermediation and companies started tapping the bond/debenture markets in the 1990s. However, the disappearance of development financial institutions, which were the main source of long term finance, caused a vacuum. While, this should have been a great opportunity for developing a bond market, this

surprisingly did not happen. Corporates resorted to their growing internal resources, raised resources through low cost equity taking advantage of the equity boom, borrowed abroad taking advantage of low interest rates and wherever possible, approached the long term debt market through the private placement route. Further, in the absence of hedging avenues, bond financing turned out to be more risky and less flexible in comparison with bank financing.

Risk Management: The derivatives markets in India are not sufficiently developed to enable both issuers and investors to efficiently transfer the risks arising out of interest rate movements. Though markets exist for interest rate swaps and interest rate futures, the number of participants is limited and the market is not broad and deep. The primary cause for this situation is the lack of a term money benchmark, which restricts the development of the swap market as well as an efficient term money market. Interest Rate options either exchange traded or OTC are not permitted. This, combined with Mark-To-Market regulations deters banks from investing in corporate bonds. Banks therefore show a distinct preference towards traditional lending which permits them to change their Prime Lending Rates (PLRs) based on their cost of funds, which includes changes on account of interest rate

movements and therefore their cost of deposits. .

Tax Deducted at Source (T.D.S): In the case of corporate bonds TDS is deducted on accrued interest at the end of every fiscal year as per prevalent tax laws and a TDS certificate is issued to the registered owner. While insurance companies and mutual funds are exempt from the provisions of TDS, other market participants are subject to TDS in respect of interest paid on the corporate bonds. Interestingly, TDS was viewed as a major impediment to the development of the Government securities market and was abolished when the RBI pointed out to the Government how TDS was making Government securities trading inefficient and cumbersome. Besides efficiency issues, the different treatment meted out to insurance companies/mutual funds on the one hand and other market participants on the other also makes it difficult to introduce a uniform computerized trading system

Stamp Duty: Stamp duty is a significant source of revenue for State governments. The Indian Stamp Act is an enactment of the central government. States have powers to make amendments to the Act. Section 3 of the Stamp Act stipulates that stamp duty has to be paid as per Schedule I to the Act. States have by way of amendment have introduced schedule IA to the act with



differential stamp duty payable in different states. Duty is levied on financial instruments both at the time of issuance or on transfer or on both depending upon the nature of the instrument, issuer etc.,. These duties are perceived to be very high and act as a deterrent to the development of the bond markets. Promissory notes attract much lower duty. In the interest of developing the corporate bond market, there is a pressing need for rationalization of the stamp duty structure across the country. Since stamp duty heavily impacts the cost of issue of bonds and debentures, it would be desirable to reduce stamp duty levels and also introduce a suitable provision which stipulates the maximum amount of stamp duty that is payable in respect of any single issue. This will not only bring down the cost of issuance but will also lead to the creation of a single stamp duty rate. As has been mentioned earlier, the stamp duty is generally levied by each State Government, and they differ across



States. Hence there is a need to take the State governments into confidence to rationalize the duty structure. Further, the stamp duty applicable for a security differs on the basis of the class of investor. This discourages corporates from issuing bonds to certain class of investors like retail investors (either directly or through mutual funds), and to long-term investors like insurance companies, provident and pension funds.

Fragmentation: Size of individual debt issuances is generally small. There is no cap on the number of issues a company can make. Corporates, especially the medium and small ones, prefer to raise resources as and when required on cost considerations. In addition, they take recourse to the private placement route, which leads to creation of large number of small issues. Corporates thus tend to go for

multiple issues primarily to avoid the hassles involved in going through the public issue route as also to limit the issue size to their current requirements. (Under the extant guidelines, if a bond issue is to be sold to 50 or more investors, the issuer has to follow the public issue route which is cumbersome, costly, and time consuming). This results in fragmentation of issues and is not conducive for the development of a liquid bond market. This however, could be corrected through regulatory caveats or by making public issuance structure simpler.

Information: Information is key to price discovery. While at a broader level, spreads on a corporate bond ought to be decided on the basis of its credit rating and the sovereign yield curve, this is not necessarily the case in reality, on account of subtle credit differences, liquidity in the paper and mandated investments which create preferences for certain issuers. Therefore, bonds with the same rating but issued by different issuers trade at different prices and in the absence of credit migration matrix it is difficult to assess the probability of default for a rating class and vice versa, price a bond based on its probability of default..

Furthermore, a centralized information system for historical trade data is required to track the change in spreads and prices on account of a variety of factors, which

is not available to date in India. Such information would help both issuers and investors in fair pricing..

Trading in corporate bonds, though mandated to be reported to the Stock Exchanges, remains an OTC market. Price discovery therefore continues to remain inefficient.

Market Practices: Uniform market practices are a prerequisite for efficient markets. This is, however, not the case in Indian markets. For instance for a trade on stock exchange like the WDM segment of NSE, the minimum amount of trade is Rs. 1 million. However, OTC market transactions, are flexible in terms of the deal size.

Coupon conventions also differ (such as Actual/360, Actual/Actual etc.,) leading to problems in settlements. Bodies like the Fixed Income Money Market Derivatives Association (FIMMDA) has developed some standardized practices. However, as FIMMDA is not yet a Self Regulatory Organization (SRO), these practices are merely recommendations at the best and are not being followed by issuers at large. While the CCIL has recently been made the central counterparty for all trades settled between market counterparties on a DVP-I (Delivery Versus Payment) basis, the system is yet to graduate to a true DVP settlement system (DVP-III) . The absence of multilateral netting also reduces the liquidity in the market.

Market Makers: The role of market makers is significant in an incipient market but it is easier said than done. Since market makers are supposed to add diversity to the market, they assume a lot of risk in such a market and need to be backed up, both in terms of financial resources and the supply of securities. Currently the Indian markets do not have a class of such market makers in the corporate debt markets. To create such a class of market makers, one solution is that the investment banks that help corporates to raise money from the market can possibly be roped in to market making in the bonds, which they have helped in issuance, However, lack of adequate compensation from issuers and/or the market is a disincentive for such a system to develop. Most issuances in the Indian market pay only very negligible fees or in most cases no fees at all. Thus, the "arrangers" of debt issues in most cases attempt to sell the issued securities on a back-to-back basis to investors or hold these on the books only in cases where there is a positive interest rate or spread trading view.

This situation, along with the considerable information asymmetry and lack of public information has also led to the development of a class of "arrangers" who distribute debt paper to smaller, non-wholesale investors such as small pension funds, upcountry co-operative and

rural banks as well as to High Networth Investors with large margins. This development is not necessarily healthy for the development of an evolved debt capital market.

Narrow Investor Base:

(a) In developed markets, provident and pension funds are large investors in corporate bonds. In India, these funds have been traditionally investing in Government securities on account of the preference for safety as well as a political preference against private sector debt and equity.. The guidelines issued by the Central Board of Trustees (which is governed by the Ministry of Labour rather than the Finance Ministry belies this preference) to these funds for their investments which are skewed in favor of Government securities, Government guaranteed investments and PSU Bonds. However, transparency in terms of pricing and credit worthiness of the borrowers would be necessary prior to a larger allocation towards private sector paper to prevent abuse of the system. In fact, there is a case to consolidate the investment function of small Pension and Provident Funds to achieve greater efficiency and professional management of these funds.



- (b) Co-operative banks are permitted to invest up to 10% of their deposits in PSU Bonds and only scheduled co-operative banks are allowed to invest in private sector bonds. Allowing all co-operatives banks to invest in high quality corporate bonds would assist the development of the debt markets. However, as in the case of pension funds, there needs to be a more credible price discovery system as a prerequisite for the opening up of the investment norms for such banks.
- (c) Retail investors' participation in tradable fixed income securities is very negligible. One of the reasons is higher interest rates offered on the Government's own small savings scheme, which is being addressed by bring these rates to align with market rates. However, the minimum trade size, transaction costs and illiquidity of bond markets hamper the involvement of retail investors in this market. While

internationally individual investors participate in the bond markets through Mutual Funds, the pre-occupation of the mutual fund industry with wholesale investors and their hunt for Asset Under Management (AUM), have led to the small investor being largely ignored by the industry. Sustainable development of the Mutual Fund industry itself necessitates a re-orientation of priorities, which the SEBI has been pushing towards. However, development of appropriate products and innovation cannot take place by regulatory fiat. In fact, the Fixed Income Plan (FMP) product was an ideal offering for the retail investor, the attractiveness of which has been greatly diminished on account of

recent regulatory developments. The regulatory injunctions were in turn the result of poor risk management practices by the fund industry itself.

