Report

of

High Level

Expert Committee

on

Corporate Bonds

and

Securitization

December 23, 2005

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CHAPTER I

Introduction

1. The Corporate Debt Market in India is in its infancy, both in terms of microstructure as well as market outcomes. Primary issuance market is dominated by non-banking finance companies and relatively small amount of funds are raised through issuance of debt papers by manufacturing and other service industries. Bank finance is the most sought after path to fulfil the funding requirement of these companies. Secondary market activities in corporate bonds have not picked up. Efforts of Securities Exchange Board of India (SEBI) and the stock exchanges to bring the trading to stock exchange platforms have not yielded desired results. On the other hand, the government securities market has grown exponentially during last decade due to many structural changes introduced by the Government and Reserve Bank of India to improve transparency in the market dealings, method of primary auctions, deepening the market with new market participants like Primary Dealers, borrowings at market determined rates, and creating technology platforms like NDS to recognize the institutional characteristics of the market.
2. Since the inception of the Planning era in India in 1951, project funding for Indian corporate sector was increasingly provided by Development Financial Institutions (DFIs) because Government encouraged setting up of a large number of development financing institutions to provide term finance at concessional rates to projects in industry. There emerged a well-knit structure of national and state level DFIs for meeting requirements of medium and long-term finance of all range of industrial units, from the smallest to the very large ones. Reserve Bank of India and Government of India nurtured DFIs through various types of financial incentives and other supportive measures. The main objective of all these measures was to provide much needed long-term finance to the industry, which the then existing commercial banks were not keen to provide because of the fear of asset-liability mismatch as also absence of project appraisal skills especially in relation to large and technologically complex projects. As the liability side with

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the banks was mainly short/medium term, extending term loans was considered by the banks to be relatively risky.

3. To enable term-lending institutions to finance industry at subsidized concessional rates, Government and RBI gave them access to low cost funds. They were allowed to issue bonds with government guarantee, given funds through the budget and RBI allocated sizeable part of RBI's National Industrial Credit (Long Term Operations) funds to Industrial Development Bank of India, the largest DFI of the country. Through an appropriate RBI fiat, the turf of the DFIs was also protected, until recently, by keeping commercial banks away from extending large sized term loans to industrial units. Banks were expected to provide small term loans to small-scale industrial units on a priority basis.
4. Till recently, public sector companies (PSUs) and DFIs had received budgetary support from the Government. The Corporate sector also raised funds from the retail markets by way of term deposits just as the banks do. This has been an age-old system quite popular with several corporates. The company statute permits corporate entities to raise public deposits within certain limits.
5. The corporate units which usually raise funds through public deposits also did not show much interest in issuing bonds although they could possibly raise more money through market borrowings than through public deposits. During the last several years several good credit-rated corporates have been showing interest in raising funds by way of private placements of debt from big lenders/investors or popularly known as Qualified Institutional Buyers (QIBs) but they have not shown any keenness to tap the public issue market. One of the reasons why they do not like to make public issue of debt appears to be that the regulatory requirements including quality and the type of disclosures are more rigorous or onerous in the case of public issues. Although the interest rates they pay on such placements would be equally attractive to retail investors, corporates have not shown much interest in the retail investors. As per the current regulations as long as the investors in a debt instrument are up to 50, private placement route could be adopted. Market feed back suggests that the corporates are not happy with this regulation and a number of them are trying to find ways for bypassing the

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requirement of distributing debt among not more than 50 investors. The usual method adopted by a corporate is to privately place its debt issue to less than 50 investors in the first place so that at the next stage these investors in turn sell the issue to much larger number of investors in the guise of a secondary market operation.

6. In so far as the DFIs are concerned the withdrawal of budgetary support and government guarantee to raise funds from the market through SLR-eligible bonds at concessional rates as well as the other policy changes introduced after onset of economic reforms resulted in DFIs slowly converting themselves into commercial banks to have access to the public deposit mechanism as also enjoy freedom to lend both on a short term as well as long term basis. With most of the commercial banks keenly competing in the term loan market there is very little incentive for corporates to tap the market primary market for borrowing through long term debt. Banks generally prefer providing loans rather than invest in bonds as there currently is no mark-to-market requirement in their case while investment in bonds are subject to mark-to-market requirements and making provisions for valuation losses.
7. In the case of high credit rated clients, however, many proactive banks, however, prefer to invest in privately placed bonds due to the restriction that existed till recently whereby they could not lend at sub-PLR rates. Banks encouraged credit rated corporate entities to issue bonds so that they could invest in them even at sub-PLR rates. Hence, loans are often being proxied as debt in the market.
8. Historically, the most of corporate entities have been depending on loans from banks and institutions and they have not shown much interest to raise even a small part of the required long term resources from the market through bonds and other debt instruments. The cash credit system has also proved to one of the major obstacles to the growth of the debt market; it has made corporate entities complacent about cost effective fund management through treasury operations. Under the age-old cash credit system banks have been granting credit/borrowing limits and burdening themselves with the cash management problems of the borrowers.

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9. In regard to equity funding, corporate entities invariably prefer the public issue route and have been servicing retail investors even when their numbers are very large. But when it come debt finance the same corporates have shied away from the hassles of servicing large number of investors as they find it highly convenient to meet their requirements of debt finance by relying on a limited number of lenders that provide both short term as well long term funds. This is also the main reason why the corproates have been relying on private placement route for debt rather than tap the retail debt market.
10. Since the primary corporate debt market did not develop efficiently and remained purely an institutional market with limited disclosure, the secondary market for corporate debt also did not develop on healthy lines. The secondary market has remained highly illiquid with only a limited number of banks/institutions participating in the same. Since banks have surplus funds and are not able to identify good borrowers they are ever on the look out for good quality paper in the market and they would prefer to hold the papers till maturity rather than trading in the same.
11. It is understood from the market sources that the corporate bond market in India continues to be largely an OTC market in which some large banks and mutual funds are the main participants. The retail investment in corporate bond market is negligible. Looking into trade information released by NSE, it is observed that negligible trade takes place either on the exchange platform or reported to it after the trades are brokered in the OTC market. NSE's WDM platform for price discovery is not at all used by NSE's WDM members. Although large number of trades are said to be facilitated by the WDM members they do not issue contract notes so that they are not obligated to report the trades to the NSE. The brokers have their own ways of getting compensated for the services they render to their clients. In such a regime the investors are said to be trading among themselves directly in the OTC market. In the OTC market, the risk of settlement is invariably absorbed by the participants themselves as the market practice forces a seller to give transfer instruction to the depository first before receiving the payment by way of cheque.

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12. It is understood from the secondary market sources that about Rs.500-600crores worth of corporate bonds were traded on an average in the OTC market on daily basis during the early part of the current year. However, since the OTC market trading data is not released by any information vendor, it is difficult to ascertain how much amount of trading actually happens in this market. The only reliable source for estimating the total amount of transactions in the market is the depositories but depositories do not publish this information on a daily basis as they do not have information on traded prices.
13. The Indian financial system is not well developed and diversified. One major missing element is an active, liquid, and large debt market. In terms of outstanding issued amount, Indian debt market ranks as the third largest in Asia, next only to that of Japan and South Korea. Further, in terms of the primary issues of debt instruments, Indian market is quite large. The government continues to be a large borrower unlike South Korea where the private sector is a very large borrower.
14. The US has one of the most active secondary markets in both government and corporate bonds. The trading volume in the US debt market is said to be much higher than the size of the equity trading. In India the average daily trading in debt is insignificant compared to equity segment. These comparisons bring out the underdeveloped nature of the Indian debt markets. The secondary debt market suffers from several infirmities. It is highly non-transparent compared to the equity market and is highly fragmented.
15. The US experience clearly bears out that the Indian private corporate sector is adopting a myopic approach by overlooking the advantages of financial disintermediation. Sooner it gets out of the habit of depending excessively on the banks, institutions, and the private placement market, the better it would be for it from a long-term point of view. The problem of asset-liability mismatches is catching up with the banks and their appetite for term debt would decline in future. Since DFI's access to long-term funds had dwindled they are not in a position to meet demand for term funds of industry and infrastructure sectors when investment activity picks up from the present low levels. When the demand

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term debt increases significantly to finance high level of investments, continued excessive dependence on banks is also not in the interest of good credit-worthy borrowers, as they would end up paying up more than what they would have to pay if they decide to raise funds from the market directly.

16. Indian investors in general are new to the debt market although most of the retail investors do prefer fixed income assets like bank deposits, postal savings schemes, etc. To entice these investors to the debt market, it would be necessary to assure them of reasonable level of liquidity in the secondary market for debt instruments. In the case of the fixed income assets such as bank deposits or postal savings schemes, the investors are protected in regard to both the principle value of investment and the rate of return. However, principal value of the debt instruments traded in the secondary market may not always be equal to their original investment value. Given the present comfort of protected investment, most of the investors would not be willing to live with the idea of decline in the bond value in the absence of a highly liquid secondary market. Conscious efforts therefore need to be made to create liquidity in the debt instruments by encouraging market makers who would give two-way bid and offer quotes with reasonably narrow spreads. Once the investors are convinced that they are assured of liquidity in the market their willingness to shift from the currently popular fixed income assets like bank deposits to tradable debt instruments like corporate debentures would be greater. As of now the average investors are not yet aware of the advantages of investing in debt instruments that are traded in the market. Tradable debt instruments are yet to catch fancy of most of the average investors although they prefer to invest major part of their savings in the fixed income securities. Therefore, it is more a matter of developing investors' tastes for such instruments before the fixed income oriented investors willingly start investing in them. In the early stages of development of the debt market it would be both desirable and necessary to introduce active market making so that investors are assured of liquidity for the debt instruments.

17. The changing financial environment would require the corporates increasingly accessing financial markets for funds rather than accessing banking channels.

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Basel II implementation in India would require banks to treat loans and investments equally for mark to market losses, if any, and eliminate the advantage of loans over investments. 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 these issues and problems. Steps should be taken to create not only an enabling mechanism to encourage primary issuance of debt by all corporate entities who require term funds for their operations but also create an environment that would increase the secondary market activity, thereby increasing liquidity in the system.

18. The secondary market for asset backed securitization products in India does not exist though there have been many primary issuance of pass through certificates which conform to such securities. As per a study by ICRA, mortgaged backed securities (MBS) market reported a 13percent growth in the year 2004-05. Primary issuance worth of Rs.33.4billion was reported that included mortgage-backed pool of a large private bank worth of Rs.12billion. Mortgage backed securitisation has tremendous growth opportunities provided there is significant growth in underlying housing finance business. The current spate of housing finance by banks will help this market to grow. For encouraging creation of an active secondary market in the mortgaged backed securities, suitable amendment to the Securities Contracts Regulation Act, 1956 is required to recognise these instruments as marketable securities. Further, the current problems relating to payment of stamp duty and tax treatment of income from securitised debt instruments need to be suitably resolved before an active market for such debt instruments could develop.

19. During the last decade significant quantum changes have taken place in the quality of the equity market. In terms of efficiency and transparency it is now ranked among one of the best markets globally. In contrast the corporate debt market continues to remain in a highly undeveloped state. Given the significantly larger requirements of debt funds that will be needed to significantly step up growth of manufacturing and infrastructure sectors very high priority has to be accorded to the growth of the corporate debt market. Widening and deepening of

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the corporate debt markets should form an essential package of the financial sector reforms. As an integral part of this strategy the corporate sector should be facilitated to raise large funds from the market to meet its growing needs. Hence, developing corporate debt market should become one of the very high priority items in the financial sector policy reforms. Given the numerous problems/hurdles facing the corporate debt market, the reform package needs to have two components. The first set reforms should be of an enabling nature that involve removal of the hurdles that the debt market faces by amending the legislative framework that determine the regulation of the securities markets as also the tax treatment of the debt both at the issuance stage and also trading in the secondary markets. The second set of reforms should involve proactive steps to enlarge issuer base and development of secondary market institutions and market makers.

20. **Constitution of the High Level Expert Committee on Corporate Bonds and Securitisation:** One of the announcements in Budget 2005-06 under paragraph 86(iv) was to appoint a High Level Expert Committee on Corporate Bonds and Securitisation that would look into the legal, regulatory, tax and market design issues in the development of corporate bond market. Pursuant to this announcement, Finance Minister has approved the constitution of the said committee under the Chairmanship of Dr. R. H. Patil (notification in Annexure – I to this chapter). The Committee shall have the following members:

Sl. No	Name	Organization	Member
1	Dr. R. H. Patil	UTI	Chairman
2	Ms. Usha Thorat	RBI	Member
3	Ms. M.H. Kherewala	CBDT	Member
4	Shri U.K.Sinha	MOF, GOI	Member
5	Shri. Pratip Kar	SEBI	Member
6	Shri. S. V. Mony	Life Council	Member
7	Shri. H. N. Sinor	IBA	Member
8	Shri C. B.Bhave	NSDL	Member
9	Ms. Chitra Ramakrishna	NSE	Member
10	Shri Rajeev Lall	IDFC	Member
11	Shri Prithvi Haldea	Prime Database	Member
12	Shri C. E. S Azariah	FIMMDA	Member

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Terms of Reference of the Working Group

21. The Committee will look into and make recommendations on the following issues:-
    a. Identify the factors inhibiting the development of an active corporate debt market in India.
    b. Recommend policy actions necessary to develop an appropriate market infrastructure for development of the corporate bond market.
    c. Recommend specific actions necessary to develop mechanisms for
        i. trading platform
        ii. clearing and settlement system
        iii. risk management
        iv. novation
    d. Measures necessary for inducing the emergence of market makers.
    e. Identify the different kind of intermediaries necessary for the bond market and measures necessary for their regulation.
    f. Recommend system for information dissemination.
    g. Recommend measures necessary for developing the participation of small investors in the debt markets including examination of any regulations that inhibit such participation.
    h. Recommend policy actions necessary to develop bond insurance in the country.
22. The Committee held six meetings to deliberate on the issues raised by the members and the Committee also invited the industry bodies like CII and FICCI to present their standpoints on the subject.
23. The Committee formed two sub-groups as follows:
    a. The sub-group under the guidance of Shri. Prithvi Haldea, Member looked into Primary Market Regulations for Development of the primary market;
    b. The sub-group on Secondary Market (Trading, Clearing & Settlement, Novation issues) under the guidance of Smt. Chitra Ramkrishna looked into secondary market issues and suggested measures to improve liquidity in the market.

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24. In order to recommend a roadmap for the development of the corporate bond market in India, it is required to look at the global markets like US, Japan, South Korea, etc. and understand how these markets have been able to set up efficient and vibrant corporate debt markets. It is required to take lessons from these markets and frame suitable policies for a sustainable development of the corporate bond market in India.
25. The Committee acknowledges with thanks the contribution made by Shri. Rajendra P Chitale and Shri. Somsekhar Sundaresan for Chapter IV of the Report.
26. The Committee also acknowledges the significant contribution made by Dr. Golaka C Nath and Shri. Ravi Rajan for preparation of the draft chapters, undertaking the study of various global markets and coordinating the meetings.
27. The Committee also acknowledges the hospitality extended by CCIL for smooth conduct of the meetings.
28. The Committee has examined each of the issues referred to it. While carrying out a comprehensive analysis and careful consideration of all related aspects, the Group is of the view that the way forward lies in critically analyzing each of the issues involved and looking at possible alternatives, timely and cost-effective solutions to them. As an attempt in this direction, the Group is pleased to submit its Report in the subsequent paragraphs, which comprises the following four chapters:

Chapter II - Global Corporate Bond Markets
Chapter III - The Indian Corporate Bond Market
Chapter IV - Asset Based Securities Market
Chapter V - Summary of Conclusions and Recommendations

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Annexure - I

F. No. 1/9/SE-2005
Ministry of Finance

Department of Economic Affairs

CM, ECB & PR Division

Stock Exchange Section

North Block, New Delhi,
Dated 5th July,2005

OFFICE ORDER

One of the announcements in Budget 2005-06 under para 86(iv) was to appoint a High Level Expert Committee on Corporate Bonds and Securitisation to look in to the legal, regulatory, tax and market design issues in the development of corporate bond market. Pursuant to this announcement, Finance Minister has approved the constitution of the said committee under the Chairmanship of Dr. R. H. Patil. The Committee shall have the following members-

1.	Dr.R.H.Patil	Chairman
2.	Representative from RBI not below the rank of Executive Director	Member
3.	Nominee of SEBI not below the rank of Executive Director	Member
4.	Member, Legislation, CBDT	Member
5.	Shri U.K.Sinha, JS(CM), DEA	Member
6.	Shri C.B.Bhave, MD, NSDL	Member
7.	Smt.Chitra Ramakrishna, Dy.MD, NSE	Member
8.	Representative from IBA	Member
9.	Representative from Life Council	Member
10.	Representative from FIMMDA	Member
11.	Shri Rajeev Lall, IDFC	Member
12.	Shri Prithvi Haldea, Prime Database	Member

TERMS OF REFERENCE

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The Committee will look into and make recommendations on the following issues:-

1. Identify the factors inhibiting the development of an active corporate debt market in India.
2. Recommend policy actions necessary to develop an appropriate market infrastructure for development of the corporate bond market.
3. Recommend specific actions necessary to develop mechanisms for

   - trading platform
   - clearing and settlement system
   - risk management
   - novation

4. Measures necessary for inducing the emergence of market makers.
5. Identify the different kind of intermediaries necessary for the bond market and measures necessary for their regulation.
6. Recommend system for information --- dissemination.
7. Recommend measures necessary for developing the participation of small investors in the debt markets including examination of any regulations that inhibit such participation.
8. Recommend policy actions necessary to develop bond insurance in the country.