- (d) FIs do not have a large presence in the debt markets. They use the debt markets for parking the funds temporarily and for portfolio management in a limited way, along with short term arbitrage activities. The reasons for these are the current tax laws and regulations on hedging their foreign exchange risk. FIs unlike in the international market, cannot undertake asset swaps to hedge their foreign exchange risk but can only enter into forward contracts to hedge the principal amount of the paper invested in (or market value, whichever is higher). However, there is reluctance on the part of the regulators to genuinely address the requirements of FIs in the debt markets unlike the equity markets, based on the belief that large debt flows restrict the operation of domestic monetary policy. The increases in debt investment limits therefore remain a cosmetic measure with no real desire to open up the market.

markets in the country, these issues require to be addressed at the earliest. While the Reserve Bank of India and the Ministry of Finance are seized of the importance of the issue, the pace of reforms and establishment of an institutional framework for the market has been slow in comparison to what has been achieved for the Government Securities market. With the size of investments envisaged for the infrastructure sector, the gross capital formation required to maintain 8%+ GDP growth, efficient channeling of the relatively high domestic savings would be required. The need therefore to move ahead with the development of this market cannot be overemphasized.



Given the acknowledged importance of the corporate bond markets as a part of efficient and deep capital

Indian Corporate Bond Market on a stupendous growth path

Vikram Kotak, Chief Investment Officer, Birla Sun Life Insurance



The Indian financial sector is rapidly transforming, marked by strong economic growth, robust markets and greater efficiency. However, compared to its world-class equity markets, India's corporate bond market is still in an embryonic stage, both in terms of the market participation and infrastructure. Since 1996 to 2008, the ratio of equity market capitalization to GDP has more than trebled to 108% while that of bond market has less than doubled to 40% of GDP. Out of this, the ratio of corporate bond market to GDP is merely 3.9%.

Amongst developing countries, it is, only South Korea that has a reasonably well-developed corporate bond market (61.8% of GDP). Total corporate bond issuances by Indian companies in 2008 stood at around US\$37 billion

against US\$185 billion by South Korean and US\$132 billion by Chinese companies. While primary issuances have been significant, issuer base is narrow and issuances are dominated by private placement and financial companies. The secondary market, therefore, has not developed commensurately. During FY09, average daily volume in corporate bond was merely ~0.1% of total issuances.

The evolution of G-Sec market has shown the impact that reforms can have on market development. It has grown at a CAGR of over 79% since the introduction of electronic trading. The RBI and Seri have been taking commendable measures to develop corporate bond market. Some of the key developments over the past decade include dematerialization of holdings, increased transparency from

compulsory reporting of trades, revamping of disclosure requirements for public offers and linking local rating agencies to international rating agencies. As a result of this, trading in corporate bonds increased by over 50% yoyo to Rs 1,48,747 crore in FY09.

In a much desired move, SEBI has recently stipulated that all trades in corporate bonds should be cleared and settled through the National Securities Clearing Corp (NSCCL) or the Indian Clearing Corp (ICCL) with effect from 1st December 2009. This move will immensely increase market volumes and encourage more companies to issue bonds since it will remove the settlement and counterparty risk and assist better price discovery. It will also facilitate repos in corporate bonds. Further, it will benefit investors, who are looking for alternate assets to



diversify their financial investments. Retail interest in bonds was seen in the recent Rs. 10 bn bond issue of Shriram Transport Finance Co Ltd, which was oversubscribed over 4.5 times within a day of opening.

To provide further fillip to bond market, the authorities are examining possibility of uniform stamp duty and speeding the issuance procedures. China's corporate bond market on local currency basis grew 90.9% yoy in the first half of 2009 encouraged by the shift in approval process which made it much quicker. Total issuance of Medium Term Notes in the first half of 2009 reached US\$ 64 bn, 251% of the 2008 issuances.

International experience proves that institutional investors are

mainstream traders of bonds once the market reaches a satisfactory level of standardization, transparency and depth. In no other economy, FII's can enjoy such high spreads in debt instruments as available in India. AAA corporate bonds are available at over 9% against 4-5% available elsewhere. Despite this, FII's have not fully utilized their investment limit of \$15 bn in bonds. They have invested US\$9 bn in debt market, which is less than 6% their current equity holdings of ~US\$140 bn. Aided by reforms on the front of clearing & settlement, improving market liquidity & ensuring better price discovery, FII's' participation in the corporate bond market may spur, providing them an incentive to stay invested if and when the down cycle in the equities take place, thereby marginalizing systemic risk posed by sudden outflow of foreign capital.

Steps towards creation of new markets such as exchange traded interest rate, foreign exchange derivatives contracts and plain-vanilla single-issuer Credit Default Swap will also add to market depth. Measures to encourage public offers and increase retail participation along with the development of market makers like that in

government securities will further aid market development. The 20% withholding tax on interest earned by foreign investors in local bonds should be lowered to lure foreign capital. Within a month of removal of withholding tax by South Korea (May 2009), net purchases of Korean bonds by foreign investors rose by over 300% to US\$7.7 bn.

From the perspective of developing countries like India, a vibrant corporate bond market can play a critical role in providing the much needed long-term funding for infrastructure development and corporate growth and help to divert country's savings to spur capital formation. In the recent global credit crisis, we saw a complete seizure of the overseas funding window (ECB, FCCB) for India Inc. A situation like this could have been averted if the country had a well functioning corporate bond market. In my opinion, the thrust laid by the authorities on the development of the corporate bond market will ameliorate the rules of the game and drive this segment of the financial market to a higher growth trajectory.

The Untapped Potential of Indian Corporate Bond Market

Joseph Massey, Managing Director and CEO, MCX Stock Exchange



India has an underdeveloped debt market. Especially the corporate bond market remains dormant. The debt market primarily comprises of government and corporate bonds, but is largely dominated by the former. The market for government bonds has grown over years on account of rising government borrowings and continuous regulatory reforms. Though corporate bonds market has expanded in size, the development has not been as impressive as in government bonds and it also suffers from illiquidity. India is a fast growing developing economy and hence the infrastructure sector needs huge financial funding, especially the long term resources.

When volumes in equity markets are thriving with average turnover of over Rs.23,000 crore in cash market segment and another Rs.70,000 crore a day in derivatives segment,

the SEBI data for corporate bonds during March „10 shows a reported turnover of less than Rs.3,300 crore, which may be multi-fold higher than the volumes witnessed 4-5 years back. The market cap of Indian equity market is around 110% of country's GDP. The market capitalization of outstanding corporate bonds in India as a percentage of GDP is just around 2.5% against 43%, 34%, 35% and 19% in Malaysia, Singapore, Hong Kong and Japan respectively. Corporate bonds constitute just over 4% of the total bond market as compared to between 40 to 50% in the above markets.

Typically, after issuance, the larger players "retail" their bonds to smaller pension funds and cooperative banks. Most of the trading is confined between financial institutions only. The development of a robust debt market brings more

confidence among foreign players in investing also in bonds with long terms. Though deals are mostly over-the-counter (OTC), transparency has increased significantly after the establishment of the reporting structure a couple of years back. Such information helps traders and others in knowing yield spread for a corporate bond over the benchmark gilt rate on a continuous basis and helps in efficient price discovery.

Road Blocks

The massive requirement for infrastructure funding necessitates India Inc to look at foreign investment apart from domestic resources. A robust domestic debt market facilitates raising such funds in the most efficient way. However, the corporate bond horizon stays less developed and less explored. Several factors have contributed to the dormancy in corporate bonds. Some



of the key factors are discussed in this write up. The market requires transformation towards development. This prompts expansion of issuer as well as investor base to bolster both supply and demand frontiers. With more depth in the market, we can also attract long term foreign investment on wholesome way.

Private placements

Most of the issues in the corporate bond market are private placements. They are made to a maximum of 50 qualified institutional investors with minimal documentation. These are small and hence several separate placements come up in the market amid the presence of smaller number of investors. On the other hand, public issues come up rarely in the market due to requirement of comprehensive documentation. Besides, the disclosure requirements were the same till recently for all companies, listed or unlisted. Public issues process is slow and the price is fixed throughout the offer period making it too costly given the marketing and the related costs

spread over time. Additionally, provision for shelf registration is absent. Hence, facility to cover a program of tranches by a single prospectus is also absent. However, in 2009, in order to simplify the regulatory framework for issuance and listing of pure debt securities for the purpose of development of primary market, the market regulator has notified the Issue and Listing of Debt Securities Regulations, 2008. The disclosures for listed entities were rationalised to make minimal incremental disclosures. Where the equity of an issuer is not listed, detailed disclosures, fewer than those made under the equity listing agreement, would need to be made.

Preference to bank funding

Because of high yield spreads differentials, corporates with AAA and higher ratings largely desire to tap bond market, while those with lesser ratings lean towards bank funding. The demand for corporate bonds from banks is limited, as they tend to prefer giving loans to buying bonds because the former need not be marked-to-market, which may give rise to possibility of unexpected demands on banks. capital. Banks can also escape interest rate restrictions and approvals if lending is done in the form of loans.

Efficient price discovery-the missing link

Right information is instrumental in efficient price discovery. Generally, the spreads on a corporate bond are decided on the parameters of its credit rating and the sovereign yield curve. However, that may not be always possible. Very often, bonds of same rating but issued by different issuers are seen to be trading at different prices. This prompts the need to have a centralized information system for historical trade data that can aid in efficient price discovery. In this regard, we need to continuously strengthen our credit rating agencies and the valuation companies.

Variable stamp duty

The biggest obstacle, however, is the stamp duty that varies across the states. Stamp duty has a heavy bearing on the cost of bond issue. Lower, rationalized and a clearly defined stamp duty would contribute significantly in expanding the corporate bonds market in a country. The stamp duty differential is also a major barrier to the development of securitization.

Regulatory Initiatives

SEBI introduced dematerialization of holdings in 2002. In 2005, the Report of the High Level Expert Committee on Corporate Bonds and Securitization suggested several desired improvements in the corporate bond and securitization

markets. Consequently, in 2007 SEBI relaxed certain norms pertaining to the issues. As a result, bond issues are no more required to be rated by two agencies and they also need not be of investment grade but SEBI prescribed having transaction reports and publishing volume data. This instilled more transparency in the market. In 2007, SEBI initiatives facilitated more comprehensive and compulsory reporting standards in the OTC bond market. Along with, documentation requirements for private placements have also been refined and made more comprehensive.

Raghurajan Committee (2009) on financial sector reforms recommended cutting down the transactions costs in issuing and trading corporate bonds, as well as reducing the required disclosures and adopting a shelf-registration scheme. The Committee also made a significant recommendation towards protection of the rights of unsecured creditors. Additionally, it has stressed on fostering conditions to reduce the preference of banks for loans by subjecting loans and bonds to similar mark-to-market requirements in aspects like interest rate exposure.

Several initiatives on the part of the regulators on the front of credit rating have also aided in fostering more transparency in the market. Local rating agencies including those

offering bond ratings have been linked to international rating agencies. Additionally, SEBI recently simplified documentation and disclosures. The publicly-listed companies on an Indian exchange are required to make only minimal additional disclosures for a public issue or a private placement; and while unlisted companies would have to give more disclosures related to debt instrument.

Of late, corporate bonds have been made eligible for undertaking repos, though with a margin of at least 25% and the maturity of repo deals could range from 1-day to 1-year. The clearing and settlement procedures have also been allowed through the platform of stock exchanges. Besides, RBI is considering the introduction of plain vanilla credit default swaps (CDS), which would provide hedge against default risk for investors.

Need for a Robust Exchange traded Secondary Market

With illiquidity and poor bankruptcy protection, buyers demand high rates. This prompts fund raisers to look for alternative sources like bank loans where costs are minimal. The larger corporate issuers have access to much cheaper funds overseas, debt capital in the form of external commercial borrowings (ECBs) and foreign currency convertible bonds (FCCBs).

Today, over 50 % of financial savings of households. goes in the form of bank deposits. In case of fixed bank deposits investors can liquidate before maturity with a penalty. Typically, such provision is absent in case of corporate bonds, where investors may have to hold on to the bonds for a long time, carrying the interest rate risk.

We may look at standardization of corporate bonds features among others for the development of an exchange traded outright and repo markets. Currently, the retailers are participating in debt market mainly through mutual funds and insurance firms. The strengthening of rating and valuation companies and market transparency would be the boon for the growth and development of the market. The liquidity in the secondary markets gives a relatively less expensive exit route to investor and thereby contributes to low yield spreads for issues and sustains investor confidence for a longer



period. The reduced yield encourages trading and lowers the incentive for holding till maturity. However, in the absence of exchange traded market, the exit route is not available.

This is a chicken and egg situation of where issuance and purchase of bond is dependent on low cost issuance and presence of exchange trade market but the exchange traded market is not active as neither there is enough paper and nor there is enough retail appetite for this paper in the absence of active secondary market.

Additionally, secondary market is not active as interest rate instrument are not active on exchanges and largely OTC traded. The correction can happen by gradually increasing the retail holding in government bonds by making bonds and broker sell government bonds through some incentive. This may marginally increase the cost of borrowing but it is worth considering the national market being created. Besides the retail investors could be initially offered shorter duration bond between 1 . 5years maturity where they get better yield than fixed deposits and there could be buyback mechanism for an investor if he intended to liquidate. This will create the pool of investors who could

come and use the exchange traded market as there is enough players to buy and sell at slightly lower rates and could hold bonds till maturity to get better yield. The corporate could also create similar feature for their borrowings so that there is a range of bonds and some assured exit mechanism. Corporate bonds could provide exit mechanism through surrender with an annual cap to prevent distortion but this assurance of buying back at discounted rates would be good confidence building measure. This could trigger an alternative window in exchanges also to price the bond and provide entry exit mechanism to investors. Corporates with lower rating could actually be prompted to use third party guarantee of buying bank so that is a cost an exit mechanism is built. Banks would be kee to provide this guarantee which is better than providing loan subject to necessary hypothecation.

Conclusion

More players can be brought into the system by fostering confidence among various agencies associated with capital markets. Investor base can be expanded by encouraging more bank investments and addressing price distortion and clearance issues. Investors are

reluctant to trade in bonds of private sector companies and those with lower ratings. Further, investors often lack confidence in the ratings agencies themselves. They are wary of the safety of their investments and they tend to reduce their exposure. This underlines the need to strengthen the rating companies and valuation entities and to instill confidence among the investors. Besides, to make corporate bond market liquid, there is a need also to have an active fixed income derivatives market.

It is therefore desirable to create new avenues and amenities in the capital markets, have relaxed regulatory and taxation regimes and disclosure requirements for corporate issues. Expansion of the investor base is a pre-requisite for having a well developed bond market in the country. This also demands streamlining the regulatory structure of the local currency bond market, encouraging innovation and competition in the market and promoting efficiency and liquidity. Only with a robust corporate bond market, our economy can achieve and sustain a robust two-digit growth rate in the coming years.

**DISCLAIMER: The views expressed in this article are those of the author and do not necessarily reflect the views of MCX Stock Exchange.*

Roadblocks and stimulants for India's corporate bond market

H.S.Sushil Kumar, Senior Manager, Business Development, CRISIL Ratings



Introduction

India is among the well-developed equity markets in the Asia Pacific region. Equity market capitalisation as a percentage of the gross domestic product (GDP) increased steadily to more than 100 per cent in 2008-09 (refers to financial year, April 1 to March 31) from a little over 20 per cent in 2002-03. In contrast, the corporate debt market in India is still underdeveloped: debt outstanding in the corporate bond market is barely 3 per cent of the GDP. Given that India will require around USD1 trillion to fund infrastructure during the Twelfth Five Year Plan period, it is crucial that the corporate debt market in the country be developed.

The global economic crisis that intensified in 2008-09 has had its impact on India. In the third quarter

of 2008-09, credit flow to companies ground to a near halt, with mid-term interest rates peaking at 14 per cent. Even companies rated highly by CRISIL paid interest of more than 11 per cent on medium-term debt instruments. However, India's corporate bond market had an unprecedented quarter-on-quarter growth of 130 per cent in primary debt issuances in the third quarter of 2008-09. The economic crisis thus served to highlight the importance of a robust and resilient debt market in India.