This issues with the approval of the Finance Minister.

(Shashank Saksena)

Joint Director (SE)

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2. **Dr. Y.V. Reddy**,

   Governor, RBI- with a request to nominate Member

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officer not below the level of Executive Director
Fax: 022-22661784

3.	**Shri M. Damodaran**, Chairman ,SEBI – with a request to nominate officer not below the level of Executive Director **Fax: 022-2285-5585**	Member
4.	**Ms. M.H. Kherewala,** Member, Legislation, CBDT, Room No. 148, North Block	Member
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CHAPTER II

Global Corporate Bond Markets

1. The developed financial markets are characterized by the existence of sound financial, legal and regulatory framework that can aid and support the development of debt markets including the corporate debt market. The US debt market is a very well developed and efficient market with high level of liquidity in the secondary markets. A large number of corporates as also banks and institutions in the US prefer to tap the market through issuance of debt instruments of various maturities rather than seek loans or deposits for meeting an appreciable part of their resource requirements. The bond markets in London and Euro zone are also reasonably well developed. In Asia, Japan and South Korea are the two countries which have reasonably well developed corporate bond markets. Unlike these developed markets, the corporate bond markets in emerging countries like India are in their infancy and require a clear vision and roadmap for their development.
2. For corporate debt markets to develop on sound lines there should be large number of issuers who need to raise resources through the bond route as also large number of investors who are willing to hold these instruments as a profitable opportunity. It has been observed that in almost all the countries that have well developed debt markets the main investors in debt instruments including the corporate debt instruments are the institutional investors. In the US, banks in particular play an important role in facilitating issuance and distribution of the marketable debt of their clients to earn fee based incomes; the banks also hold such instruments in their portfolio for generating profits through their treasury operations. In the US, the mutual funds are one major class of investors in the corporate debt as nearly one-half of the asset portfolios of the mutual funds is in the form of various class of debt securities including corporate bonds. Insurance companies and pension funds are the other set of major investors in debt instruments. In many countries funds under management of institutional investors

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have been growing faster than the supply of local instruments in which they can invest.

3. The global issuance of debt has been on the rise. The outstanding debt for all countries increased from US$ 9186 billion to US$14056 billion in March 2005. Figures on debt released by Bank for International Settlements (BIS) indicate that the size of outstanding debt issued by financial institutions and private corporate sector has almost doubled since 1995. The size of the corporate bond market of a country in relation to its GDP varies from country to country depending on the extent to which its corporate debt market has developed. The US has a huge corporate debt market which accounts for 22percent of its GDP, followed by Japan with 16percent and Euro area with 10percent of GDP.
4. Cross country analysis suggests that countries with larger outstanding government debt tend to have larger corporate debt markets. An active market for government securities with various maturities helps to develop a reliable yield curve that serves as a benchmark for pricing corporate debt instrument. Since sovereign securities are considered as risk free market prices of government securities help in estimating a yield curve that reflects risk-free, returns for various maturities. When corproates issue their debt instruments the markets price them keeping in view their relative risk perception.
5. In many respects the debt market including the corporate debt market is dissimilar from the equity market. Although the equity markets in most parts of the world are getting increasingly institutionalized the equity held by retail or non-institutional investors continues to be large. The retail investors are also quite active in the secondary equity markets. The debt markets on the contrary continue to be dominated by the institutional investors both in regard to the primary and the secondary markets. The main investors in the debt securities continue to be commercial banks, investment banks, mutual funds, and pension/provident funds. For some countries like the US foreign institutional investors including foreign central banks are also the investors as the US dollar is a reserve/transaction currency and foreign investors invest in the US debt markets as they are deep and liquid. As a backdrop for the discussion on the road map, appropriate design, and

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the reform steps to be taken to build a vibrant corporate debt market in the country it would be highly instructive to understand the structure and main characteristics of the global corporate debt markets. The first country chosen for discussion is the US. Any study on global corporate debt markets would be incomplete without understanding the US market which has the largest and perhaps the most liquid and deep corporate debt market in the world. The other two countries chosen for our analysis are Japan and South Korea, both from the Asian region having well developed corporate debt markets.

US CORPORATE BOND MARKET

Primary Market:

6. The corporate bond market in the United States is the largest corporate bond market in the world in terms of both dollar value issued and turnover. In 2004, of the total bond issues made globally, the US accounted for 44percent with Japan featuring as the second largest at 15.2percent. The U.S. market is well diversified and consists of: Agency Mortgage Backed Securities; Federal Agency Securities; Treasury Bonds; Corporate Bonds; Asset Backed Securities; and Municipal Bonds. The experience of the U.S. bond market is a clear indication that a well diversified bond market can help channel resources both to the private sector and the government.
7. The corporate debt outstanding in US has been steadily increasing over the years and as of first quarter of 2005, the total outstanding corporate bonds stood at US$4894.2billions. Table II-1 gives the outstanding level of public and private bond market debt in US. The amount outstanding in corporate debt is higher than the US treasury securities. Corporate debt constituted about 20percent of the total outstanding debt. However, it is lower than the mortgaged backed securities that account for 23percent of the outstanding debt.

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Table-II-1: Outstanding Level of Public & Private Bond Market Debt (US$ billion)

Year	Municipal	U.S. Treasury(1)	Mortgage-Related(2)	Corporate*	Fed Agencies	Money Market(3)	Asset-Backed*(4)	Total
1995	1,293.5	3,307.2	2,352.1	1,937.5	844.6	1,177.3	316.3	11,228.5
1996	1,296.0	3,444.7	2,486.1	2,122.2	925.8	1,393.9	404.4	12,073.1
1997	1,318.7	3,441.8	2,680.2	2,359.0	1,022.6	1,692.8	535.8	13,050.9
1998	1,402.9	3,340.5	2,955.2	2,708.6	1,300.6	1,977.8	731.5	14,417.1
1999	1,457.2	3,266.0	3,334.2	3,046.5	1,620.0	2,338.8	900.8	15,963.5
2000	1,480.9	2,951.9	3,564.7	3,358.6	1,854.6	2,662.6	1,071.8	16,945.1
2001	1,603.7	2,967.5	4,125.5	3,835.4	2,149.6	2,566.8	1,281.1	18,529.9
2002	1,763.1	3,204.9	4,704.9	4,094.1	2,292.8	2,546.2	1,543.3	20,149.2
2003	1,892.2	3,574.9	5,309.1	4,462.0	2,636.7	2,526.3	1,693.7	22,101.2
2004	2,018.6	3,943.6	5,472.5	4,704.5	2,745.1	2,872.1	1,827.8	23,584.2
2005Q1	2,052.7	4,085.8	5,555.1	4,894.2	2,702.9	3,014.3	1,839.2	24,144.2

*The Bond Market Association estimates
(1) Interest bearing marketable public debt.
(2) Includes GNMA, FNMA, and FHLMC mortgage-backed securities and CMOs and non-agency MBS/CMOs.
(3) Includes commercial paper, bankers' acceptances, and large time deposits.
(4) Includes public and private placements.
Sources: U.S. Department of Treasury, Federal Reserve System, Federal National Mortgage Association, Government National Mortgage Association, Federal Home Loan Mortgage Corporation, Thompson Financial

8. The primary issuance through private placement is higher for debt with about US$515.5billion in 2004 vis-à-vis US$28.9billion for equities. The private placement has been going through ups and downs in US and it went down drastically to US$307.1billion in 2002 from US$510.5billion. Table II-2 gives the details of private placement market in US.

Table-II-2: PRIVATE PLACEMENTS, 1999-2004 (US$ Billion)

Value of U.S. private placements				Number of U.S. private placements		
Year	Debt	Equity	Total	Debt	Equity	Total
1999	368.80	77.70	446.50	3,285	462	3,747
2000	358.70	124.40	483.20	2,879	661	3,540
2001	510.50	80.60	591.10	2,063	809	2,872
2002	307.10	40.50	347.50	1,779	568	2,347
2003	489.40	28.80	518.20	2,630	533	3,163
2004	515.50	28.90	544.50	2,714	547	3,261

Source: Thompson Financial Securities Data; Securities Industry Association.

9. As of end-2004, foreign investors held about a quarter of all corporate bonds. They own an even higher proportion of marketable US Treasury obligations,

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$1,870 billion out of $4,372 billion or about 43percent. The foreign investors have played a dominant role in the US bond market. The foreign holdings have been steadily increasing and in 2004, the same was outstanding at US$1775.50billion. Table-II-3 gives the foreign holdings of the US securities.

Table-II-3: Foreign Holdings of US Securities, 1995-2004 (US$billion)

Year	Stocks	Corporate bonds	Treasuries (1)	Total
1995	549.50	361.50	963.10	1,874.10
1996	672.4	433.2	1,215.40	2,321.00
1997	952.9	501.6	1,362.60	2,817.10
1998	1,250.30	607.8	1,394.00	3,252.10
1999	1,611.50	752.1	1,358.60	3,722.20
2000	1,643.20	920.6	1,462.80	4,026.60
2001	1,572.70	1,115.90	1,597.80	4,286.40
2002	1,260.80	1,266.90	1,904.30	4,432.00
2003	1,669.00	1,499.50	2,165.90	5,334.40
2004	1,906.10	1,775.50	2,669.70	6,351.30
(1) Includes agency issues.				
Source: Board of Governors of the Federal Reserve System.				

10. The majority of the corporate bonds are straight bonds (bonds with a stated maturity and semi-annual interest payments). However, over the years, corporations have issued zero coupon bonds (bonds with no coupon payments) and deep discount bonds (bonds selling for a discount of more than 20percent), depending upon market conditions.

Secondary Market

11. Bond markets in US have a long history.[1] Today bond markets in US remain large and economically significant by any measure. The US corporate bond market has 37000 bonds outstanding and more than 3000 registered market participants. The municipal bond market has well over one million bonds outstanding and more than 2000 registered dealers. The average daily trading volume in long term corporate bond and municipal securities for the first 5 months of 2005 was about

[1] Speech by SEC Commissioner Roel C Campos on June 21, 2005 at Tokyo

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US$37billion compared to US$56billion for the NYSE. Bond investors include retail investors with small portfolios, as well as the largest institutional investors. According to NYSE, 92percent of the par value of all debt traded in US capital market is traded OTC. Currently NYSE's Automated Bond System (ABS) provides a market for less than 1percent of corporate bond trading. The settlement agencies like FICC provide Real Time Trade Matching System (RTTM) for the OTC trades. The OTC market dominates the corporate bond market in US while stock exchanges have not been able to attract the participants into their fold.

12. A study by NASD shows that about 60percent of retail investors do not understand the risk associated with bonds. However, about 65percent of transactions in the corporate bond market are in quantities of fewer than 100 bonds or amounts less than US$100,000 in par value. The trend shows that retail participation in corporate bonds will continue to rise. A recent study by SEC economists found that the transaction costs decline when corporate bond prices become transparent.
13. In 1998, former Chairman Levitt noted that "[t]he sad truth is that investors in the corporate bond market do not enjoy the same access to information as a car buyer or a homebuyer or, dare I say, a fruit buyer."[2] To address the lack of price transparency in the corporate debt market, Chairman Levitt called on the NASD to do three things: (1) Adopt rules requiring dealers to report all transactions in U.S. corporate bonds and preferred stocks to the NASD and to develop systems to receive and redistribute transaction prices on an immediate basis; (2) Create a database of transactions in corporate bonds and preferred stocks. This would enable regulators to take a proactive role in supervising the corporate debt market, rather than only reacting to complaints brought by investors; and (3) In conjunction with the development of a database, create a surveillance program to better detect fraud in order to foster investor confidence in the fairness of these markets. As a result, broker-dealers must now report all Over-the-Counter (OTC)

[2] Speech by SEC Commissioner Roel C Campos on June 21, 2005 at Tokyo

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corporate bond transactions to the NASD's Transaction Reporting and Compliance Engine (TRACE) System.

14. The secondary OTC market trades of corporate bonds are reported to the NASD through its Trade Reporting and Compliance Engine (TRACE) for regulatory and surveillance purposes. On Sept. 3, 2004, SEC approved an NASD rule requiring all corporate bonds except Rule 144A and asset-backed securities to be transparent through TRACE by Feb. 1, 2005. Table-II-4 gives the average trading volume in secondary market.

Table-II-4: Trading Volume of Long-Term Corporate Securities

Year	**Value of Trades (US$ Billion)**	Monthly Average
2003	249.30	20.78
2004	254.70	21.23
2005	109.90	21.98

Source: Federal Reserve Bank of New York (2005 data includes upto May'05)

JAPANESE CORPORATE BOND MARKET

Market structure:

15. The corporate bond market in Japan was heavily regulated until 1985. The relaxation of market eligibility standards, the establishment of rating agencies, and the start of bond futures trading followed by the liberalization of financial transactions contributed to the development of the bond market. The measures included abolition of securities transaction tax, deregulating brokerage commission, preparing legal framework for securitization, allowing banks to issue straight (unsecured) bonds, and introduction of registration system for securities companies.

16. Japanese non-financial corporate liabilities have tended to rely on bank intermediated lines of credit, so the Japanese corporate bond market accounts for a smaller share of fixed income securities outstanding than other G7 developed markets. The role of asset securitization in Japan has evolved from being predominantly a method of raising funds for corporates' asset financing to restructuring for corporates under bankruptcy and reorganization. Securitization transactions done on the basis of the latter were quite evident following the Asian

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financial crisis in 1997. From residential and real estate mortgages, the range of underlying assets has expanded to include bank loans to businesses. For developing the asset-backed securities market the Bank of Japan (BOJ) has included asset-backed securities as part of BOJ's eligible securities to be purchased.

17. There are no specific rules restricting the participation of retail investors in Japanese bond markets. Investors in Japan's bond market comprise individual investors, the Postal Savings System, Postal Life Insurance Service (Kanpo), public and corporate pension fund systems, investment trusts, licensed banks, and insurance companies. Among the major market participants in Japan's bond market are domestic and foreign securities companies that serve as dealers, brokers, traders, and underwriters in the primary and secondary markets. In October 2004, the MOF launched a new primary dealer system, the JGB Market Special Participant Scheme. Initially composed of 25 banks and securities companies approved by the MOF, the system is designed to promote adequate financing, and to maintain or increase liquidity, competitiveness, transparency, and stability in the JGB market. JGB Market Special Participants can take part in buy-back auctions of the MOF, apply for stripping and reconstruction of STRIPS, participate in non-price competitive auctions and liquidity supply auctions, and be preferential counterparties for MOF interest rate swap transactions.
18. Japan has five major exchanges for corporate equities, bonds and derivatives. Each exchange follows its own listing and trading system. For instance, the Tokyo Stock Exchange uses its Tokyo Stock Exchange Trading Network System (ToSTNET), which also provides a platform for off-hours trading in equities and bonds.
19. The issuance of corporate bonds in Japan till 1987 was regulated by a 'Bond Committee' controlled by major commercial banks. The bond issuance conditions were unfavorable to the development of the corporate bond market and involved the use of collateral, high management fees, and quantitative limits related to the company's equity. However by 1997 most of the restrictions on corporate bond issues had been relaxed. In 1990, eligibility criteria based on accounting

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information were replaced by a single bond rating criterion. In 1996 eligibility criteria were removed in the final stage of the liberalisation of Japanese corporate bond markets. In 1997, the severe financial environment surrounding Japanese financial institutions and the accompanying default of several large and medium-sized banks and securities companies led to a dramatic widening of the spreads on both corporate bonds and debentures. Measures like expansion of the number of corporate bond issues for which quotations announced by the JSDA (Japanese Securities Dealers Association) to all issues from April 1997 and the abolition of bond transaction price range (government bonds, corporate bonds, etc) contributed to price transparency and market liquidity. Table-II-5 gives the outstanding bond issuances in Japan.

Table-II-5: Outstanding Bonds of Japanese Corporate Issuers

Period	Amt. Outstanding (US$ Billion)
1999	714.40
2000	655.80
2001	613.80
2002	683.00
2003	769.70
2004	787.30

(Source:BIS - International Financial Statistics (Table 16B) http://www.bis.org)

20. Highest rated triple-A and especially double-A rated borrowers have historically dominated the non-government bond segment of the yen market. Although such borrowers continue to account for over half of new issuance, single-A rated entities have become relatively more active. Also, whereas in the past issuance tended to be concentrated in medium-term maturities, non-government issuance of longer-dated bonds is picking up. Notably, in contrast to the dollar and euro markets, there appears to be little competition among non-government borrowers in the yen market to offer potentially liquid securities. The average size of new international issues is much smaller in the yen market than in the other major markets, and there are few instances of very large offerings by non-government borrowers.