Policy makers have sought to elevate India's corporate bond market to the same pedestal as the equity market. Setting up a high-level experts committee on corporate bonds and securitisation was a step in this direction. Although the regulators have addressed some key issues

raised by the committee, these measures have not led to substantial development in the Indian corporate bond market.

This article highlights factors that impede the development of the Indian corporate bond market: these factors include the reluctance of investors to provide project funding, and unfavourable investor perceptions and regulations. The





article also suggests measures that will help the regulators address the investing community's concerns relating to credit and liquidity in the corporate bond market.

Low investor appetite for project funding

In 2009, India ranked foremost in the global project finance market. Corporates in India raised USD30 billion during the year, accounting for 21.5 per cent of the global market. However, the corporate bond market services a miniscule share of India's project funding requirements- projects in the country are funded primarily through a combination of domestic loans and international debt. The following factors have prevented the bond markets from capitalising on the surge in demand for project funding:

- ❖ Regulatory restrictions and internal investment guidelines prevent long-term investors from investing in corporates with ratings that are lower than the mandated minimum;
- ❖ Higher spreads for corporates rated in the 'A' and 'BBB' category (most project companies are in this category) make it comparable with that of a bank loan;
- ❖ Consortium banks and financial institutions act as one-stop shops for all financing needs of project companies, thus preventing companies from exploring bond options.

Provident funds and insurance companies are ideally placed to invest in long-term projects. However, provident funds prefer investing in Government of India (GoI) securities, instead, while insurance companies cannot invest in corporate bonds that are rated lower than 'AA'.

Most large infrastructure and greenfield projects, therefore, continue to be funded through loans or external commercial borrowings (ECBs).

Unfavourable Investor perceptions

India's corporate bond market has a healthy mix of domestic investors, including insurance companies, at the longer end of the yield curve, and banks and mutual funds at the other end of the curve. Although investment objectives vary from one investor category to another, investment decisions indicate the following patterns:

- ❖ A strong preference for highly rated debt instruments, as these are perceived to be liquid;
- ❖ Most investments are held to maturity, either because of internal policies or regulatory restrictions.

Another feature of India's corporate debt market is the absence of contrarians. The investor base in the debt market is small, the community is well connected, and well informed about other investors' preferences. Such familiarity pre-empts the emergence of contrarians. However, a combination of contrarians and conventional investors is required for the debt market to become vibrant.

Regulations

More than 90 per cent of the bonds outstanding in India consists of Govt securities. One reason for the smaller share of corporate bonds in the market is poor liquidity.

Regulators have sought to enhance the liquidity in the corporate bond market through several initiatives. The Reserve Bank of India's (RBI's) recent draft guideline on repurchase agreements (repo) for corporate securities is a step in this direction. These initiatives have provided a measure of relief to investors; however, active transactions are essential in the secondary market if the corporate bond market is to become more robust.

Infrastructure and greenfield projects are currently being funded through loans, rather than bonds. This is due in part to the regulations that currently govern bond market investments. Unlike loans, investments in corporate bonds have to be marked to market. For investors, this usually increases the volatility in earnings. Such a requirement does not apply to loans; banks, therefore, prefer loans over bond investments.

A recent (May 2009) circular from

the Securities and Exchange Board of India (SEBI) on simplified listing agreements for debt securities has clearly defined secured debt instruments as those with a security cover of 100 per cent. Issuers without the requisite security cover have to issue unsecured debentures, which carry higher stamp duties than secured debt instruments do.

Moreover, stamp duty varies from state to state: this is because stamp duty is a state subject, and an important source of revenue for the states, and is, therefore, outside the ambit of reforms for the development of the debt market. Although the regulators and policy makers have proposed to the Central government that the stamp duty structure be rationalised, a final decision by the government is still awaited.

Conclusion

In order for the corporate bond market to be vibrant and robust, the investing community's concerns pertaining to credit and liquidity need to be addressed. CRISIL recommends the following:

Addressing credit issues: In early 2007, RBI issued guidelines on the

new capital adequacy framework for the implementation of Basel II norms. The guidelines require the banks to provide risk capital on the basis of the rating assigned to the loan facility. Consequently, CRISIL alone has rated more than 4000 entities, while the credit rating agencies have collectively rated more than 8000 entities, since then.

The banks have been extending loans to corporates across rating categories. Having evaluated the credit quality of these corporates, the banks can now also consider investing in the bond issues of these corporates. RBI's guidelines will, then, help both the issuers and investors in the corporate bond market.

CRISIL has, in the past, endorsed the view that the risk-adjusted yield on lower-rated debt instruments (in investment-grade categories) is superior to the yield on 'AAA'-rated





instruments (refer to article: 'A'-rated instruments provide higher risk-adjusted yields: A CRISIL study). The superior returns are adequate compensation for the associated liquidity risk.

CRISIL's default study, which is published annually, indicates a high rating stability for 'A' and 'BBB' credits: at 83.08 per cent and 73.92 per cent, respectively. The default rates observed for 'A' and 'BBB' categories are 2.36 per cent and 5.15 per cent, respectively. This strong combination of higher rating stability and lower defaults should encourage investors to consider the corporate bond segment.

We believe that long-term investors, such as insurance, pension, and provident funds, should be allowed to initially invest a portion of their portfolio in debt securities with long maturities and in greenfield projects rated up to the 'A' and 'BBB' categories.

Addressing liquidity issues: To make the corporate bond market more vibrant, it is necessary that secondary market transactions be made on these securities. RBI's primary dealers have enhanced the liquidity of GoI securities through market making. One of the main activities of primary dealers is to provide a two-way quote for GoI securities at any time. To a great extent, today's liquid GoI securities market is the result of effective market making by the primary dealers. The regulators will need to enable the implementation of a similar arrangement for India's corporate bond market.

RBI's negotiated dealing system has been successfully implemented for trading and reporting transactions on GoI securities. The regulators propose to implement a similar order matching system for the corporate bond market, in consultation with exchanges and clearing houses. Such a system, in tandem with an effective

market maker, will augment the development of the corporate bond market.

Allowing foreign institutional investors to take up an active role in the domestic corporate bond market will help usher in the much-needed contrarians.

Indian Economy - an Update



If there is one word that can aptly capture the performance of the Indian economy in the past one year is - Resilience.

The recent financial crisis, which transfigured into full-blown economic crises, was deep and painful enough that studies and analysis of its cause and effects will continue for years. Disintermediation of risk is widely credited as one of the reasons, which brought vengeance to our planet. Things like securitization and CDS, which essentially created a scenario where the originator of a financial transaction did not need to be the ultimate holder of the business deal as risk were re-allocated, were the 'Armageddon' that shook the bedrock of the financial architecture worldwide. More so, the manner in which these instruments were used where the 'doctrine of insurable interest' went for a toss on the speculator's roulette was a real cause for concern.

The Reserve Bank of India need to be commended as they were quick enough in noticing the sparks and preventing it from becoming ember, as the developed world still examines the ashes and tries to explain the fire. We certainly will examine the issue of financial regulations, world wide including India in details in the coming issues of our journal. For the Moment, it is the Indian economy which is at the heart of our discussions.

2009 was the Year that made the Indian economy run and stumble and while most of the policy makers believe that the worst is behind us, we need to stay cautious and keep a close tab in the rear view mirror. In the words of the Finance Minister outlined in his Budget Speech "I can say with confidence that we have weathered these crises well. Indian economy now is in a far better position than it was a year ago. That is not to say that the challenges

today are any less than what they were nine months ago..."

While the US and the Europe still debates on the V,U,L,W or the more recent inverted square root shape recovery, our economy has certainly experienced the first bout of economic growth. A lot from here depends on *Lord Indra* and how well-calibrated the 'stimulus' exit will be. The gradual winding and tightening of such measures has already begun as the focus shifts back to 'high trajectory' growth, fiscal prudence and price control.