21. The corporate bond issuance is dwarfed by the Government bond issuances. In the year 2004, only Yen6273billions worth of corporate bonds were issued through

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public offering vis-à-vis Yen190494billion issuance of Government securities. The Table-II-6 gives the year wise comparison of Government and corporate bonds in Japan. (*Source: JASDA Annual Report 2004*)

Table-II-6: Public and Corporate Bond Issuance

Domestic Public and Corporate Bonds Issued Through Public Offerings

Billions of yen

Fiscal Year	1999	2000	2001	2002	2003	2004
Government bonds	104,215	133,901	140,947	152,719	179,021	190,494
Other public bonds	5,386	7,460	7,271	9,847	14,182	17,430
Corporate bonds	8,832	8,479	8,849	8,040	7,269	6,273
Yen-denominated foreign bonds	867	2,382	1,298	641	943	1,677
Total	119,299	152,222	158,366	171,247	201,415	215,874

Secondary Market

22. Most bonds are usually traded on the OTC market in Japan. To enhance fair and efficient bond transaction, the JSDA is trying to reform or rationalize the OTC bond market by establishing or revising systems or business practices related to OTC bond transactions. To provide reference information for members of the association and investors, the JSDA publicizes reference prices of about 4,500 bonds. To promote fair and efficient bond transactions, JSDA collects and compiles data and information related to bonds and provides many different statistics and useful reference information and data for members of the association and investors through the Internet.
23. JSDA is reforming the system of off-exchange transactions of listed stocks to make it more fair and efficient and ensure investor protection. It also calculates and reserves data and information related to off-exchange transactions of listed stocks and provides useful reference information and data for members of the association and investors. The trading in secondary market is in pure OTC form. The trading is more concentrated in government securities and less in corporate bonds.

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24. Till the time Jasdaq was considered to be an OTC market by the Securities and Exchange Law it could not accept at market trade orders and was restricted in its business scope. In response, JSDA decided to convert Jasdaq Market Inc. into a stock exchange. In December 2004, Jasdaq Market received approval to become a stock exchange from the Financial Services Agency and is now known as Jasdaq Securities Exchange. The Japanese settlement system has gone through the major reforms process during last 5 years.

KOREAN CORPORATE BOND MARKET

Primary Market

25. The Korean bond market is one of the largest markets in Asia. Various reforms are behind this rapid development, including gradual market liberalization. Currently, all fixed income instruments are available to foreign investors. Government bonds are the most traded asset class and form the basis for benchmark yields. Issues of quasi-government and special public bonds dominate the domestic bond market, representing over half of the total amount of bonds outstanding. Almost all corporate bonds issued in Korea are non-guaranteed. Securitization has become an important financing tool in Korea since it was used to restructure banks' non-performing loans following the Asian financial crisis. This market has expanded further to include the securitization of residential mortgages, credit card receivables, future trade receivables and various types of leases and loans. The market for asset-backed securities is an important feature of the Korean bond market. Most bond issues are listed on the Korea Stock Market Division. However, more than 95percent of bond trades take place over-the-counter.
26. The Financial Supervisory Commission (FSC) is the key market regulator in Korea. Issuers in the Korean debt market comprise the Government, special public enterprises, special purpose companies, corporations and financial institutions. Ministry of Finance and Economy (MOFE) issues Korea Treasury Bonds while Korea National Housing Corp. issues National Housing Bonds. Among the issuers of the public/quasi-government bonds are the Korea Asset

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Management Corporation (KAMCO), Korea Housing Finance Corporation (KHFC) and Korea Deposit Insurance Corporation. KAMCO and KHFC issue a range of asset-backed securities (ABS), including mortgage-backed securities (MBS). Special purpose companies, including the ones set-up by banks, issue a substantial amount of ABS backed by credit card receivables. Major investors in the Korean bond market include banks, securities companies, insurance companies, investment trust companies and pension funds.

27. The Korean corporate bond market, which is one of the most developed in Asia in terms of size and growth, has been a vital component of Korea's rapid economic advancement. Despite this success, however, significant deficiencies exist in the structure of the corporate bond market. To address these deficiencies, some of which were revealed by the 1997 financial crisis and the credit crunch of 2000, Korea has undertaken major reforms.
28. Korea's corporate bond market has seen significant structural changes since the 1997 financial crisis. Changes include the introduction of credit enhancements such as asset-backed securities and partial guarantees, an increased awareness of the importance of credit analysis and credit ratings as also the recognition of creditors' critical roles. Moreover, investors began to take more responsibility by closely monitoring issuers' credit ratings and performances. To help implement these changes, the Korean government took various initiatives to transform the basic infrastructure of the country's bond market. It shifted its primary role from direct market involvement to prudent regulation and supervision, and consolidated separate supervisory bodies for greater management proficiency.
29. In 2002, the four largest conglomerates, or *chaebols*—Samsung, Hyundai, LG and SK—accounted for 12.4 percent of total corporate bond issuances. Remaining large businesses, and medium and small businesses, represented 83.3 and 4.4 percent of bond issuances, respectively. Figure-1 gives the issuance of corporate bonds in Korea since 1980.

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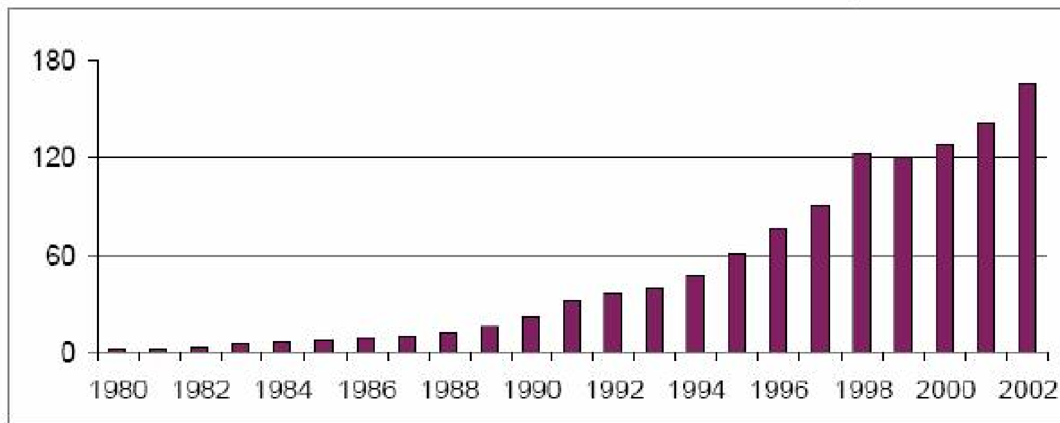
Figure-1: Growth of Corporate Bond Market in Korea



Source: Bank of Korea, "Monthly Bulletin", Financial Supervisory Service (after 2000)

30. The financial sector is the largest investor in the corporate bond market, holding approximately 80 percent of the total corporate bonds issued in 2002. Major bondholders among financial institutions are banks and Investment Trust Companies (ITCs), which tend to hold bonds to maturity. In 2002, ITCs and Investment Trust Management Companies (ITMCs) accounted for 37 percent of outstanding corporate bonds, banks held 20 percent, and insurance companies (mostly life insurance) held 12 percent. Individual investors held 2 percent of the total, and foreign investors have only a small share in the total bond market. Figure-2 gives the distribution of corporate bond investors. ITCs are the largest investors.

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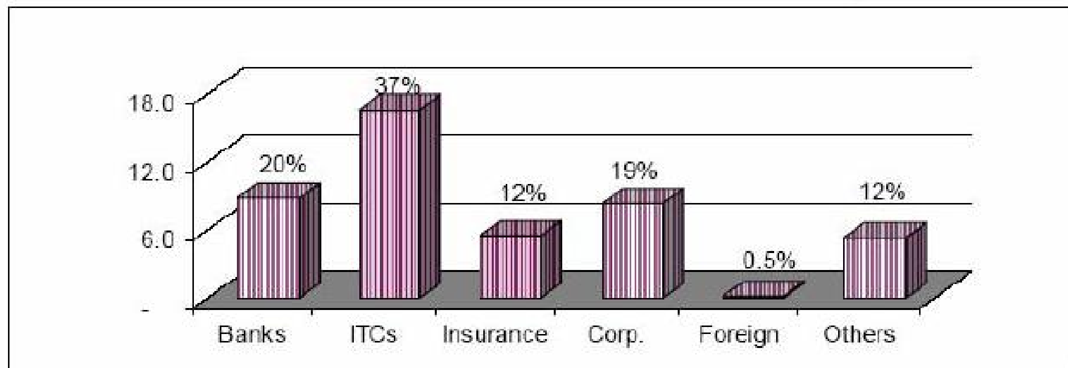
Figure-2: Distribution of corporate bond investors

(Unit: trillion won)



Source: Korea Securities Computer Corp.
Note: "Corp." in Net Investment by Investors includes government sector.

31. Historically, three-year corporate bonds have dominated the Korean corporate bond market. Throughout the 1990s, more than 90 percent of issued corporate bonds had three-year maturities, and the share of bonds with short- to mid-term maturities reached 99.4 percent of the total corporate bond market after 1997. Unsteady market conditions, such as high inflation rates, as well as low confidence, resulted in a strong preference for short-term bonds. The situation has not changed materially till recently.

32. In Korea bonds are classified largely into three categories according to the issuer - corporate bonds, government bonds and special public bonds. The latter two are typically referred to as public bonds. By year-end 2003, the total outstanding amount of KSE-listed bonds reached 607.3 trillion won. Public bonds accounted for 75 percent and corporate bonds 25 percent. The sharp increase in the number of bond issuances has helped financial restructuring in the financial, public and corporate sectors. Table-II-7 gives the key statistics of listed bonds in Korea.

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Table-II-7: Key statistics of Listed Bonds in Korea

Public Bonds			Corporate Bonds			Total	
Year-End	Number of Listed Issues	Amount Listed	Number of Issues	Number of Listed Issues	Amount Listed	Number of Listed Issues	Amount Listed
1999	5,701	253,298	1,078	4,054	111,121	9,755	364,418
2000	5,030	296,805	727	2,436	127,877	7,466	424,683
2001	5,585	363,505	742	2,306	141,223	7,891	504,729
2002	6,303	422,629	682	2,260	141,313	8,563	563,943
2003	6,528	471,151	662	2,422	135,143	8,950	607,294

Source: Korea Stock Exchange

33. The corporate bond market is one of the largest of bond markets in Korea, amounting to 165.5 trillion won (US$ 138 billion), or 27 percent of the total bond market, in 2002. Despite this overall size, the share of corporate bonds in the total bond market has decreased by 11.4 percent since 1997 (from 38.4percent in 1997 to 27percent in 2002), when corporate bonds occupied a strong position in Korea. The share of the corporate bond market in 2002 is also far behind the average share (36.5 percent) of corporate bonds over the last twenty years starting from 1980. The primary reason for this drop of the corporate bond share in the bond market is that the increase in the volume of government and public bonds has outpaced the growth rate of corporate bonds.
34. The new corporate bonds issues accounted for about 30percent of the total outstanding debt though it increased to 56percent in 2001 from 25percent in 1999. In 2003, the same has fallen to about 33percent of the outstanding debt. The Table-II-8 gives the yearly issuances, redemption and outstanding of Korean corporate debt. Figure-3 gives the growth and distribution of Korean bond market

Table-II-8: Outstanding Amounts of Corporate Bonds

Year	Corporate Debt (USD Billion)
1999	112.1
2000	133.4
2001	122.4
2002	150.2
2003	171.3
2004	150.2
2005	159.2
For 2005, the figures are as of March	

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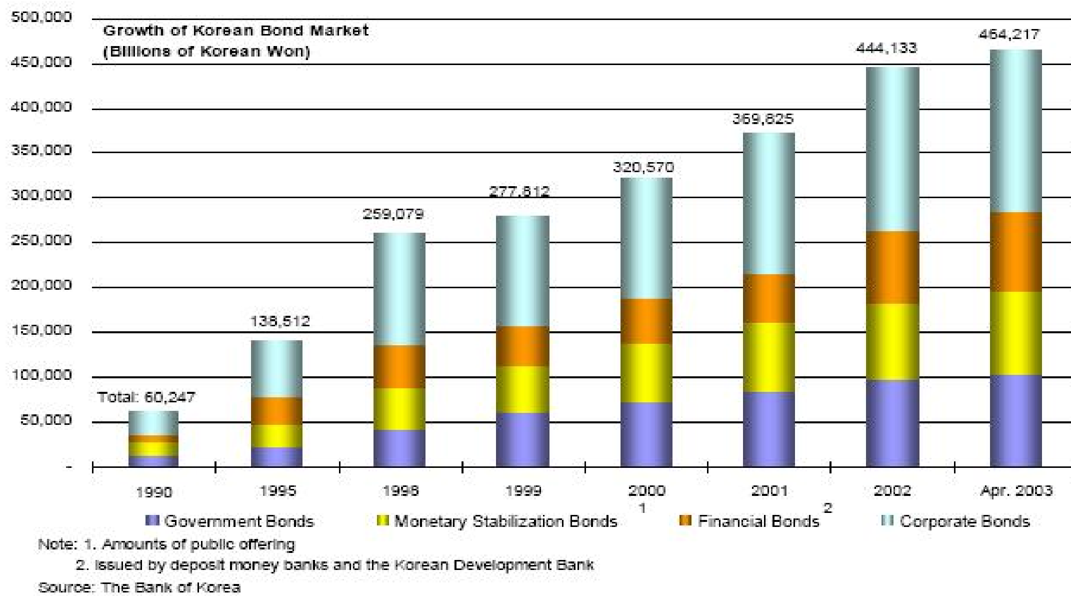
Figure-3: Korean Bond Market Distribution



Secondary Market:

35. As noted above, at the end of 2002, the Korean corporate bond market reached 166 trillion won US$138 billion), which accounted for approximately 27.8 percent of national GDP. From 1980 until 1999, the corporate bond market averaged growth of 23 percent per year, with a temporary boom period in 1998. In mid-1999, however, the bankruptcy of the Daewoo business group eroded investor confidence in corporate bonds and Investment Trust Companies (ITCs). In 1999, for the first time, the market recorded negative growth (-2 percent), and it is still struggling to regain the momentum it enjoyed prior to the Daewoo crisis.
36. KSDA is responsible for any disclosure or administration of information related to over-the-counter trading, including yields, trading volume, trading value, issuing terms and conditions, and trading results. Disclosures are made available through Korea Securities Computer Corporation (KOSCOM) terminals and also through KSDA website.

37. The secondary market is divided into the Korea Stock Exchange (KSE) and the Korea Securities Dealers Association's (KSDA) over-the-counter (OTC) market.

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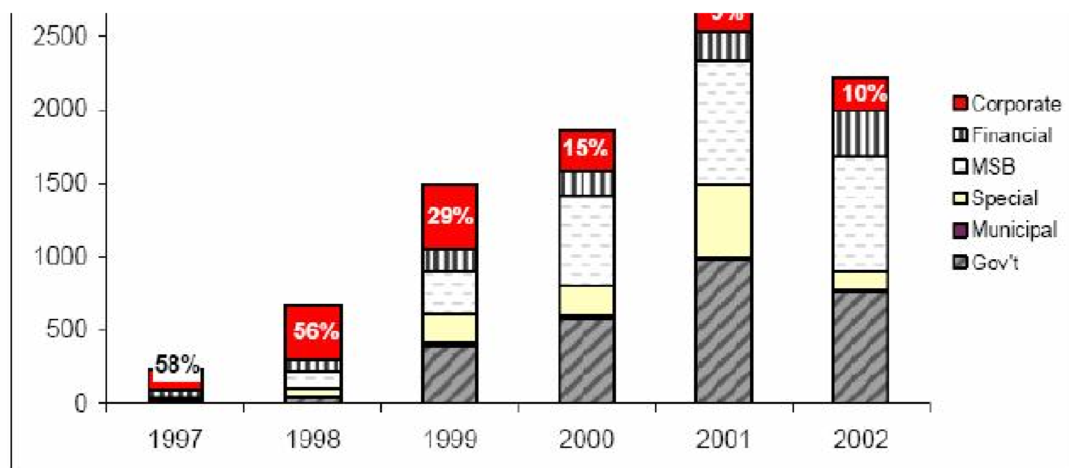
The KSE offers competitive trading of listed bonds only, while in the OTC market both listed and unlisted bonds are traded. Bonds are traded directly between individual investors and securities firms or financial institutions.

38. In the past, the secondary market experienced liquidity constraints because institutional investors, who comprise approximately 90 percent of the total bond investor group, operated with a "buy-and-hold" investment strategy. However, the sizeable growth of the domestic bond market, active ITC participation, and improved discipline in portfolio management have all contributed to building greater depth and liquidity. For example, the total volume of traded corporate bonds grew significantly between 1997 and 2002, from 133.2 trillion won (US$ 139.3 billion) to 224.2 trillion won (US$ 186.6 billion) (with an exceptional year in 1998-1999 when the volume surged to 381.5 trillion won (US$ 272.7 billion) and 436.9 trillion won (US$ 367.5 billion), respectively). Nevertheless, the corporate bond market was a mere 10 percent of all bond trading in 2002, a remarkable decrease from 58 percent in 1997 and 56 percent in 1998. Figure-4 gives the bond trading volume in OTC market.

Figure-4: Bond Trading Volume in OTC Market



Source: The Korea Securities Dealers Association

39. The OTC market accounts for 96 percent of the total trade volume in 2002 in corporate bonds. It is generally regarded as the more attractive bond trade market because it offers lower trading costs and more flexible terms of trade. The listing of debt securities on the KSE is largely a formality designed to enhance

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acceptability, as most institutional investors are prohibited from investing in unlisted securities. Institutional investors play the most dominant role and are the largest investors in the corporate as well as Government bonds. The stock exchanges play a very small role in bond trading. Table-II-9 gives the trading bifurcation of Korean secondary bond market.

Table-II-9: Trading Value of Bonds

(Unit : billion won)

Year	Korea Stock Exchange	OTC Market	Total
1999	587,214 (24.5)	1,813,366 (75.5)	2,400,580
2000	54,339 (2.5)	2,115,546 (97.5)	2,169,885
2001	28,450 (0.1)	2,910,153 (99.0)	2,938,603
2002	94,348 (4.2)	2,115,734 (95.7)	2,210,082
2003	429,803 (14.8)	2,472,893 (85.2)	2,902,696

Note: Percentage of total in parentheses, figures are total sales and purchase values.
Source: Financial Supervisory Commission

40. OTC trading is either one-to-one trade or brokerage trade where broker intermediates: one-to-one trading is brokerage firms acting as dealers by selling individual bond inventories to customers, while brokerage trading involves brokerage firms facilitating transactions between investors.
41. The secondary market trading is concentrated in Korean Government bonds and in recent years, the share of corporate bond in total bonds has increased to 7.36percent in 2005 (upto August'05) from 5.06percent in 2004. In 2002 and 2003, the same were about 5.5percent though in 1999 the corporate bonds used to account for nearly 10percent of the total trading in bonds.

Table-II-10: Bond Trading Volume & Value (Trading Volume)

Year	Government Bonds (Billion KRW)	Ordinary Bonds (Billion KRW)	Total (Billion KRW)	Corporate Bond as % to Total
2004	358400	19085	377485	5.06
2005	242780	19298	262078	7.36

STRUCTURE OF GLOBAL MARKETS

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42. A particular feature of the global corporate bond market is the variety of regulatory environments in which bonds are traded. In countries like Australia, Brazil, Canada (Ontario and Quebec), France, Germany, Hong Kong, Italy, Japan, Malaysia, Mexico, Singapore, Spain, Switzerland, United Kingdom, United States, corporate bonds are predominantly unlisted securities, traded in the OTC market.
43. In Europe, most corporate bonds are listed on the exchange, although in many of these countries, a significant proportion of the trading nonetheless occurs over-the-counter. For instance, the Luxembourg Bourse has listed more than 20,000 corporate bonds, but most of the trading takes place away from the exchange, and much of it outside Luxembourg. These listings are generally to enable institutional investors and fund managers that are required to invest only in listed bonds.
44. Over the last decade, the rapid evolution of electronic order-handling technology has not only enabled dealers to improve client access and automate trade execution, but has also led to the launch of a number of fully electronic trading platforms for corporate bonds. A number of exchanges have adopted these systems, but in some countries, this type of trading system has more commonly been offered by Alternative Trading Systems (ATSs). The ATSs offer a variety of trading methodologies and target different types of participants. Dealer-based systems generally provide for dealers to display quotes or enable users to request quotes from multiple dealers, and negotiate electronically with the dealer that provides the best price. User-to-user systems enable users, who may include investors and/or dealers, to trade with each other (usually on an anonymous basis) through a cross-matching system. Execution on a cross-matching auction system may be on a continuous or periodic basis. Where these cross-matching systems provide for investor participation, they may not only enable users to trade more advantageously, but also allow a wider range of market participants to contribute price making liquidity to the market. The ATSs providing trading in corporate bonds have been very popular in Canada and in the United States since the mid1990's. Italy, Hong Kong and the United Kingdom also have such ATSs.

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45. The volume of trading in corporate bonds that is conducted away from exchanges appears to reflect both the historical development of the market in different countries and the continued large volume of bilateral dealing. This contrasts strongly with equity markets, which are generally structured as order-driven, central auction markets and are mostly electronic.
46. In some countries, the transparency arrangements for listed bonds also provide for the publication of post-trade information when the bonds are traded off-market. Some other countries require the trades to be reported to the market upon which the debt security is listed within a prescribed period of time. The trade information is then disseminated to the public in the same manner as if the trade had been executed on the exchange (Canada, Hong Kong, Italy, Mexico, Singapore, and Switzerland). In Australia and Japan, such off-market trades are reported to a non-exchange self-regulatory organization (SRO) or industry organizations involved with OTC markets. In some of the countries, the reporting requirement applies only if the trade is executed by or between exchange participants (Canada, Hong Kong, Italy, and Singapore). In many countries ATSs may trade listed and/or unlisted corporate bonds (Canada, Hong Kong, Italy, Japan, the United Kingdom, and the United States).
47. There are trading platforms like EUROMTS and EUREX-BOND that are providing trading solutions in the OTC market efficiently. The MTS was originally set up by Italian central bank and Treasury dept. in 1988 and later in 1997 privatized and managed through MTS Spa. It is owned by banks and institutions which are spread all over the world, mainly in Europe and USA. The electronic inter-dealer market for Italian Government bonds, known as MTS (from *Mercato Telematico dei Titoli di Stato*), is highly transparent trading system In July 1997, ten years after its inception, MTS switched to a new operating regime in which the names of market makers who post bid and ask quotes for each security are not revealed. The MTS system has been developed to provide liquidity to European government debts.
48. In its recent of electronic transaction systems for fixed income markets, the Bond Market Association identified 77 systems operating in the United States and

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Europe in late 2003, as opposed to 11 in 1997. Of these platforms, 31 were based principally in Europe. All the systems identified supported the government bond market. However, over the past three years, due to competition, platform vendors and traders have also accelerated their adoption of electronic execution for less liquid products such as corporate debt securities, asset-backed and mortgage-backed securities. The latter trend was less significant for inter-dealer platforms. In fact, in relationships between intermediaries concerning less liquid financial instruments, traditional trading channels continue to be largely predominant, despite the existence of devoted segments on several platforms.

MTS Group

49. MTS Group, the first wholesale electronic market in the euro area, reinforced its leadership in government securities transactions and promoted the integration of the euro denominated bond market by broadening the range of securities traded and services offered and by exporting its platform to other European countries: between 2001 and 2003 the number of national markets using the MTS platform rose from 5 to 12. Among the new EU Member States, Poland announced in October 2003 the implementation of a domestic government bond market based on the MTS system. Like MTS Italy, all the other domestic MTSs are quote-driven and based on the obligation for market makers as a whole to quote two-way prices during the day. The rules of each market, however, such as conditions of access, obligations of market-makers, list of traded securities etc are established by shareholders in accordance with national law. Because all national MTS use the same platform as MTS Italy, participants in the market can employ the same workstation to access all the MTS markets they have joined, thus benefiting from economies of scale. Moreover, some MTS markets (e.g. Belgium, Finland and Denmark) drew up an agreement for reciprocal access, which makes the operators of each market dealers on the other markets, too.
50. Some MTS markets were provided with new functionalities and services. For example, since 2003 the Italian, Finnish and Portuguese platforms have allowed exchange operations to be managed, and MTS Spain and MTS Portugal have activated a segment dedicated to T-bills. The application of electronic trading to

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relationships between intermediaries and institutional investors has also showed significant developments in recent years, with progressive diffusion and the use of dealer-to customer platforms, of which TradeWeb and BondVision are the most important.

51. The search for efficiency gains has reinforced a dynamic movement towards consolidation among EU settlement providers. Progress in this process has been achieved, both in the form of structural changes and strategic measures. Consolidation has involved mergers of institutions providing similar services ("horizontal consolidation") and mergers of institutions providing different but integrated services ("vertical consolidation").
52. In the United Kingdom the settlement of government bonds was integrated into the security settlement system for equities and bonds (CREST) in 2000. The settlement of money market securities was integrated into CREST in 2003. At the EU level, horizontal consolidation, which had already started when Clearstream International and Euroclear Group were set up, continued with the merger of CREST with the Euroclear Group in September 2002.

EUREX-BOND SYSTEM

53. The EUREX-BOND provides participants with an electronic platform for off-exchange, "wholesale" trading in European bonds. Also, by having networked the Eurex Bonds trading platform into the settlement system of Eurex Clearing AG, a direct link between spot and futures markets is available for the first time to enable electronic basis trading of bonds via a central order book. The necessary liquidity in the bond and basis trading markets is provided by market makers. The EUREX-BOND is also owned by banks and institutions.
54. The basic objective of EUREX-BOND is to provide highly liquid market for European bonds on an electronic trading platform, thereby increasing transparency for all market participants. It tries to provide easy and cost-efficient way to trade bond and basis products along with modern and reliable clearing structure integrated in Eurex Clearing. It also provides attractive incentive to market makers.

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55. In addition to Eurex Frankfurt AG, the following financial institutions are the shareholders of Eurex Bonds GmbH: ABN Amro Bank N.V., Banco Bilbao Vizcaya Argentaria S.A., Barclays Bank Plc., Bayerische Hypo- und Vereinsbank, BNP Paribas, Commerzbank AG, Credit Suisse First Boston Zurich AG, Deutsche Bank AG, Dresdner Kleinwort Wasserstein Online Ventures Ltd London, Morgan Stanley Dean Witter Fixed Income Ventures Inc., WestLB AG.
56. The ownership structure is institutional. All market participants have equal privileges when trading bonds and basis on Eurex Bonds and thus may enter orders and quotes into the system. Furthermore, to guarantee sufficient liquidity in all products, a number of market participants have committed to act as market makers. Trading on Eurex Bonds is based on a market model in which quotes and orders are entered into a central limit order book. All market participants have the facility of entering buy or sell limit orders into the system. As a result, orders can be executed either in full, partially or not at all. Non-executed parts of a limit order remains in the order book. While all market participants may enter quotes into the system, market makers are committed to enter a minimum of quotes throughout the trading day.
57. Since the end of October 2000, the responsibility for both the clearing of derivatives and clearing of all spot transactions executed on the Eurex Bonds trading system is assumed by Eurex Clearing AG. Eurex Clearing AG also acts as central counterparty between buyers and sellers, thus guaranteeing trading anonymity as well as contractual fulfilment of each and every transaction. Besides enabling centralized cross-border risk management, market participants' benefit from a reduction in margin requirements as a direct correlation is made between risk positions and portfolio diversification. In addition the participants take advantage of using one collateral pool for all products offered by Eurex.
58. Each market participant has the opportunity to choose an ICSD account either at Clearstream Banking Luxembourg or Euroclear for the settlement of its cash market trades. In addition to an ICSD account a Clearstream Banking Frankfurt account could also be used for the settlement of selected cash market trades. As soon as a buy or sell order is executed in the system, related settlement

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instructions are forwarded automatically. Settlement takes place in accordance with the customary international timeframe of T+3 days for all trades in fixed-income bonds and T+2 days for all trades in German Treasury discount papers (Bubills).

59. All executed basis trades are automatically broken down by the system into two components. The resulting cash market position (the "cash leg") is forwarded directly to the appropriate settlement organization. The number of futures contracts (the "futures leg") is calculated simultaneously and booked into the corresponding participant’s futures account with Eurex Clearing AG. These positions can be netted against existing positions from other futures trades. Margining and regulation are in accordance with the clearing conditions of Eurex Clearing AG.
60. With the introduction of the FI-CCP on June 6, 2005 Eurex Bonds provides the following new functionalities for the clearing of cash bond trades to its participants: Settlement netting, Combined netting with Eurex Repo trades, Shaping of delivery instructions, (Gross-) delivery management, Gross-/Net processing, Improved reporting (end-of-day and intraday reporting, report selection), Trade status inquiry, Trade blocking, Trade linking.
61. The benefits of these new functionalities for the participants are: Insulate against counterparty risk, efficient calculation/allocation of collateral, extension of trade management, reduction of settlement volume/delivery instructions, reduction of cross-border settlements

SUMMING UP

62. Globally there are a number of successful and efficient structures where market participants join together to provide trading platforms. Generally such trading platforms are owned by banks and institutions as the markets are basically institutional in nature. These institutions possibly have found it less costly to trade in OTC markets among themselves but require an efficient price discovery mechanism. These trading platforms have operated on mutual arrangements often with no-profit no-loss model.

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63. There are well defined clearing and settlement mechanism in place in global markets which can form role models for Indian corporate bond market as it has almost the same institutional structure. A trading-cum-clearing corporation set up by leading market participants on for-profit model may be suitable for clearing and settlement purposes. The global market set ups in corporate bonds do provide a path which Indian corporate bond market may like to tread. If corporate bond market needs to be developed efficiently, it would be desirable to adopt a flexible approach that allows adoption of different types of market structures that would bring more transparency into the existing system and create infrastructure that would bring trading and settlement efficiency. It is therefore desirable that banks and institutions are given freedom to set up their own trading-cum-clearing and settlement system that would facilitate their OTC deals.

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CHAPTER III

The Indian Corporate Bond Market

Introduction

1. The corporate bond market in India has not kept pace with the developments in the equity market, which has matured and grown to global standards. It has suffered from chronic neglect, both in terms of policy and infrastructure, and has been almost entirely restricted to a set of domestic institutional investors. For an active secondary market, there is a need for a wider range of issuers and of investors, and with different perceptions for investment and trading in the secondary markets.
2. With continued pace of economic reforms and growing business confidence together with increasing global recognition of India's technical capabilities and economic potential, entrepreneurs are willing to invest in large, global scale projects to enhance infrastructure as well as to promote exports. As capacity utilizations in a wide range of industries have been in excess of 80-90percent, entrepreneurs are now willing to invest capital to grow capacities. This is expected to result in increased competition for financial resources as companies look to expand.
3. India has aggressive targets for GDP growth rate at 8percent-10percent p.a. The investment in infrastructure by both the government and the private sector has been relatively low in the past. Achieving financial closure for large infrastructure projects has often been difficult and time consuming given the quantum of funds required and long gestation periods. Banks continue to be exposed to problems of asset / liability mismatches when they lend long tenor as such long term assets are inevitably funded through significantly shorter tenor liabilities.
4. In future, infrastructure development will be a significant growth driver. Broadening and deepening of the bond market is required to provide long tenor project finance. India's financial system is still largely dominated by the banking system with a deposit base largely of less than 3 year tenors. A borrower who requires long-term funds (10-15 years) is still dependant on a few providers of

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such long maturity loans. Infrastructure projects like power, telecom, ports, airports, urban infrastructure, roads etc require long-term funds. Consequently, we need a significant growth in the insurance, pension and provident fund sectors since they are the logical providers of long-term money. Simultaneously, small investors need to be brought into the long-term debt capital market. In the absence of such growth, Indian corporates with large expansion plans would expose themselves to significant refinancing risks.

5. The recent past has witnessed many Indian corporates effecting overseas acquisitions as part of their vision of global growth. The overseas subsidiaries of these companies have accessed foreign currency loan/bond market to fund these acquisitions. The ECB guidelines have been liberalized in 2004 enabling corporates to access the foreign currency loan market to fund overseas acquisitions. This is imparting greater flexibility in funding cross border acquisitions.
6. As demand for funds from the corporate sector grows rapidly, large government borrowings may create a crowding-out situation for the corporate sector.

Market Structure

7. In terms of market microstructure, automated nationwide real time trading facilities, depository mode of settlement, and wide investor base the Indian equity markets have shown remarkable transformation during the last decade. Until the mid-nineties Indian equity markets were ranked at the bottom of the league of global equity markets. Until the mid-1990s, the Indian equity markets were considered as one of the most non-transparent and riskiest markets in the world on account of their grossly inefficient trading and settlement systems. After the significant improvements in trading and settlement systems that were brought about jointly by NSE and NSDL Indian equity markets are currently ranked not only in the top bracket of the global league but that in several respects Indian equity markets are considered to be well ahead of the markets of even some of the highly developed countries. However, the radical transformation that has been witnessed during the last decade in relation to the Indian equity markets has not percolated to the corporate debt markets. In several respects the debt market

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continues to remain highly inefficient especially due to the absence of basic market infrastructure that would help its development on sound lines.