The impressive run of 8-9 per cent of GDP growth ended in the 2008-09 when the economy expanded 6.7 per cent, and the latest third quarter figures came at 6 per cent year-on-year from 7.9 per cent. However a more recent analysis of Industrial Production, a leading indicator points toward a more robust GDP growth in 2009-10. Industrial production index grew 16.7 per cent year-on-year in

January, a slight deceleration from December when production was up by a revised 17.6 per cent, though remained at an above-trend rate. Six core infrastructure industries grew at 4.5 per cent in February against a meager 1.9 per cent during the corresponding month last year. One such survey of economists carried out by FICCI in January 2010 has pegged the GDP growth at 6.9 per cent for 2009-10 while the Finance Minister is hopeful of a 7.2 per cent expansion in output.

The exports and the exporter community in general were torpedoed the way 'Pearl Harbour' was devastated. Billions in export and millions in jobs were lost. In September 2008, export growth evinced a sharp dip and turned negative in October 2008. This was for the first time in seven years; exports had declined in absolute terms. India's merchandise exports fell 6.6 per cent for the 13th straight month in October 2009 to \$13.19 billion, from \$14.13 billion in the corresponding month last fiscal. But in November last year winds changed course and headwinds turned into tailwinds. India's exports climbed in November for the first time in 14 months after sliding an average 21 per cent since October 2008. Overseas shipments rose 18 per cent to \$13.3 billion from a year earlier. Aided by cut in duties and other relaxation to exporters, the

recent data released by the ministry of commerce shows merchandise exports grew 34.8 per cent to \$16.09 billion for the fourth consecutive month in the month of February.

India's capital market relies on FII to a great extent, which by its very nature happens to be very volatile. The chink in the our BOP armour was exposed, when the United States felt the first tremors in the shape of housing crisis followed by a couple of bankruptcy, Lehman Brothers in particular in the latter part of 2008.

Its spillovers became visible in September-October 2008 with overseas investors pulling out a record \$13.3 billion and fall in the nominal value of the rupee from Rs. 40.36 in March 2008 to Rs. 51.23 in March 2009, reflecting at 21.2 per cent depreciation during the fiscal 2008-09. The annual average exchange rate during 2008-09 worked out to Rs. 45.99 compared to Rs. 40.26 against the US dollar in 2007-08 which is the biggest annual loss for the rupee since 1991 crisis. Yet, as the world economy resuscitated, Emerging Markets fuelled by vast interest rate differential between the Orient and the Occidents once again brought considerable inflows in the country. As per the latest data the total investment made by FIIs in the Indian market for the first three quarters (April-December) stood at



\$19.75 billion in 2009-10, as against a net \$9.15 billion being pulled out from Indian stocks in the same period of the last year. Need we say more...?

Actually yes, because things are not as healthy as one might get a feel of it by reading the last few paragraph. Just to remind you "that is not to say that the challenges today are any less than what they were nine months ago..." The reason why Mr. Pranab Mukherjee had to invoke *Lord Indra* is because of the runaway inflation, which poses the biggest threat to our economy as of now.

Wholesale price inflation has also begun to spike, surging from -0.2 per cent year-on-year in August 2009 to 8.6 per cent in January 2010 and 9.9 per cent for the month of February. The main question for policymakers and the private sector is when

inflation will moderate. Here are both the scenarios that may pan out - With a normal monsoon this year, food inflation should moderate sharply in the second half of 2010 or in early 2011. This will help to bring down the overall inflation rate, as food prices have a weighting of around 15 per cent in the wholesale price basket and 55 per cent in the four consumer price baskets.

However, if there is another weak monsoon and agricultural production drops further, policymakers will have few options. The recent 25 bps increase in the overnight rates by RBI interest rates won't have a major impact on food

prices, though it will encourage capital inflows that could cause the rupee to appreciate, making imported food cheaper, but higher interest rates has its own set of problems, making the availability of credit dearer thus impeding the growth of India Inc. and the overall economy. FICCI believes that broad spectrum macroeconomic approach through tightening monetary policy could prove counter-productive at this stage.

What we are facing right now are supply side issues coupled with distribution shortfall and deficiencies in storage and transportation of food grains. No doubt supply

augmentation is the solution to this problem. "The recent measures announced by the government to draw down on the food stocks, liberalize import of refined sugar and processing of raw sugar will have a calming effect on food prices. FICCI welcomes and supports these efforts of the government", said Dr. Amit Mitra, Secretary General, FICCI.

We too stare to the skies to dampen Inflation that would not only help rein inflation but also help achieve the 4 per cent agricultural output that would eventually pave the highway for a sustained broad-based recovery in 2010.



Policy Updates



Banking sector

- ❖ Addressing the concerns of the small and medium scale pharmaceutical industry, the Reserve Bank India (RBI) has advised banks to adopt a flexible approach in respect of exporters, who for genuine reasons are unable to bring in corresponding additional contribution in respect of higher credit limits sought for specific orders.
- ❖ RBI has eased asset classification infrastructure and project loan guidelines. In case of infrastructure projects, RBI has increased the grace period to a total of four years if the reason for delay in starting production is because of arbitration proceeding or a court case and to three years if the delay is for reasons beyond the control of promoters. For project loans, RBI has extended the grace period to one year from six months from the original date of commencement of commercial operations.
- ❖ RBI has asked banks to classify perpetual non-cumulative preference shares as capital. The bank added that debt instruments such as innovative perpetual debt, hybrid debt capital, perpetual cumulative preference shares, redeemable non-cumulative preference shares and redeemable cumulative preference shares and subordinated debt should be clearly classified as borrowing.
- ❖ RBI has decided to introduce Separate Trading of Registered Interest and Principal of Securities (STRIPS) in Government Securities as part of its efforts to develop the Government Securities market. STRIPS in Government Securities will ensure availability of sovereign zero coupon bonds, which will lead to the development of a market determined zero coupon yield curve (ZCYC). STRIPS will also provide institutional investors with an additional instrument for their asset-liability management.
- ❖ With a view to strengthen and institutionalise the mechanism for maintaining financial stability, the government has decided to setup an apex-level Financial Stability and Development Council. Without prejudice to the autonomy of regulators, this Council would monitor macro prudential supervision of the economy, including the functioning of large financial conglomerates, and address inter-regulatory coordination issues. It will also focus on financial literacy and financial inclusion.
- ❖ The government in consultation with the RBI has decided to



provide appropriate Banking facilities to habitations having population in excess of 2000 by March, 2012. It is also proposed to extend insurance and other services to the targeted beneficiaries. These services will be provided using the Business Correspondent and other models with appropriate technology back up. By this arrangement, it is proposed to cover 60,000 habitations.

- ❖ For the year 2010-11, the government will provide a sum of Rs.16,500 crore to ensure that the Public Sector Banks are able to attain a minimum 8 per cent Tier-I capital by March 31, 2011. Recognizing the role Regional Rural Banks (RRBs) play in providing credit to rural economy, the government will also provide further capital to strengthen the RRBs so that they have adequate capital base to support increased lending to the rural economy.
- ❖ To ensure that the banking system grows in size and sophistication to meet the needs of a modern economy. The Reserve Bank is considering giving some additional banking licenses to private sector players, Non Banking Financial Companies could also be considered, if they meet RBI's eligibility criteria, said the Finance Minister in his Budget speech.

- ❖ The Reserve Bank of India has issued revised guidelines on Uniform Accounting for Repo/Reverse Repo Transactions. The guidelines will replace the guidelines issued in March 2003 which treated 'repo' as a combination of two independent sale/purchase transactions as per the legal provisions prevailing then. The accounting norms now propose to capture the economic essence of 'repo' as a collateralised lending/ borrowing transaction that is structured as a legal sale / purchase of securities as recognised by the RBI (Amendment) Act, 2006.
- ❖ The Reserve Bank of India has issued a notification introducing a new category of Non Banking Finance Companies as "Infrastructure Finance Companies". The existing categories of NBFCs are Asset Finance Companies, Loan Companies and Investment Companies.
- ❖ Following the recommendations of the Working Group on Benchmark Prime Lending Rate, RBI has decided to replace the existing lending rate system with a new base rate system for banks from July 01 2010.
- ❖ The Reserve Bank of India has permitted repurchase agreements

or repos using corporate bonds as collateral starting from March 1, 2010. This would add much warranted liquidity in the corporate bond market. Only listed corporate debt securities, which are rated "AA" or above by a rating agency is eligible for repo. To contain leverage, a minimum haircut of 25 per cent has been stipulated and selling of borrowed securities under repo has not been allowed during the period of repo.