8. Corporate debt can be traded in such a way that frees market forces could be allowed to have their influence in the price discovery process. The same degrees of freedom as are currently applicable to the equity market should also be made applicable to the corporate debt without causing any problem to the financial system. The interest rates as reflected by the market prices of corporate debt instruments are influenced basically by the credit-worthiness of the borrowing entities as also the prevailing level of interest rate at which the government borrows for similar maturities. A corporate entity with good track record, sound financial position and expected good cash flows enough to service the debt can raise funds at highly competitive rates, which are not significantly above the rate at which government raises funds with instruments of similar maturity. The level of interest for the debt issued by a corporate with good credit rating will be higher than the rate applicable to the government loan of similar maturity, with the difference explaining the credit risk attached to a corporate debt.

9. It is significant to note that the reform process in the corporate debt market began way back in the early 1990s. The Government took an important decision to abolish all controls that it used to exercise on the interest rates that corporates could pay whenever they raised capital through debentures. In May 1992, after consulting RBI, Government abolished the ceiling on interest rates that the erstwhile Controller of Capital Issues used to stipulate in regard to the issues of corporate debentures May 1992. During the last decade RBI also gradually abolished all the stipulations in regard to the level of interest rates that the banks could charge on their loans to corporate entities. Another major development that has taken place during the last decade or so was the withering away of the development banks which were the major source of external long term finance for funding their new/expansion/diversification projects. All these major developments should have encouraged corporates to approach the capital market to raise resources through debentures of various maturities financing their investment plans. This in turn would have led to the growth of an active and

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vibrant corporate debt market. Strangely not only has this not happened but whatever developments that we notice in the corporate debt market have been in the direction of making the primary or issue process highly non-transparent and secondary market highly dormant and average daily trading volumes miniscule in relation to the outstanding stocks of the corporate debt.

Need for new initiatives

10. The radical improvements in the quality of the equity markets in India during the last decade have been directly as an outcome of the initiatives taken in setting up of NSE and NSDL and strengthening of SEBI through various measures including empowering it with necessary regulatory powers. Despite the fact that the Indian equity markets have a long history of more than a century markets had remained highly inefficient, confined mainly to metros and large cities, and non-transparent. They were not considered to be investor friendly. The major equity market players did not show any particular desire to upgrade market standards even after the equity markets were opened up to the foreign institutional investors. A limited number of powerful market intermediaries who benefited from inefficient and transparent system were opposed to any type of reforms that would minimise their clout in the system and eat into their high profits.
11. All the quantum improvements in the quality of markets that took place were after institutional and regulatory initiatives---many of which were not welcomed by the market intermediaries who used to exercise tight control over the management of stock exchanges---were put in place. Recent Indian experience further confirms the fact that capital markets left to themselves do not have a tendency to become efficient and vibrant in the absence of outside intervention through appropriate regulatory initiatives as also encouragement from the authorities to bring about institutional reforms. This is for the reason that there are no strong autonomous or in-built forces in the mechanism of the capital markets that help them to upgrade their functional quality.
12. History of financial markets all over the world shows that efficiency and vibrancy of capital markets improves in a slow and gradual fashion and that too over very long periods of time. A number of major improvements in the functioning of the

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capital market and the quality of their regulation in several developed countries have often been as a result of the response of the authorities to the crisis situations. For instance, the 1929 stock market crash led the US government to set up the Securities Exchange Commission and put in place other related regulatory measures to protect investor interests and safeguard market integrity. It has also been observed that steps taken in response to crisis situations are often delayed, halting, and not adequate enough to deal with the problems effectively. The general approach adopted on the part of the authorities in most parts of the world is not to proactively initiate steps for the development of the capital/financial markets on lines which help in creating healthy and vibrant markets. Under normal conditions which are free from serious crisis situations authorities in most of the countries are unwilling to proactively intervene and try to upgrade quality of the markets as they often presume that market players know what is good for the markets and there is no need for the authorities to intervene and try to shape their developments.

13. This approach suffers from some obvious deficiencies. It is also necessary to recognise that there is no universal set of reform measures that could fit situations in all countries at all times. The reform measures intended for a particular segment of the capital/financial market should take into account the basic nature of the market as well its current stage of its development before preparing the market design and rules of the game are being framed. In other words, reforms meant for equity markets may not always be equally relevant for the debt markets.
14. For creating robust corporate debt markets it is desirable that appropriate policy reforms are introduced to encourage building up of necessary market infrastructures that facilitate growth of an active primary market as also a vibrant and transparent secondary market. The recent initiatives that have helped in upgrading the standards of the equity markets would not work equally effectively in the case of the corporate debt market. While Indian equity markets have a history of more than a century the corporate debt market worth the name is a phenomenon of only about a decade. Hence creation of efficient and vibrant corporate debt markets would necessitate working on both sides of the coin:

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Firstly, the issuer base itself has to be widened in a proactive fashion. Secondly, rules of the game have to be made fair and equitable so that interests of the investors in corporate debt have to be fully protected.

15. In this context it is worth recapitulating briefly the important reforms that have taken place in the G-sec market. When reform measures were introduced by the RBI about a decade ago there was already a large captive base of investors and the floating stock of the government debt was sizeable. The only limitation under which RBI had to introduce reforms in the G-sec market was that it could not be allowed to have the same degree of freedom as the equity markets because of the continuing huge fiscal deficit. Nonetheless, RBI has succeeded in bringing about several reforms to improve transparency and efficiency of the G-sec market. Before we turn to a discussion on issues related to the corporate debt market and the steps that need to be taken to reform it, it would be worthwhile to note briefly the significant changes that have helped in upgrading the standards of G-sec and money markets.

Money & the Govt. Securities Markets

16. Reforms introduced by RBI in the money market over the last several years have transformed it from a tightly regulated rate regime to a more market determined regime. RBI has removed all the restrictions on the money market and made it almost an inter-bank market so that available liquidity at any time gets redistributed at the market determined call money rates. Apart from banks the call money market is now open only to the primary dealers in view of their crucial role in the G-sec market. RBI has established a corridor of repo and reverse repo rates at which it either is willing to pump in liquidity or absorb excess liquidity from the banking system. Call money rate move freely within this corridor depending on the liquidity conditions in the banking system. Clearing Corporation of India Ltd has introduced a money market instrument called CBLO which is a significantly improved version of the repo instrument by integrating in it the features of tri-partite repo and making it a tradable instrument. Transactions in CBLO take place on an automated anonymous order-driven transparent trading screen. As the trading on the CBLO screen is transparent to the entire market on a

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real time basis, the CBLO market has played an effective role, along with the call money market and the repo market, in equilibrating available liquidity in the system in an efficient manner. Table-III-1 gives the summary of money market operations in India since 2003-04.

Table – III -1 Money Market Operations (Rs. Crore)

Period	Repo		CBLO	
	No of trades	Volume	No of trades	Volume
2003 - 04	20927	943189	3060	76851
2004 - 05	24364	1557907	29351	976757
2005 - 06 (upto Nov 2005)	15937	1047613	38790	1534160

17. Changes of far reaching nature have taken place in both the primary and the secondary markets for G-secs and the T-bills. Efforts towards development of the G-sec market have been focussed on to three major areas: institutional measures, innovations through newer instruments, and enabling measures. As a result of these reforms the G-sec market is getting increasingly broad based. The primary market has been considerably strengthened with RBI proactively encouraging the setting up of the Primary Dealers (PDs) who bid aggressively in the auctions for G-secs and T-bills and take active market making in these instruments. Primary issue of G-secs and the T-bills are through the auction mechanism and therefore market determined. In the early days when the RBI introduced the auctioning process it used to modulate the auction mechanism by subscribing to the instruments being auctioned whenever it felt that the rate at which auction would go through will throw up interest rates which it felt were not in alignment with the prevailing interest rates. As the market gained experience RBI stopped participating in the bidding process and allowed the interest rates to be determined by the demand-supply conditions. This has helped in narrowing the gap between cut-off price and the weighted average price. Now there is a strong correlation between bids at the primary auction and secondary market yields thereby indication improved price discovery process particularly at the auction. The Negotiated Dealing System introduced by RBI has helped in significantly upgrading the settlement process through CCIL, which acts as the central

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counterparty guaranteeing all the settlements in G-secs and money market instruments. Since August this year the NDS has been upgraded further by introducing an anonymous automated order-matching trading screen for G-secs which is made available to only the RBI regulated entities in the first phase. The NDS order matching system also known as NDS-OM has helped in supplementing the pure bilateral OTC form of trading system where the telephone is the means to trade negotiation. Within a month of its launch the NDS-OM has attracted a sizeable chunk of the G-sec trading mainly because it helps to save costs for banks in their back-office operations as also get best prices on real time transparent trading screen. The new system is providing much better and efficient price discovery process. The market has also benefited from much lower bid ask spreads besides reducing intra-day price volatility. The system has proved to be very much user friendly and provides information on the state of the market on a real time basis. The success of the new trading system for the G-secs provided by the NDS-OM can be gauged from the fact that, in about a month's time from its launch, it has overtaken the combined trading volume of the brokered and direct trades. An analysis of the trades done on the NDS-OM and the other OTC trades in G-secs indicates that the NDS-OM is far more efficient than the OTC market.

18. The consolidation of government securities has received priority and most of the time during last couple of years; the Govt. has re-issued the existing securities to increase floating stocks in the market. This has helped in increasing liquidity in the market. In the process, Govt. has elongated the maturity structure of the bonds. The primary market is functioning in a smooth manner. Table-III-2 gives the resources raised through primary issuance from the debt market in various years.

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Table III-2 Debt Issuance (Rs. crore)

Issuer	1999-00	2000-01	2001-02	2002-03	2003-04
Corporate*	59399	56577	515,61	752,41	695,03
Public Issues	4698	4139	5341	4866	7190
Private Placement	54701	52433	46220	66948	59215
Government	1,13336	128483	152508	181979	198157
Total	172735	185060	204069	257220	267660
*Source: Prime Database (for corporate debt) & RBI (for Government debt), ISMR-2004 (NSE) * included Euro issues*					

19. Government bond market in India developed faster due to infrastructural and policy changes made by regulatory authorities in early and mid 1990s. The advantage of the sovereign bond market over the corporate bond has been inherent in credit quality, mandatory requirement of SLR, Delivery versus Payment mechanism, settlement guarantee system, etc. Till recently, gilts market was a pure bilateral OTC market where telephone was the mode of dealing in a bond. Before introduction of centralized clearing and settlement mechanism, the settlement of transactions used to be done directly through transfers of SGL balance and funds at RBI. Though it was a DVP mechanism, it still has a degree of cash flow risk due to failure of a settlement. The Negotiated Dealing System (NDS) was set up in Feb, 2002 to ensure centralized reporting of all deals in Govt. securities by regulated entities. The creation of CCIL was helped to put in place an efficient clearing and settlement mechanism that would provide guaranteed settlement to market participants. The process of change has been very smooth. The market has gained substantially with increased netting factor. Table-III-3 gives the trading activity in the market.

Table-II-3: Trading Volume in Gilts

Period	Gilts Trading	
	No of trades	Volume (Rs. crore)
2002 - 03	191843	1076147
2003 - 04	243585	1575133
2004 - 05	160682	1134222
2005 - 06 (upto Nov 2005)	95151	662496

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Primary Corporate Debt Market

20. From 1985-86, the Public Sector Undertakings (PSUs) have been issuing bonds which are subscribed mainly by the institutional investors including banks. Retail investors' interest in the market has been rather thin. The falling interest rate during the recent past has encouraged the corporate sector to look up to the bond market rather than rely largely on the banking system for loans. Bond issues by the corproates have risen sharply during the last decade although there was a small decline in the amounts raised through the bond route during 2003-04.
21. Major issuance is currently through private placement where disclosures have been rather scanty. Many issuers prefer private placement route mainly because of its operational ease. The private placement market is dominated by Financial Institutions, Banks and PSUs who mobilized about 80percent of the resources while other private corporate sector entities mobilized only about 20percent of the resources. The privately placed bonds also lack liquidity in the secondary market as many of the investors adopt the practice of holding these bonds up to their maturity. An important development in the corporate bond market has been that most of the issues are now held in the dematerialised form in the depository.
22. With a view to imparting greater degree of transparency SEBI issued directives making trading of corporate bonds mandatory on the order matching screens of the stock exchanges. RBI also simultaneously issued instructions to all the banks and primary dealers that their investments in unlisted corporate bonds should not exceed 10percent of their investment portfolio of non-SLR securities. At one stage banks were not allowed to lend at rates lower than the PLR of respective banks. Banks intending to extend loans to their high credit rated borrowers at rates lower than their respective PLRs camouflaged them as investments in privately placed bonds since RBI’s interest rate directive did not apply to lending by way of investment in bonds. After RBI removed this restriction on sub-PLR lending banks are not tempted to resort to investment in bonds merely to lend below the PLR. There was also another reason why banks used to prefer the private placement route. Any bank lending amounting above a particular size, the loan proposals have to be screened through the Board or Board committees. Hence the

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appraisal has to be sufficiently detailed and rigorous enough to pass through the scrutiny of the Board or its sub-committee. However, if the same amount of money is lent by way of investment in the corporate bonds it did not have to go through the scrutiny of the board or the committee. The regulation that at least 90percent of the non-SLR investment portfolio should be deployed in the listed securities helps to ensure meeting the public issue requirements with their detailed disclosures and mandatory rating.

23. Corporate bonds are issued in India through private placements and public issues. It is the private placements that occupy the premier place. Even in the present buoyant equity market, 68percent of the resources raised (in 2003-04 and 2004-05) were through bonds private placements. This was as high as 83percent to 91percent in the preceding 7 years as given in Table-III-4.

Table-III-4: Resources Raised by Corporate sector

Year	Public Equity Issues	Debt Issues			Resource Mobilisation (2+5)	Share (%) of Private Placement in		Share (%) of Debt in Total Resource Mobilisation (5/6*100)
		Public Issues	Private Placements*	Total (3+4)		Total Debt (4/5*100)	Total Resource Mobilisation (4/6*100)	
1	2	3	4	5	6	7	8	9
1995-96	8,882	2,940	10,035	12,975	21,857	77.34	45.91	59.36
1996-97	4,671	7,015	18,391	25,406	30,077	72.39	61.15	84.47
1997-98	1,132	1,929	30,983	32,912	34,045	94.14	91.01	96.67
1998-99	504	7,407	38,748	46,155	46,658	83.95	83.05	98.92
1999-00	2,975	4,698	55,073	59,771	62,746	92.14	87.77	95.26
2000-01	2,479	4,139	52,456	56,595	59,074	92.68	88.80	95.80
2001-02	1,082	5,341	45,427	50,768	51,850	89.47	87.61	97.91
2002-03	1,039	4,693	48,424	53,117	54,156	91.16	89.42	98.08
2003-04	17,821	4,324	48,428	52,752	70,573	91.80	68.62	74.75
2004-05	21,432	4,095	55,384	59,479	80,911	93.12	68.45	73.51

* Data of 2000-01 and onwards includes only issues with a tenor and put/call option of 1 year or more, while the data for earlier years includes all issues irrespective of tenor or put/call option.
Source: Prime Database

Private Placements of Corporate Bonds

24. The growth in gross bonds private placement issuances has been very impressive. From a level of Rs.10,035crore in 1995-96, the volume has grown to Rs.55,384crore in 2004-05 (Figure-III-2). The total volume of issuance has as such risen by roughly five times over the 10-year period. The total mobilisation over the last 10 years has been an impressive Rs.4,03,244crore.

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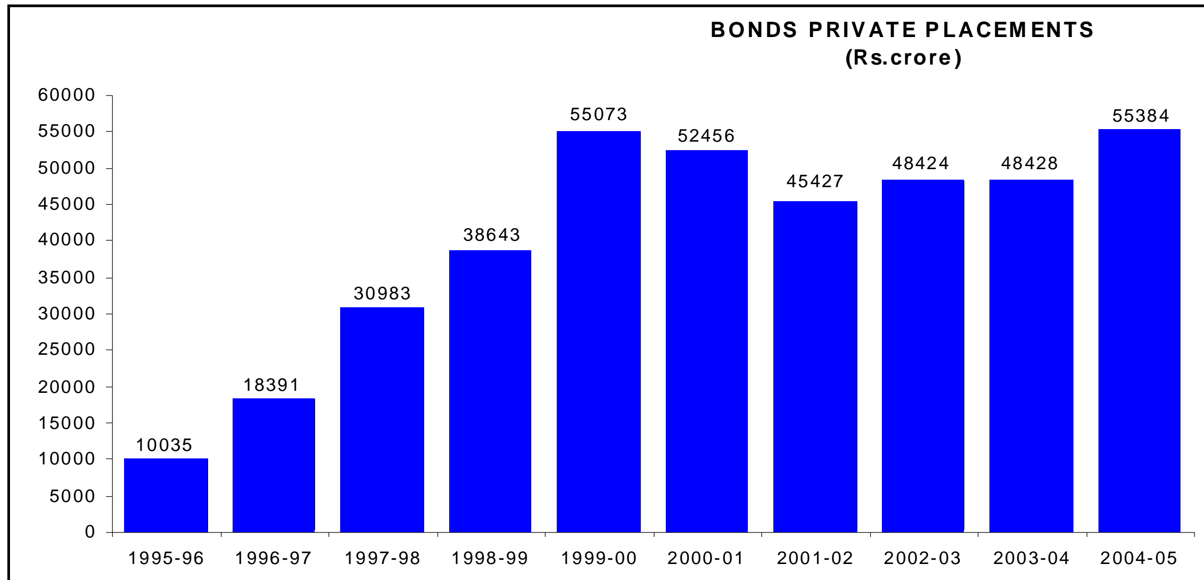
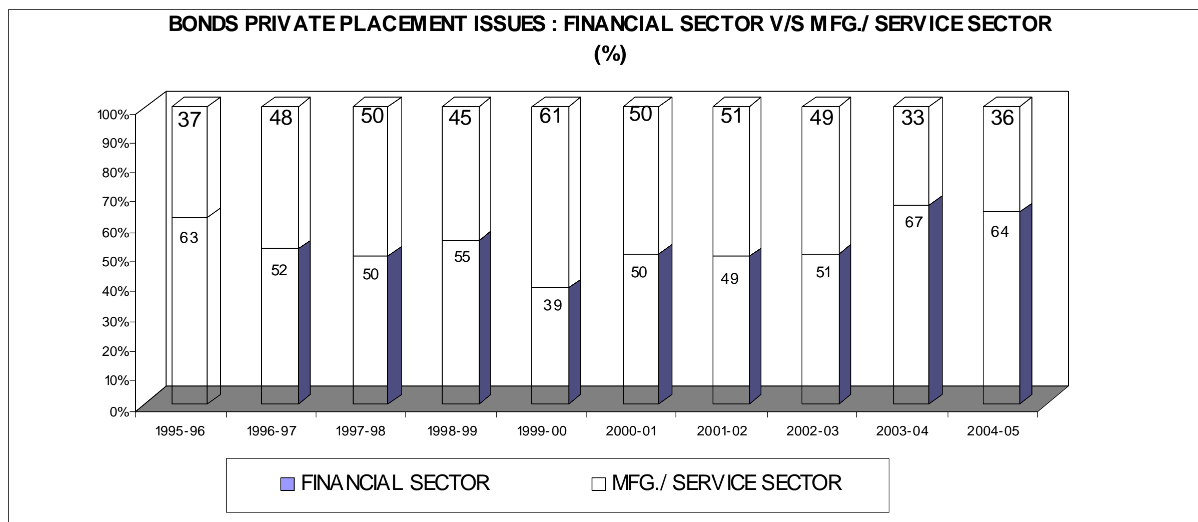
Figure-III-2: Private Placement of Debt



Data of 2000-01 and onwards includes only issues with a tenor and put/call option of 1 year or more, while the data for earlier years includes all issues irrespective of tenor or put/call option.
Source: Prime Database

25. Significantly, the real corporate bond (manufacturing/services sectors) issuances have been a very small part of the total issuances. Most of the corporate bond issuances have been by the financial intermediaries, for example, dominating with a 64percent share in 2004-05 (Figure-III-3).

Figure-III-3: Issuer category



Source: Prime Database

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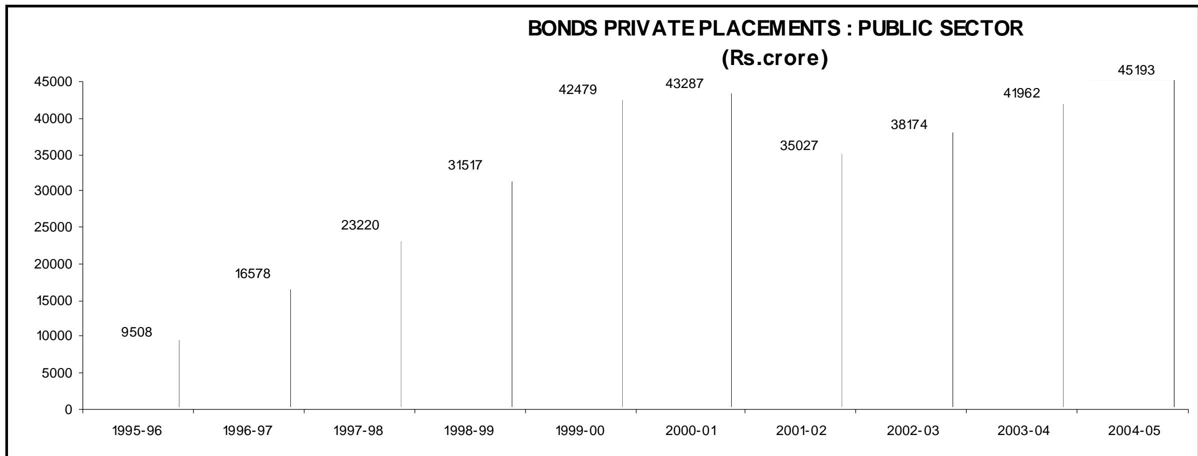
Domination by the public sector

26. The bulk of the issuance has been by the public sector (Figure-III-4), which collectively has raised Rs.3,26,945crore or a massive 81percent of the total amount in the last 10 years. For the public sector, comprising both central public sector units (PSUs) and state level undertakings, private placements have been a very easy way of raising money as most of the investments have flown in on the implicit sense of government guarantee.

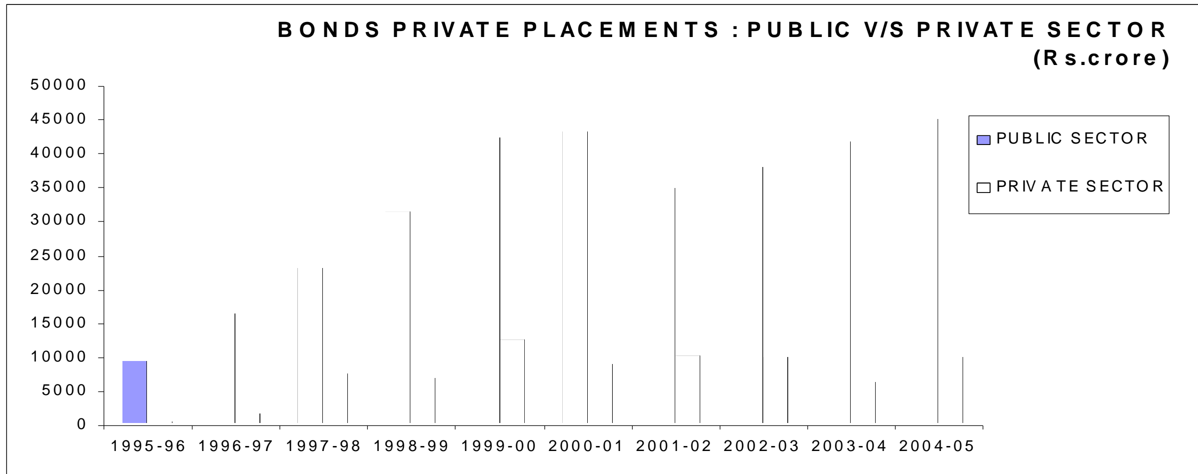
Figure-III-4: Public Sector Companies raising funds from the market



Source: Prime Database

27. The year-wise share of the public and private sectors is shown in Figure-III-5. It is evident that in each of the years, the private sector pales in comparison to the public sector.

Figure-III-5: Public Vs Private Sector



Source: Prime Database

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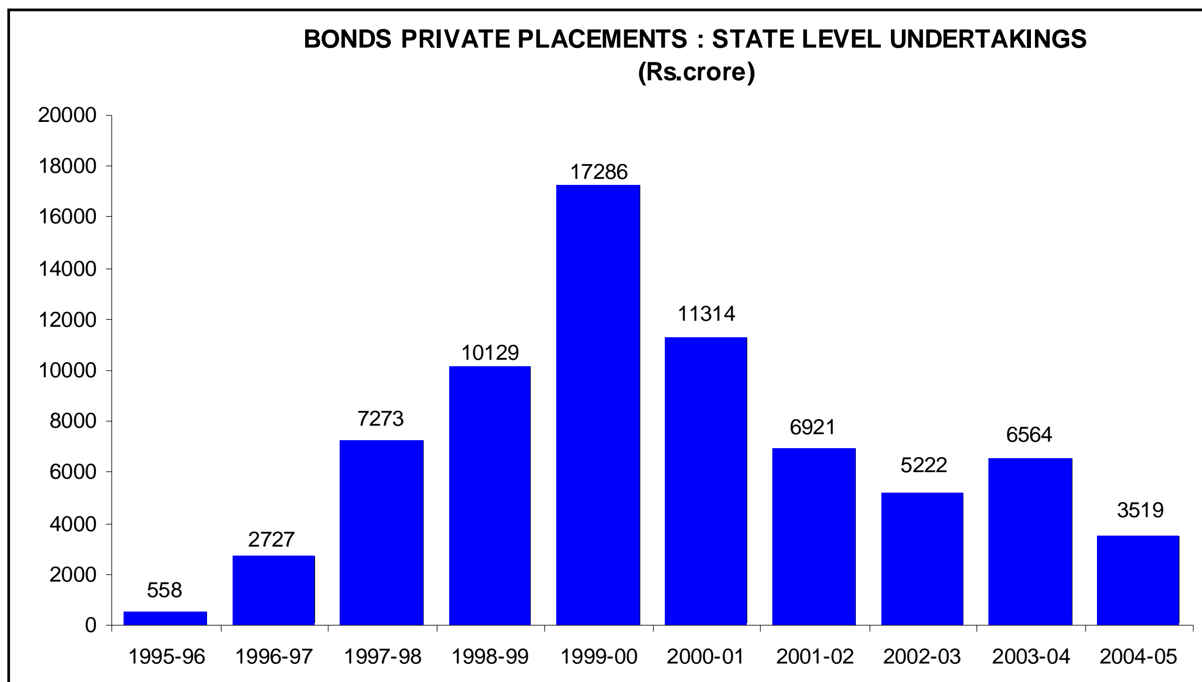
State level undertakings

28. A segment of the public sector issuances have been the bonds from state level undertakings, which over the last 10 years, have mobilized a huge amount of Rs.71,513crore (Figure-III-6).

29. Many of these undertakings do not have any revenue streams to be able to pay interest or redeem the bonds. Issue stage as well continuing disclosures have been almost non-existent while there is no system for monitoring of funds utilization. Fortunately, some curbs put by the RBI in 2001 on banks investing in such bonds has since led to a lower level of such issuances. Some regulations also brought in by SEBI in 2003 have impacted such issuances.

Figure-III-6: State Level Undertakings' Private Placement in Debt



Source: Prime Database

Private sector

30. Significantly, the raising from the private sector has been extremely low; its share has been less than or around only 20percent of the total mobilization in each year. In 2004-05, only Rs.10,191crore of issuance took place in the private sector, and this value has shown little growth after 1997-98 (Chart-III-7).

31. One major reason for the low levels of mobilization by the private sector is the regulations which make the market available only to the top-rated companies.

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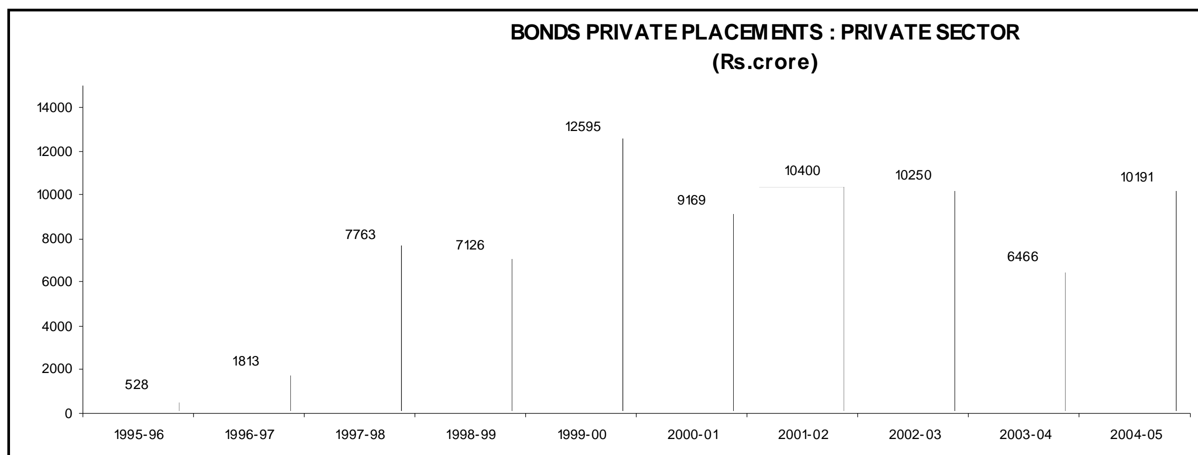
Significantly, of the total volume of issuance of Rs.55,384crore of privately placed debt in 2004-05, Rs.53,749crore was credit-rated. This suggests that credit rating is effectively a pre-requisite for bond market access. The ease with which monies can be raised in the overseas markets is also a contributing factor.

32. Interestingly, a large amount of mobilization by the private sector has been to retire old expensive debt, and not so much for capex. Whatever small amount that has been raised by the private sector has been through private placement route which has been preferred over the public issue route due the obvious advantages of finer pricing, lower cost of issue, lesser time frame and minimal regulatory approvals.

Chart-III-7: Private Sector Bond Private Placement



Source: Prime Database

33. The number of issuers from the private sector too has been extremely low and, in fact, has been falling since 1998-99; from 126 in that year to only 43 in 2004-05. (Chart-III-8).

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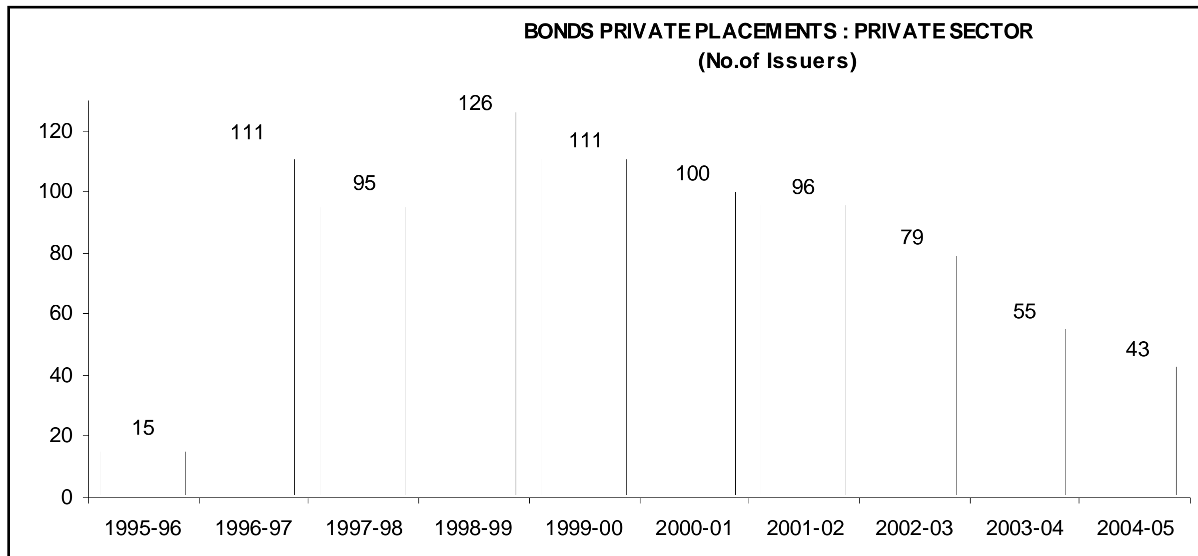
Chart-III-8: Private Sector Bond Private Placement –Number of issues

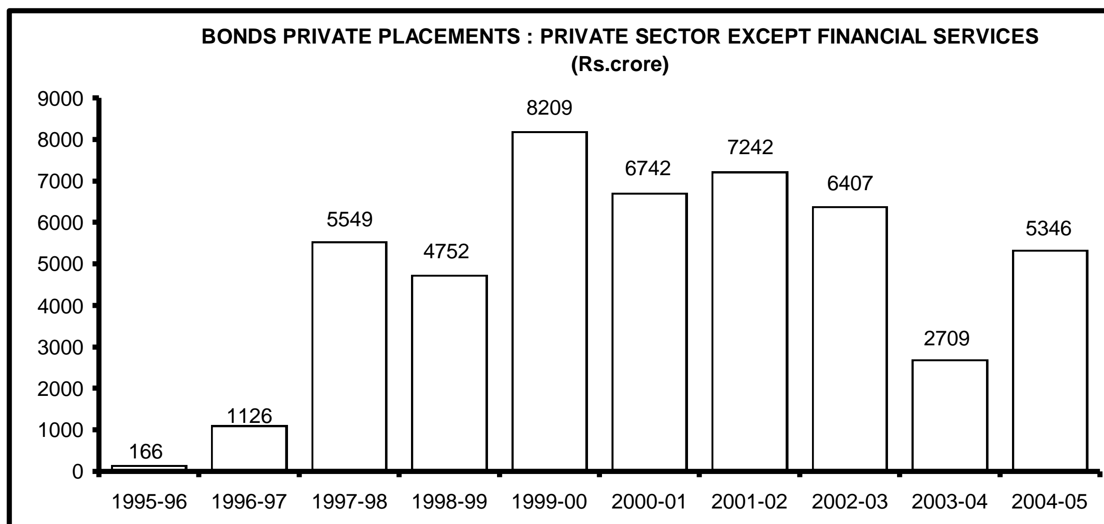


Source: Prime Database

Private sector manufacturing/services

34. The picture becomes less comforting if one was to look at the amounts mobilized directly by the corporate sector for manufacturing/services, i.e. excluding the amounts raised by the private sector financial services companies. This amount was only Rs.5,346crore in 2004-05, down from Rs.8,209crore in 1999-00 (Chart-III-9).