- ❖ On March 19, 2010 RBI raised the repo rate under the Liquidity Adjustment Facility (LAF) by 25 basis points from 4.75 per cent to 5.0 per cent with immediate effect. RBI also raised the reverse repo rate under the LAF by 25 basis points from 3.25 per cent to 3.5 per cent.



Capital market Sector

- ❖ RBI has revived the scheme for companies to buy back foreign currency convertibles bonds (FCCBs). It will keep the window open to consider applications till June 30. Indian companies were allowed to buy back FCCBs, both under automatic and approval routes, until December 31, 2009. The scheme was discontinued with effect from January 1. Both the company concerned and the economy will benefit from the buyback at a time when FCCBs are trading at a discount.
- ❖ Aimed at institutionalising the implicit focus and making financial stability an integral driver of the policy framework the Reserve Bank on March 25, 2010 released its first financial Stability Report. As per the findings of the report, the banking sector remains broadly healthy. Banks remain well capitalized in terms of regulatory capital adequacy ratios, with higher core capital

and sustainable financial leverage, and this has contributed to financial stability. Stress tests for credit and market risk reveal banks' ability to withstand unexpected levels of stress, said the report.

<http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=586>

- ❖ RBI has asked banks to start calculating interest on savings account on a daily basis, starting April 1. At present banks compute interest on the lowest available balance in the account, between the 10th and the last date of any month. And the rate of interest on a savings bank account is 3.5 per cent annually. If one withdraws a certain amount from his/her account on the last day of a month, the interest on that amount is lost for the entire month.

- ❖ National Stock Exchange (NSE) and MCX Stock Exchange launched futures trading in additional pairs of currencies - Euro, British Pound and Yen from February 1, 2010. The lot size per contract permitted for trading in Euro-Rupee and British Pound-Rupee contracts will be of 1000 Euros and British Pounds each. Lot size per contract for Japanese Yen-Rupee contract will be of 1,00,000 Japanese Yen, circulars issued by NSE and MCX-SX said.
- ❖ The Ministry of Corporate Affairs (MCA) has relaxed norms for classification of 'vanishing companies'. Under a key revision, an entity cannot be identified as 'vanishing company' if any of its directors - executive or non-executive - can be traced. Earlier, if the managing director or any of the whole-time directors could not be traced, the company was termed as vanishing.
- ❖ The Securities and Exchange Board of India (SEBI) has modified provisions related to valuation of debt and money market instruments to ensure that portfolios of fund houses reflect the current market scenario.



<http://www.sebi.gov.in/circulars/2010/imdcir162010.pdf>

- ❖ SEBI has decided to tighten regulations for credit rating agencies (CRA). The regulator will bring in necessary amendments to the existing SEBI Credit Rating Agencies Regulations (CRA), 1999 such that agencies will require its approval for any change in status or constitutions in CRAs with regards to change of control, change in managing director and whole time director, among others.
- ❖ The government has revised auctioning norms for institutional investors in the Follow-on Public Offers of PSUs. Institutional investors, who could earlier revise their bids only upwards, will now be able to revise them up or down.
- ❖ The Securities Appellate Tribunal has defined what constitutes 'persons acting in concert' or PAC. Close business association between two or more persons is not sufficient to make them persons acting in concert.
- ❖ In the interest of investors and to improve transparency, all regulatory orders i.e., orders against listed companies, trading/clearing members and arbitration awards, issued by the exchanges need to be made available to investors, said SEBI.

- ❖ A meeting of the core group constituted by the Ministry of Corporate Affairs for convergence of Indian Accounting Standards with the International Financial Reporting Standards (IFRS) gave its recommendations on the convergence of insurance, banking and non-banking finance committee. Accordingly, all insurance companies will convert their opening balance sheet as on 1 April 2012. All scheduled commercial banks and urban co-operative banks having a net worth in excess of Rs 300 crore will convert on 1 April 2013 and urban cooperative banks having a net worth between Rs 200-300 crore will convert on 1 April 2014. All non-banking finance companies (NBFC) which are listed on the Bombay Stock Exchange and the National Stock Exchange and those with a net worth of Rs 1,000 crore will convert their balance sheet on 1 April 2013. All listed NBFCs and unlisted ones having a net worth in excess of Rs 500 crore will converge on 1 April 2014.
- ❖ The Central Board of Direct Taxes (CBDT) has asked income-tax authorities to disallow the forex derivative loss claimed by companies on the basis of 'marked to market' valuation. Simply put, forex derivative loss, recognised on MTM basis, would

be added back for the purpose of computing the taxable income of the company concerned (assessee).

- ❖ The Cabinet has decided that all central public sector enterprises (CPSEs) must compulsorily follow a set of corporate governance norms, similar to market regulator SEBI's regulations in this regard for listed companies. The move would bring the policy on independent directors and audit committees for unlisted CPSEs almost on par with SEBI norms for listed companies.
- ❖ SEBI has brought in sweeping changes for the mutual fund industry. These include, a cut in the new fund offer (NFO) period to 15 days and tighter corporate governance norms. The market regulator has extended Application Supported by Blocked Amount (ASBA) to mutual funds. There will be a compulsory ASBA facility for all NFOs from July 1. The limit for time allotment of



units for open-ended schemes, except ELSS, has been reduced to 15 days. The new fund offer period for equity-linked saving schemes (ELSS) continues to be governed by government guidelines. NFO proceeds can now be used only on or after the closure of NFO period.

- ❖ SEBI has barred fund houses from tapping the unit premium reserve to distribute dividends. Instead, it has directed mutual funds to pay dividends only from realised gains.
- ❖ With a view to improve transparency and corporate governance, market regulator SEBI made it mandatory for all listed companies to disclose their financial results within 45 days of the end of every quarter. Companies would also be required to disclose their audited financial statements within 60 days of every financial year end, SEBI said while amending the equity listing agreement.
- ❖ Come this May and the wait for IPO investors to see the companies get listed will get shorter. SEBI has said that from May 1, all companies going for an IPO should get their shares listed within 12 days after the close of the offering, down from 22 days now.

Insurance Sector

- ❖ In a move that could make unit-linked products (ULIPs) more attractive for customers, the Budget for 2010-11 has removed the service tax on all charges on unit-linked products offered by life insurance companies, with the exception of the fund management charges.
- ❖ The Insurance Regulatory and Development Authority (IRDA) has made it mandatory for insurance companies to disclose the remuneration of independent directors as part of its steps towards improving corporate governance. IRDA has also imposed restrictions on the appointment of family members and close relatives on the same board as independent directors.
- ❖ The insurance and capital market regulators are in the process of finalizing the listing norms for insurance companies. The valuation norms are already finalized and have been sent to the Institute of Actuaries for clearance. Once the committee clears, then it will be sent to SEBI, which would take a final call.
- ❖ The government has suggested the idea of a new financial instrument called catastrophe bonds that would help insurance companies to transfer the risk of



disasters into the capital market, which is suited for investors who are hungry for high-returns. Catastrophe bonds are popular among major institutional investors abroad as they typically pay investors a coupon of Libor plus a spread anywhere between 3 per cent and 20 per cent because they carry high risk.

- ❖ In a bid to crackdown on pyramid schemes, IRDA has barred companies that do not have a substantial customer base of their own from becoming corporate agents. The regulator has also specified that any entity seeking a corporate agency license should have a turnover, assets or income of at least Rs 15 crore.
- ❖ IRDA has issued a circular asking all companies to disclose all details of their controlled funds. A controlled fund includes premium

received for traditional insurance policies as well as unit-linked life assurance funds (both group and individual), annuity funds and shareholders' funds. The circular has amended the earlier definition to include funds received under ULIPs.

- ❖ The Government has decided to extend the Rashtriya Swasthya Bima Yojana (RSBY) to all

Mahatma Gandhi NREGA beneficiaries who have worked for more than 15 days during the preceding financial year, said the Finance Minister in his Budget Speech. RSBY became operational on April 1, 2008 and so far more than 1 crore smart cards have been issued under this scheme.

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“the above news items have been collated from daily newspapers”.