Chart-III-9: Private Sector excluding Financial Services Companies



Source: Prime Database

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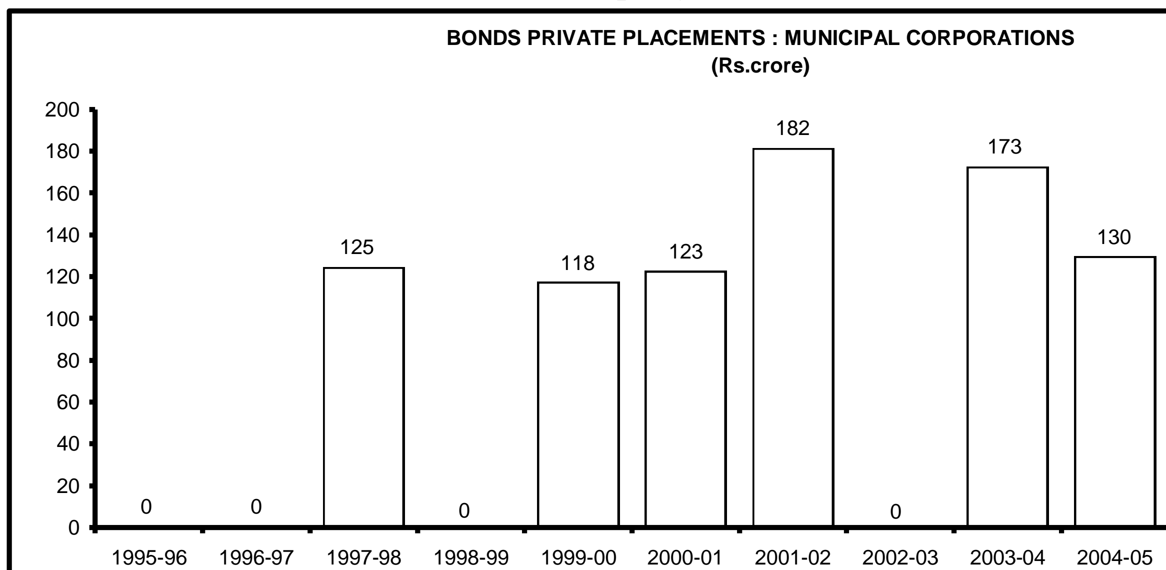
Municipal bonds

35. Municipal bonds are a major category of bonds in most developed markets, including the US. These have, however, not really taken off in India. Over the preceding 10-year period, from 1995-96 to 2004-05, the total mobilisation through municipal bonds has been a paltry Rs.851crore (Chart-III-10) limited to only 11 issuers.

Chart-III-10: Municipality Bonds



Source: Prime Database

Public issue of bonds

36. The primary market for corporate bonds has also engaged in public issues, though in a very minimal manner. In 2004-05, while Rs.21,393crore of equity were sold, only Rs.4,095crore of bonds were sold on the public issue market. The public issue bonds market has just not been growing (Figure-III-11).

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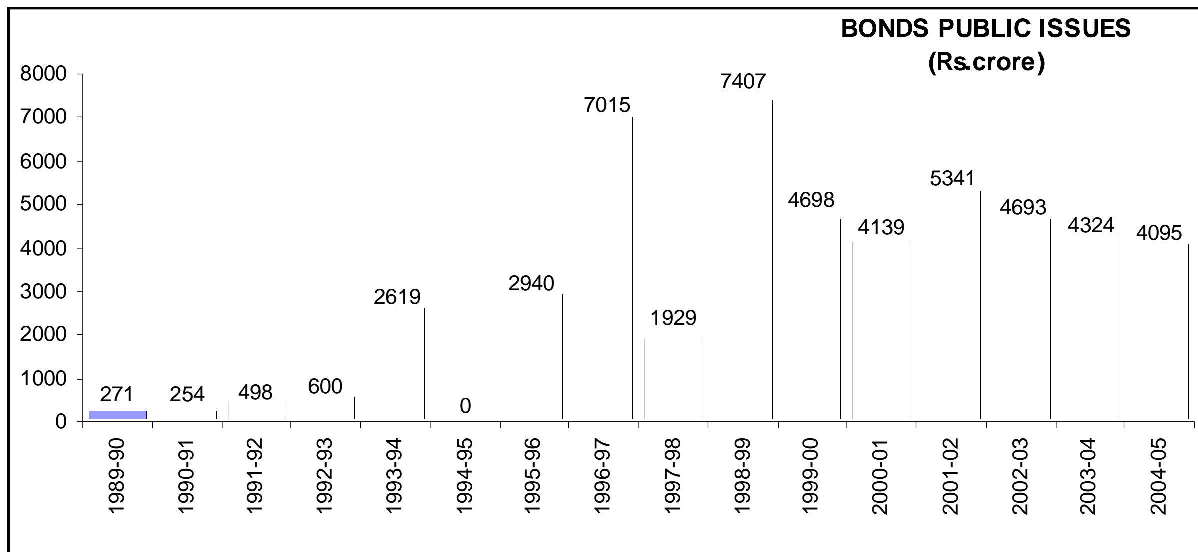
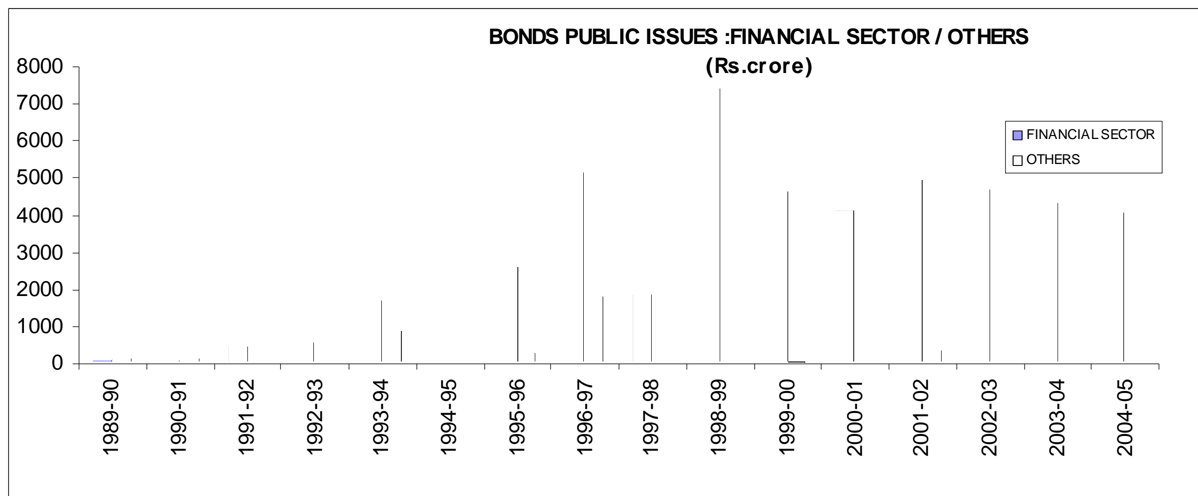
Figure-III-11: Bonds Public Issues



Source: Prime Database

37. Even the meagre issuances that have been made have almost entirely been from the financial institutions (Figure-III-12)

Figure-III-12: Issuers Classification



Source: Prime Database

38. As such, what we witness in public issues are not corporate bonds but in a truer sense, these are bank bonds. Significantly, most of the raising by the financial institutions earlier was through long-term Deep Discount/Money Multiplier Bonds. Having made the initial mistake of offering a long-term high coupon

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commitment, the subsequent bonds issuances have been for Infrastructure Bonds where the retail participation has been mainly because of the tax benefits.

Listing of Corporate Debt

39. The SEBI directive issued in early 2004 that all secondary market trading should be on the automated order matching screens of the stock exchanges is having an unintended negative impact on the corporate bond market. It was hoped that these directives to the market intermediaries and investors would enhance transparency and make price discovery process more efficient. These regulations however do not apply to spot trades which are defined as trades between any two investors which are settled in two days. Since investors in corporate bonds, who are mostly institutions, do not prefer to go stock exchange screens have resorted to bilateral deals amongst themselves. Even when some of the institutional investors take the help the brokers, the brokers do not issue contract notes and the deals are shown as direct deals. The brokers are compensated for their services in one form or the other. Since the brokers are not issuing contract notes they are not obliged even to report such deals to the stock exchange. This is the main reason why the deals which would have otherwise got reported to the stock exchange and would have thereby imparted some degree transparency to the secondary market in corporate debt are not being reported to the exchanges after the SEBI directive. Thus the steps taken by SEBI to force shifting of corporate bond trades to the exchange screens have proved to be counterproductive.
40. Most of the corporates keen to issue bonds are not happy with the listing guidelines on corporate bonds. Their complaint is that they are excessively detailed and do not necessarily serve the intended purpose. There is a general demand that the listing guidelines to be thoroughly reviewed and all the superfluity that exists should be done away with. In the listing guidelines for equity issues also there is great deal of discomfort among the issuers. But since corporates do not approach the market for equity issues frequently they somehow have come to live with them. But the same cannot be said about the corporate debt. Corporate entities would like to approach the market preferably with much greater frequency than in the case of equity. Secondly, since the listed companies

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are obliged to abide by the continuous disclosure requirements of SEBI there is no need that they should also be asked to make too many detailed and exhaustive disclosures whenever they approach the market with their debt issues. There is a strong case that at least in the case of already listed companies the disclosures to be made at the time of their bond issues should be substantially abridged and they are asked to make only the required incremental disclosures whenever they approach the market with debt issues.

Rating rationale

41. Looking at the nature of the corporate debt market there is a need to have totally different approach to the problem of disclosures in regard to corporate debt issues. As already noted the corporate debt market is essentially a market of institutional investors. Investment in corporate bonds is currently not favoured by the retail investors and the global trends are also pointers to the fact that the retail investors in corporate bond are not likely increase in future. When it comes investing in fixed income assets retail investors generally prefer other avenues such as bank deposits, postal savings schemes, mutual funds etc. The main attraction for the retail investors to invest in equities is the opportunity for capital appreciation. Similar attraction is totally missing in the case of corporate debt. The retail investors in the US therefore prefer the mutual fund route for investing in fixed income investments. As part of its investment strategy a mutual fund invests in a large number of debt instruments so that risks get diversified. Portfolio investment theory tells us that the risks attached to a portfolio of securities tend to be lower than investment in fewer securities. Secondly, an efficient mutual fund manager is much better informed than an average investor about the choice of debt securities and also would be making an exit well in time from poorly performing securities. Thus there are several reasons why the corporate debt market is becoming increasingly institutionalised.
42. An institutional investor is invariably a better informed and sophisticated investor and hence the type of disclosures that such an investor needs would not be the same as are made in the prospectuses issued at the time of public issues. Quite often institutional investors attach a great deal of importance to the rating

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judgement of a professional rating agency. A rating agency goes through thoroughly into all the relevant information before it announces its rating value. All the rating companies also release their rating rationale in the form of a write-up and together with an analysis of the financials of the company, its strengths and weaknesses, its competitive position in the industry, and its future prospects. Given the importance attached by the institutional investors to the rating valuation of a professional rating agency it would be reasonable to depend to a large extent on the rating of two professional rating agencies as the basic minimum requirement for listing a corporate debt on a stock exchange. This yardstick should be adopted at least in cases of corporate debt instruments which are meant exclusively for the institutional investors.

43. When an issuer decides to tap the market through a debt instrument the issuer may be given an option to decide whether he wants the issue to be exclusively for the institutional investors or all types of investors including the retail investors. If the issuer wants to restrict the scope of the debt issue to institutional investors the listing requirements may restricted only to rating of the issue by any two of the SEBI recognised rating agencies. For making this option more attractive and acceptable to institutional investors it may be desirable to make it obligatory on the part of the rating agencies to provide much more detailed information in their rating rationale write-up on such important areas as information/figures on the outstanding debt of the issuer through different instruments, projected cash-flow for the next five years, possible impact on the finances of the issuing company on account of pending litigations/claims which are of material nature, etc. In case the issuer decides to keep the issue open to the retail investors it may be made mandatory for the issuer to go through the full disclosure route as is being done today.

44. In this context it may noted that a number of reservations are being expressed about efficacy and utility of current format of the prospectus for public issues, especially about the nature and type of disclosures that are required to be made in the prospectus for corporate debt issues. It is being suggested that a through assessment or examination should be made about the format of the prospectus for

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bond issues, and the nature and type of disclosures that have to be included in the prospectus as also the listing document that the bond issuers have to sign with the stock exchanges. There is also the common complaint that the massive information given in the prospectus for public issues is not vetted properly and also the fact average investors are not able to make head or tail of all the voluminous information provided in the prospectus. For example, full list financial claims or the legal suits pending against issuing company are given in the prospectus but a common investor is not in a position to assess meaningfully the possible impact of them on the finances of the issuing company. Hence a common investor gets a feeling of being lost in the jungle of disclosures that are provided in the prospectuses. There is a general feeling that the current public issue requirements are too onerous and counter-productive and time consuming. Hence many issuers prefer to tap foreign markets for debt given the fact it is relatively hassle free and money can be raised in much shorter time. In short, a regulatory arbitrage is built into the current public issue requirements especially in the case of debt instruments. This issue calls for an urgent and thoroughgoing review of the listing requirements for all issues and much more so in the case of corporate debt issues.

Market preference for high rated bonds

45. Investors in corporate debt instruments are excessively safety conscious as could be noted form the fact that there is hardly any demand for paper which is rated below AA or its equivalent by the rating companies. World over any paper rated BBB (or its equivalent) and above is considered as investment grade, except that the interest rate to be paid on BBB has to be high enough to compensate for the risk attached to it in relation to the highest rated paper. Basically it is a question of risk-reward matrix with higher risk being compensated by higher return. Globally there is considerable demand for debt paper which is rated below AA. In fact the maturity of the market is often judged by the skill of the investors to factor risk-reward matrix in their investment decision so that they do not miss the high return opportunities that may exist in the case of BBB rated paper. Judged from this matrix it is clear that Indian debt market is yet to mature. This is indicated by the

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analysis of the outstanding bond issues with reference to their rating values assigned to them by the recognised rating agencies. Over 82percent of the debt paper is AA and above, as demand for other investment grade paper is not large enough. The majority of institutional investors by amount in the corporate debt paper are banks which are all the while in favour of highly rated paper while at the same extending loans to not so well rated corporate clients. Thus most of the banks adopt an asymmetric credit evaluation methodology when they are willing to provide loan to a client but unwilling to invest in the debt paper issued by the borrower if the debt paper is not rated very highly by the rating agencies. It is hoped that as the corporate debt market grows in size and becomes deep, liquid, and broad-based investors will start understanding the risk-reward matrix much more intelligently. Institutional investors will start to appreciate increasingly the risk-adjusted returns and the arbitrage that the market provides. Table III-4A and III-4B give the outstanding corporate debt in the market in terms of rating class, issue sizes and no. of issues.

Table-III-4A: Corporate Bonds - Outstanding Issues (Aug 25, 2005)[3]

Rating Class	No. of Issues	Market Share(%)	Issue Size (Rs.Cr)	Market Share(%)	Market Cap (Rs. Cr)	Market Share(%)
AAA/MAAA	955	61.61	92609	69.81	93872	69.68
AA+/LAA+/MAA+	320	20.65	19605	14.78	19821	14.71
AA/LAA/MAA	175	11.29	13248	9.99	13692	10.16
AA-/LA-	31	2.00	1272	0.96	1322	0.98
A+/LA+	16	1.03	1545	1.16	1559	1.16
A/LA/MA	16	1.03	1512	1.14	1529	1.13
A-	12	0.77	1063	0.80	1065	0.79
BBB+	11	0.71	833	0.63	877	0.65
BBB/LBBB	8	0.52	722	0.54	725	0.54
B	6	0.39	257	0.19	257	0.19
Grand	1550	100.00	132666	100.00	134719	100.00
Rating Not Available	82		9906		9916	

[3] *Source: NSE WDM segment*

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Table-III-4B: Corporate Bonds (Structured Obligations) - Outstanding Issues (Aug 25, 2005)[4]

Rating Class	No. of Issues	Market Share (%)	Issue Size (Rs.Cr)	Market Share (%)	Market Cap (Rs. Cr)	Market Share (%)
AAA	19	8.60	3116	12.83	3144	12.75
AA+	6	2.71	175	0.72	175	0.71
AA	5	2.26	263	1.08	267	1.08
AA-	15	6.79	1700	7.00	1777	7.20
A+/LA+	24	10.86	3042	12.53	3197	12.96
A/LA	136	61.54	12328	50.77	12671	51.37
A-	10	4.52	1900	7.82	2017	8.18
BBB+	3	1.36	200	0.82	204	0.83
BBB	2	0.90	840	3.46	495	2.01
BB	1	0.45	718	2.96	718	2.91
Total	221	100.00	24282	100.00	24665	100.00

Secondary Market

46. The gilts are not only dominating the primary market but these securities have reasonably good secondary market. The secondary market trading in gilts constitute about 97percent of the market. The secondary market in non-Govt. debt papers suffers from chronic illiquidity. Trading in corporate debt papers was relatively thin during last two years and accounted for about 3percent of the total debt traded in the market. Table–III-5 gives the secondary market activity in debt.