Executive Summary

Annual Banking Survey

(February 2010)



Survey on Indian Banking System: The Current State & Road Ahead

The pace of development for the Indian banking industry has been tremendous over the past decade. As the world reels from the global financial meltdown, India's banking sector has been one of the very few to actually maintain resilience while continuing to provide growth opportunities, a feat unlikely to be matched by other developed markets around the world. FICCI conducted a survey on the Indian Banking Industry to assess the competitive advantage offered by the banking sector, as well as the policies and structures required to further stimulate the pace of growth. **The results of our survey are given as follows:-**

- ❖ A majority of the respondents, almost 69% of them, felt that the **Indian banking Industry was in a very good to excellent shape**, with a further 25% feeling it was in good shape and only 6.25% of the respondents feeling that the performance of the industry was just average.
- ❖ This optimism is reflected in the fact that 53.33% of respondents were confident in a growth rate of 15-20% for the banking industry in 2009-10 and a greater than 20% growth rate for 2014-15.
- ❖ Some of the **major strengths** of the Indian banking industry, which makes it resilient in the current economic climate as highlighted by our survey were regulatory system (93.75%), economic growth (75%), and relative insulation from external market (68.75%).
- ❖ On being asked to rate India on certain essential banking parameters (Regulatory Systems, Risk Assessment Systems, Technological System and Credit Quality) in comparison with other countries i.e. China, Japan, Brazil, Russia, Hong Kong, Singapore, UK and USA the following results emerged:
 - **Regulatory systems** of Indian banks were rated better than China, Brazil, Russia, UK; at par with Japan, Singapore and Hong Kong where as all our respondents feel that we are above par or at par with USA.
 - Respondents rated India's **Risk management systems** more advanced than China, Brazil and Russia; 75% of the respondents feel that we are above or at par with Japan, 55.55 % with Hong Kong, Singapore & UK and 62.5% with USA.
 - **Credit quality** of banks has been rated above par than China, Brazil, Russia, UK and USA but at par with Hong Kong and Singapore and 85.72% of the respondents feel that we are at least at par with Japan.
 - **Technology systems** of Indian banks have been rated more advanced than Brazil and Russia but below par with China, Japan, Hong Kong, Singapore, UK and USA.

- ❖ Respondents perceived ever rising customer expectations and risk management as the greatest challenge for the industry in the current climate.
- ❖ 93.75% of our respondents saw **expansion** of operations as important in the future, with branch expansion and strategic alliances the most important organic and inorganic means for global expansion respectively.
- ❖ An overwhelming 80% of respondents admitted that the primary strength of NBFCs over banks lies in their ability to provide reach to the last mile and were also unanimous in the need to strengthen NBFCs further.
- ❖ Further, 81.25% also felt that there was further **scope for new entrants** in the market, as there continue to remain opportunities in unbanked areas. However, 57.14% felt that **NBFCs** may be allowed to be established as banking institutions but only if adequate capitalization levels, a tiered license that enables new entrants to enter into specific areas of the business only after satisfactorily achieving set milestones for the prior stages, cap on promoter's holdings and other regulatory limitations are ensured.
- ❖ 73.33% of our respondents are cent per cent compliant with **core banking solution** requirements, with the remainder, comprising mostly of our public sector respondents, lagging behind in implementation in rural areas.
- ❖ Public Sector Banks, Private Sector Banks as well as Foreign Banks view difficulty in hiring highly qualified youngsters as the major threat to their **HR practices** ahead of high staff cost overheads, poaching of skilled quality staff and high attrition rates.
- ❖ Due to long-term maturity, the trend for prime lending rates seems to be changing now. However, there are other factors which have led to the stickiness of lending rates such as wariness of corporate credit risk (33.33%), competition from government small savings schemes (26.67%).
- ❖ With regards to loan disbursement, while industry shows preference for a joint appraisal system, banks are happy with the current system and in fact 71.43% of our respondents felt that there was no need for standardized credit appraisal across the industry.
- ❖ Over 92% of the participants agree with recent **stress test results** that Indian banks have the capacity to absorb twice the amount of their current NPA levels.
- ❖ Almost 80% of the banks see **personal loans as having the greatest potential for default**, followed by corporate loans and credit cards.
- ❖ 87.5% of the respondents consider credit information bureaus vital for the measurement of asset quality. Nevertheless, at the same time, over 60% of respondents felt the need for regulation capping FDI at 49% and voting rights to 10% in **Credit Information bureaus**.
- ❖ 93% of participants still find **rural markets to be a profitable avenue**, with 53% of respondents finding it lucrative in spite of it being a difficult market.
- ❖ More than 81.25% of all respondents have a strategy in place to tap rural markets, with the remainder as yet undecided on their plan of action.
- ❖ All banks in our survey weigh Cost effective credit delivery mechanisms (100%) as most important to the promotion of **financial inclusion**, followed by factors such as identifying needs and developing relevant financial products (75%), demographic knowledge and strong local relations (62.5%) and ensuring productive use and adequate returns on credit employed (43.75%).
- ❖ Almost 62% of the respondents see **consolidation** as an inevitable process for their banks in the future, while the remainder does not consider it an essential factor for their future progress. 77.78% of public sector respondents were of the opinion that foreign banks should not be allowed to play a greater role in the consolidation process.

Synopsis of Events



FICCI's 13th Conference on Insurance

FICCI organized its Annual Conference on Insurance **"India Insurance 2020"** on **12th January 2010** at **Hotel Taj Lands End, Mumbai** under the aegis of FICCI's Insurance & Pensions Committee, chaired by Mr. V. Vaidyanathan, Chairman CEO & Mg. Director, ICICI - Pru Life Insurance Co. Ltd.

The Insurance sector has indeed grown from strength to strength, yet there are several policy issues that need special attention. FICCI conference in its 13th year aimed to discuss and debate the current issues and challenges faced by the industry and set a roadmap to enable the Indian Insurance Industry become globally competitive. The conference attempted to sketch the emerging landscape of the Insurance Industry, and the shape it will take a decade from now.

Eminent industry experts gather to examine trends and strategize for the future of insurance penetration, product development, distribution and administration.

The conference focused on

- ❖ Analyzing the crucial role of the insurance industry in facilitating growth of Indian economy in decade from now
- ❖ Highlighting new developments and regulations in the insurance arena
- ❖ Discussing and debating issues of importance to Life Insurance and Non Life Insurance industry and help create a conducive environment for facilitating further growth.
- ❖ Discussing potential innovative strategies penetrating "Micro Insurance"

The conference aimed at addressing several issues, challenges and developments in the insurance industry. The Boston Consulting Group (BCG), the world-renowned consultancy, was the Knowledge



Partner for this year's conference. BCG in consultation with industry has helped design the agenda of the event.

The conference was a mix of Special Sessions/ Talk, Panel Session and Sessions focusing on the following topics: -

- ❖ Insurance and the Economy 2020
- ❖ Convergence of Insurance with Broader Financial Services
- ❖ Life Insurance 2020
- ❖ General Insurance 2020
- ❖ Micro Insurance

Mr. J. Hari Narayan, Chairman, IRDA delivered the Keynote Address. The conference was also addressed by some of the following leading Industry experts



FICCI's Conference on "Scaling the MFI Activity by Strengthening Human Resources"

FICCI organized a Conference on "Scaling MFI Activity by Strengthening Human Resource" on 21st-22nd January, 2010 at Federation House, New Delhi. The conference had been organized under the aegis of the FICCI's Financial Inclusion Committee chaired by Mrs. Naina Lal Kidwai, Group General Manager & Country Head- India, HSBC Ltd.

FICCI through this forum aimed at bringing forth some of the best industry experiences for Microfinance Institutions (MFIs) which will help them strengthen the Human Resource(HR) practices of their organizations and help them scale up their work and achieve the goal of Financial Inclusion.

The conference focused on some of the Key HR issues like Quality Training, Mass Hiring, Compensation

and Benefits, Organizational Structure & Succession Planning and Culture and Ethics.

To have a more focused approach on the subject matter, different methods of delivery were adopted at the forum. These included:

- ❖ Panel Discussion - To provide an overview of the issues of concern with perspective from some of the industry leaders.
- ❖ Workshops - In-depth workshops on each of these topics to provide deep insights in the areas which need special focus, with smaller groups of size about twenty in number, on each of the identified topics.
- ❖ Plenary Session -Sharing experience post workshop in the Plenary Session to help evolve proper strategies.

The conference was addressed by some of the leading Industry experts which included Senior Representatives from Financial Services Industry, Microfinance Institutions such as Sa-Dhan, Grameen Foundation, Ujjivan and Consultancy firms such as McKinsey



& Company Inc., Watson Wyatt, Hewitt Associates, et al.

The conference participants included key decision makers from Microfinance Institutions (MFIs) involved in designing Management and Organizational Strategy. This experience sharing has been extremely enriching for Microfinance Institutions (MFIs) in their endeavour to expand their businesses as also emulate some of the best practices in order to scale up their activities.



Seminar on 'De Risking the Indian Economy: Commodity Futures & Options'



The government and private sector have used commodity futures and options in some commodities in the past, which has had a beneficial impact for industry and economy. Nevertheless, hedging is still limited to a few sectors, and there is scope for hedging practices to be extended to sugar, iron ore, and other industrial sectors to reap the potential of these instruments. However, before moving forward, there is a need for dialogue at the business and regulatory level as also the need to create political consensus on showcasing the advantages of the use of these instruments for the economy. With this vision FICCI organized a **Seminar on 'De Risking the Indian Economy: Commodity Futures & Options'**, on

12th March 2010 at Federation House, New Delhi under the aegis of FICCI's Task Force on De-Risking the Economy, chaired by of Mr. M. S. Verma, Former Chairman SBI & TRAI and Chairman, IARC.

This seminar provided a platform to kick-start a debate between policy makers and industry stakeholders, and focused on:

- ❖ Creating a roadmap for efficient and enhanced risk management and price discovery through commodity futures and option.
- ❖ Positive international experiences and best practices.
- ❖ Institutions and structures required to ensure effective utilization of these instruments for beneficial impact on the economy.

Shri Kaushik Basu, Chief Economic Advisor, Ministry of Finance, Government of India delivered the Keynote Address at the Seminar.

The seminar consisted of two panel discussions: -

- ❖ Dimensions Of De Risking The Indian Economy
Chair: Shri Sharad Joshi, Member of Parliament, Rajya Sabha



- ❖ Institutions And Structures Available In India
Chair: Shri. Rajiv Agarwal, Secretary, Department of Consumer Affairs, Government of India



FICCI – Sa-Dhan National Microfinance Conference

FICCI in collaboration with Sa-Dhan, the Association of Community Development Finance Institutions organised the National Microfinance Conference on 17th - 18th March, 2010 in New Delhi. The theme of this conference was *'Financial Inclusion and Responsible Microfinance'*.

National Microfinance Conference is being organised every year from the last eight years, to provide a platform for policy dialogue & a forum for stakeholders to exchange views, experiences and suggestions on various operational issues of microfinance and enterprise building.

This year over 1000 delegates participated at the forum. The Conference has been instrumental in providing impetus to the growth of the sector and draw attention of policymakers in formulating favorable policy changes. The forum helped identify the changes required to support the financial inclusion

initiatives in the Microfinance sector as well as provide appropriate financial services.

The conference was addressed by some of the leading Industry experts such as:

- ❖ Mr R Gopalan, Secretary, DFS, Ministry of Finance, Govt of India
- ❖ Mr G C Chaturvedi, Adl Secretary, DFS, Govt of India
- ❖ Mr Tarun Bajaj, Joint Secretary, Ministry of Finance, Govt of India
- ❖ Mr Jyotiradiya Scindia, Hon. Minister of State for Commerce and Industry, Govt of India
- ❖ Mr Salman Khurshid, Hon Minister for Corporate Affairs, Govt of India
- ❖ Dr Montek Singh Ahluwalia, Dy Chairman, Planning Commission
- ❖ Dr K C Chakrabarty, Deputy Governor, RBI
- ❖ Mr Anil Swaroop, Joint Secretary, Ministry of Labour, Govt of India
- ❖ Ms Naina Lal Kidwai, Group General Manager & Country Head-India, HSBC Ltd
- ❖ Mr Nandan Nilekani, Chairman - Unique Identification Authority of India (UIDAI) et al.



Future Events



FICCI's Health Insurance Conference July 2010

FICCI is organising a one day **Conference on Health Insurance in July, 2010. Mr. J. Hari Narayan, Chairman, IRDA has been invited to deliver a Keynote Address in the Inaugural Session of the conference.**

Health Insurance penetration is important for access to quality healthcare by enhancing affordability for masses at large. Although, health insurance has recently seen several positive developments which are clearly reflected in the significant growth of the sector in last two years, there is no room for complacency. The road to achieve universal health insurance coverage is long. Lack of consumer awareness & satisfaction, claim settlement issues, need for standardization of services provided & understanding between the health care providers and health insurance companies, lack of product innovation etc are some of the issues of concern.

There is a strong need to make the health Insurance a viable business

proposition through better understanding between healthcare providers and health insurance companies.

FICCI is deeply involved in the space of Health Insurance and has made several path breaking initiatives in health insurance. FICCI has constituted an Advisory Board on Health Insurance comprising senior representatives of the healthcare providers, the health insurance companies, QCI, World Bank and IRDA to identify a few critical issues that would pave way for greater penetration of health insurance and greater customer satisfaction.

The focus of this year's FICCI's Health Insurance Conference is:

- 1) To share the findings and disseminate the work done so far on:
 - ❖ “ Promoting Quality Healthcare through Health Insurance”

- ❖ “ Standardisation of Billing Procedures in Hospitals”
- ❖ “ Standardisation of TPA/Insurer and TPA/Hospital Contracts”

- 2) To discuss the way forward to increase health insurance penetration in the

Country and to make quality healthcare affordable to masses at large.



9th edition of FICCI-IBA Global Banking Conference: 7-9th September 2010, Hotel

FICCI and IBA are pleased to announce the **9th edition of FICCI-IBA Global Banking Conference on 7-9th September 2010, Hotel Trident, Mumbai**. Building on the success of the conference year after year, the forum will continue its tradition in delivering a learning based agenda thereby reflecting the current market developments and exploring the next big steps in developing a sound and vibrant banking industry.

Acclaimed by past attendees as an industry-relevant world class event with outstanding content, speakers and organisation, the forum would once again provide a key platform for the financial services industry experts not only to gain insights about changing consumers behaviour, regulatory developments and forecasts of the future economic

the movers and shakers of financial services industry.

Key Stakeholders – The conference will aim to bring together the following at this platform.

- ❖ Executives of the Banking and Financial Services sector
- ❖ International Banking and Financial Services Companies foraying into India
- ❖ Policy makers and regulators
- ❖ Financial and Commodity Exchange Operators
- ❖ IT vendors and technology providers
- ❖ Private Equities and Venture Capitalists
- ❖ Fund Managers and Institutional Investors

- ❖ Consultants and Analysts
- ❖ Corporations
- ❖ Educational Institutes

Be at the forefront of a premier banking convention to:

- ❖ Learn from world's renowned national and international keynote speakers
- ❖ Benefit from a combination of keynote presentations, case studies and panel discussions
- ❖ Obtain regulatory updates from the Government and the Regulators
- ❖ Build profitable new relationships with peers from across the globe



Conference on “Asset Reconstruction: The Way Forward”- Last Week of May, 2010

FICCI is organising a one day conference on **Asset Reconstruction: The Way Forward in the last week of May, 2010. Mr. R Gopalan, Secretary, Financial Services has been invited to deliver a Keynote Address in the Inaugural Session of the conference.**

The Indian ARC Sector has evolved significantly during the last five years and has played an important role in regulating and controlling Non Performing Assets (NPAs) of the financial sector and redeployment of

idle capital for productive uses. However, ARCs today face certain challenges which if not addressed in a timely manner would hamper their efficient functioning. To name a few, the challenges faced by ARCs include NPA Valuation, Information and Data Availability, Recovery Period, Standardisation of Sale Process etc.

The forum would therefore aim to highlight some of these challenges faced by ARCs and put forth an action plan for sustained growth of ARCs.

Key Stakeholders:

This conference is designed for all organizations and agencies with an interest in and commitment, to tackle the challenges of the ARCs, including:

- ❖ Banks
- ❖ Financial institutions
- ❖ Credit Rating Agencies
- ❖ Consultancies
- ❖ ARCs et al.



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