Table - III - 5: Secondary market activity in Debt Securities (Rs. Crore)

Year	Corporate Debt	Market Share (%)	Gilts	Market Share (%)	Total
2003-04	41977	2.60	1575133	97.40	1617110
2004-05	37969	3.24	1134222	96.76	1172191
Source: NSE Factbook 2005, CCIL Factbook 2005					

47. The low level of activity in the corporate bonds is due to the fact that the market is dominated by a limited number of players and inadequate disclosures about the securities which were issued mainly through the private placement route during the past. The trading was mainly confined to PSU bonds and commercial papers. There was very little or no retail interest in corporate debt due institutional structure of the market.

[4] *Source: NSE WDM segment*

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48. The corporate bond market in India is a pure and simple OTC market as all the deals are done over phone by market participants. The situation is no different even when the brokers are involved. As already noted above SEBI move to bring the OTC deals in corporate bonds to the market through an order matching mechanism has proved to be counterproductive. Following SEBI move in the matter the stock exchanges also issued notice banning negotiated deals[5]. But the reality of the situation is that there is no proper order matching system in place that would ensure efficient price discovery in corporate bonds. NSE's WDM segment gives an option to a market participant to set an exposure limit against another preferred participant while making it zero for others and in the process executing a pure negotiated deal. Thus the trading system in effect is not an anonymous order matching system in spirit. Initially such counter party exposures were required to be set up before the market opens which was causing inconvenience to market participants to execute a deal during the day if prior counter party limit is not fixed. But after the issuance of NSE WDM circular dated July 20, 2004, such irritants have been abolished allowing setting up counter party exposures any time during the day and a market participant can do a pure negotiated trade. NSE had to relax its strict standards which it maintains in the case of the anonymous automated order matching system for the equity market primarily because the debt market players are still not ready for an order matching system where they do not know the counterparty to the trade.
49. For a debt market to grow vibrantly and on healthy lines the investors should have access to all essential information on issuers for making right investment decision. Secondly, for having an efficient secondary market there should be fair degree of transparency since transparency is really the driving force in any market. In India the secondary market in equities has proved that transparency does not have any effective substitute for ensuring efficient price discovery and attracting investors to actively participate in the market. It is therefore imperative that all such relevant information is available in the public domain on a real time basis so that the same information is simultaneously available to all interested sections.

[5] NSE WDM CIRCULAR NO : 55 Ref No: NSE/WDM/1206 dated September 28, 1999

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Further, dematerialization facilitates settlement process, reduces transactions costs, and can be easily integrated with the existing electronic settlement system for capital market in the country. The regulatory requirement for institutions and banks to invest in electronic form of debt has also helped to enhance the maturity of the market.

Clearing & Settlement

50. Unlike secondary market in gilts, corporate debt market currently does not have a structured clearing and settlement mechanism in place. The market practice is loaded more in favour of buyer as the seller has to first give instruction to depository for transfer of securities and then receive the cheque from the buyer. Hence, the risk is higher for the seller and it may hamper the market development process. The bilateral settlement that happens at present is adding burden in terms of costs. In spite of RTGS being in place, there is a time lag between the pay-in and pay-out in corporate debt market transactions. Unlike gilts market where no TDS is deducted while selling, TDS is a major issue in corporate bonds market. Companies deduct tax on accrual basis. Hence there is physical exchange of cash when multiple trading happens in a security in the market. In this context it may be recalled that TDS on G-sec was abolished after RBI took up the matter with the government explaining how TDS provision was making G-sec trading both inefficient and cumbersome.

51. One of the major problems in regard to the TDS on interest income from corporate bonds is that it is not uniformly applicable to all the investors. While insurance companies and mutual funds are exempt from the provisions of TDS all other market players are subject to provisions of TDS in respect of interest paid on corporate bonds. In view of the differing TDS treatment for different market players it is not possible to introduce an anonymous automated computerised trading system and a meaningful price discovery process. Therefore it is desirable to have a uniform TDS rule if an efficient trading system is to be introduced for the corporate bonds. Since the major players in the corporate bond market are almost the same institutional investors who also operate in the G-sec markets it is

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desirable that TDS provision in respect corporate bonds is also abolished as in the case of G-secs.

52. The secondary market trading activity in corporate bonds is not fully reported to the stock exchanges. In their capacity as members of the stock exchanges the brokers are obliged to report details of all trades in respect of which they issue contract notes. In order to avoid reporting to the stock exchanges as also to save cost of stamp duty on contract notes a number of brokers have stopped issuing contract notes although the trades are facilitated by them. The investors whose trades in corporate bonds are facilitated by the brokers compensate the brokers for their services in some other form by not calling it as brokerage. Table-III-6 gives the trading statistics of all corporate bonds in the market that includes deals through brokers reported in NSE WDM fro the period from Jan'05 to July'05. The trading in AAA rated securities during first 7 months of the year accounts for only 19percent of the total outstanding debt in the said category.

Table – III-6: Trading Volume and Rating Class (Jan'05 to July'05)[6]

Rating Class	Trade Value (Rs. Cr.)	Market Share	No. of Trades	Market Share
AAA	18047	84.05	1964	83.26
AA+	2161	10.06	272	11.53
Rating NA[7]	830	3.87	86	3.65
AA	250	1.16	20	0.85
AAA(So)	95	0.44	11	0.47
P1+	40	0.19	4	0.17
PR1+	25	0.12	1	0.04
UR	25	0.12	1	0.04
Total	21472	100	2359	100

53. The secondary market trading is heavily biased in favour of higher rated papers like AAA and AA+ which account for about 95percent of the total trading. Other lower rated papers are hardly traded and hence investors must be willing to use a buy and hold strategy for these papers.

[6] Information made available by a leading debt broker which tracks all trades in corporate bonds
[7] Rating information not available

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54. Retail investors in India prefer to invest mainly in equities. Retail debt market would take considerable time to develop as it would require great deal of efforts in educating investors about the advantages of investing in debt instruments. A deeper bond market would help in better price discovery for all. NSE has taken initiative of providing an electronic platform for trading in corporate papers in both capital market and WDM segments. It also provides settlement guarantee if the papers are traded in capital market segment of the exchange. The total trading volume in retail debt market (less than Rs.1crore of investment) during 2004-05 constituted about 0.05percent (0.03percent in 2003-04) of the total debt market turnover.[8]
55. A consolidated database on historical trading patterns and investor behaviour, based on actual OTC market trade information, is not easily available. This is very essential to understand the perceived risks in the market. There is no reliable data stream available that can provide information on credit spreads on corporate bonds. Presently this is largely guided by rating information. However, this alone should not form the only basis of calculating credit spreads on bonds as two AAA+ bonds issued by different issuers with more or less same maturities trade at different yields. Since there is no proper credit migration matrix available, it would be difficult to calculate the risk or the probability of default.

What Ails Corporate Bond Market

56. **Stamp Duty:** Stamp duty on debentures as per Article 27 of Indian Stamp Act is 0.375percent *ad valorem*. The promissory notes attract much lower duty of 0.05percent. Further stamp duty is different in different states for mortgage and assignment. In the interests of developing the corporate bond market there is pressing need for rationalisation of the stamp duty structure across the country. Since stamp duty impacts heavily the cost of issue of bond paper 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. With a view to encouraging issuance of debt paper of shorter

[8] Source NSE Fact Book 2005

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maturities it is suggested that the stamp duty payable on bond issues should be fixed on the basis of tenor and issuance value. In the absence of a tenor based provision, the stamp duty costs of a debt paper with say two year maturity becomes highly discouraging. It is suggested that stamp duty rate should not exceed 0.05percent of face value of the debt per year (maturity) of the bond issue amount (across tenors), with a cap of 0.25percent or Rs.25lakhs whichever is lower. For example, the maximum stamp duty rate should be 0.25percent *ad valorem* with a cap of Rs.25lakhs for a 7-year instrument. Further re-issuances of corporate bonds should be clubbed with the previous issues to determine maximum stamp duty payable viz., a series of re-issuances should be considered as one issue with maximum stamp duty payable thereon being based on the amount payable had it been a single issue.

57. In case of certain category of debt securities the stamp duty applicable differs on the basis of the class of investor. For example in case of a bond issued in the nature of a promissory note the applicable stamp duty is 0.50percent of the amount issued, however if the investors are RBI, IFCI, IDBI, commercial banks and co-operative banks then the applicable stamp duty is 0.10percent. This discourages corporates from issuing bonds to a whole lot of investors like retail investors (either directly or through mutual funds), and to long-term investors like insurance companies, provident and pension funds. In case of a secured debenture the stamp duty is exempted; however stamp duty needs to be paid on the creation of the charge, which comes under the purview of the state where the charge is created. Different state governments follow different rate structure, leading to corporates executing deeds in states where the duty is low notwithstanding where their substantial business interest lies. Apart from the inconsistencies in the stamp duty structure, the rates themselves are quite steep as compared to some of the developed markets. See table below for comparison of the stamp duty structure in various markets. Debentures are covered under Article 27 of Indian Stamp Act (central Act) which has the current stamp duty at 0.375percent *ad valorem* and it is more than 5percent of interest cost for short dated bonds. The Table-III-7 gives comparative stamp duty structure in various places.

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Table-III-7: Stamp duty in some of the developed markets vis-à-vis in India

Nature of Instrument	Singapore	Malaysia	Maharashtra	Delhi	Gujarat
Issue of Promissory Notes	Nil	Nil (Pvt. Debt Securities, ABS, Company Bonds)	0.5% 0.10% in case investor is bank/select institution	0.5% 0.10% in case investor is bank/select institution	0.5% 0.10% in case investor is bank/select institution
Issue of Debentures	Nil	Nil (Pvt. Debt Securities, ABS, Company Bonds)	0.36% (Unsecured Debenture)	0.36% (Unsecured Debenture)	0.36% (Unsecured Debenture)
Creation of Charge					
Non equitable Mortgage	S$4 (0.04%) for every S$1000 (Max S$500)	RM5 (0.05%) for every RM 1000 (Max RM 500)	1% (Max Rs. 5 lac)	2% (Max Rs. 2 lac)	2% (Max Rs. 2 lac)
Equitable Mortgage	S$2 (0.02% for every S$1000 (Max S$500)	RM5 (0.05%) for every RM 1000 (Max RM 500			
Eg: For a Rs.50cr. issue	0.0027%	0.0024%	0.10%	0.04%	0.04%
Pawn/Pledge			1% (Max Rs. 5 lac)	0.5% (Max Rs. 0.50 lac)	0.2% (Max Rs.1 lac)

Source: *MAS, Bank Negara Malaysia, Indian Stamp Act and respective state stamp acts*

58. Since stamp duty is generally charged by respective State Governments, a group may be set up by the Government drawing representatives from the Central Govt., leading States and market participants to suggest the modalities of the stamp duty payable on corporate bonds which would be applicable across the country. A suggested matrix for such consideration is give in Table III-8 as under :

Table No: III-8: Proposed Stamp Duty Structure for Corporate Bonds

Maturity	Stamp Duty	Maximum Stamp Duty (Cap)
Upto 1 year	@ 0.05 % of face value	Rs. 10 lacs
1 to 3 years	@ 0.05% of face value per year	Rs. 15 lacs
3 to 5 years	@ 0.05% of face value per year	Rs. 20 lacs
Above 5 years	@ 0.05% of face value per year	Rs. 25 lacs

59. **Fragmentation**: Issuers have been increasingly using the private placement route which leads to creation of multiple numbers of smaller issues as there is no bar on number of issuances a company can make. So there is no proper consolidation of

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issues. Such fragmentation of the issues should be stopped to improve liquidity in the market. Corporate entities opt in favour of multiple issues primarily to avoid the hassles involved in going through the pubic issue route. Under the current regulatory regime 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. Hence issuers make several issues of bonds and each such issue is sold to 49 or less number of investors. Some of the issuers have resorted to making several issues of bonds in a single day just to ensure that none of the issues violates the public issue guidelines. Fragmentation of issues is inimical to creation of liquidity and depth in trading. It also increases costs associated with trading in the secondary markets.

Banks' & corporate bonds

60. Corporate bonds are at times quasi-loans and banks prefer to invest in them on their own terms in private placement markets. Earlier banks preferred to invest in privately issued bonds of high credit rated corporates when they were not allowed to lend to such clients at sub-PLR rates. Since corporate bonds were not subject to RBI regulation about lending at sub-PLR rates, banks used to negotiate terms with such good clients and used to lend funds in the guise of privately placed bonds. However, the situation changed after banks were allowed to lend at sub-PLR rates.

61. For too long Corporates have got accustomed to raising loans from banks and term lending institutions as they find this route to be relatively hassle-free. Even well established corporates find that it is relatively easy to convince bankers as to why they need loan funds and how they will be in a position to service these loans. They feel that it is far more difficult to raise funds through bond flotation as it involves convincing a larger number of highly demanding investors, many of whom may be raising far more searching questions both about the viability of the projects/schemes for which funds are being sought. In view of the expectations about rising interest rates, currently a number of banks prefer to provide funds through the loan route rather than invest in corporate bonds. In a rising interest rate regime investments in bonds prove to be less attractive compared to similar

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maturity fixed interest loans for the simple reason that banks will have to adjust downwards their investments in bonds when bond prices fall in response to rise in interest rates. Mark to market regulations requires writing down the value of bonds when market prices of bonds fall. While investment in corporate bonds is subject to mark to market regulations the same rule does not apply to bank loans because loans do not have a market price; some banks are therefore keen to avoid investing in corporate bonds if they have the slightest fear such bond prices are likely to fall either because of the possibility of downgrading of credit rating of companies issuing bonds or that there is a possibility of general level of interest rates going up in not too distant future. However, after RBI mandates banks to adopt Basle II norms, this problem will no longer remain much relevant. Under Basle II norms banks will have to periodically revalue their loans extended to corporate entities with the help of their own internal model developed for risk-based credit rating corporate borrowers. Until Basle II regulations come into force investments in bonds will continue to remain a less preferred option for a number of Indian banks.

62. **Information:** Centralized information on trading history is not available. This will help both issuers and investors in fair pricing of the papers. Only trades reported to the exchange are reported in the press and readily available in the websites. Large numbers of trades are executed in the market sans brokers. Hence there is a need to centralize such trading information for the benefit of all. Regulators will also benefit from the same data base to track the information on an issuer or a specific bond. Information of defaults is not published anywhere. Such information is very vital for investors.
63. **Clearing and Settlement:** There is no centralized counter party to the trades in secondary market. The risk is directly borne by the market participants. Netting benefit is not available in this market. Absence of novation adds risk of settlement to both buyers and sellers.
64. **Risk Transfer:** There is no hedging mechanism available to the market participants. Exchange traded interest rate futures are not available as stock exchanges have not yet introduced the products designed and approved by the

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regulators. The new products have been designed as the market participants did not evince much keenness to trade in the interest rate futures products that were based on ZCYC.

65. **TDS Provisions:** TDS on Corporate Bonds is deducted on accrued interest at fiscal year end as per prevalent tax laws and the TDS certificate is issued to the registered owner as of the fiscal year end and interest is paid, on the interest payment date, to the registered holder at the relevant time (when interest is paid), net of the TDS deducted at fiscal year end. Hence intermediate holders have to settle TDS through exchange of cash. Since TDS is deducted on accrual basis, a buyer may receive only part of an accrued coupon, and left with the tedious process of collecting a TDS certificate from a previous seller. Investors who are subject to TDS find it difficult to sell the bond to those who are not. Hence there is a need to exempt interest payments on corporate bonds and securitized assets from the requirement of Tax Deduction at Source.

66. **Standardized Market Practices:** Currently the trading and issuance happen in a totally non-standardized way. If traded in stock exchanges like NSE-WDM, the minimum amount of trade is Rs.10lakhs but there is no such bar in direct deals among the participants. There are entities who also invest amount less than Rs.10lakhs. Currently bonds are issued with varying coupon conventions, e.g., Actual / 360, Actual / 365, Actual / Actual, 30/360 etc. leading to problems in settlements. A single standardized method for interest day count conventions need to be finalised and followed for the growth of the market.

Development of Primary Market

67. Creating an enabling mechanism for issuance of bonds in the primary market is vital to the development of corporate bond market. A robust primary market is the supplier of quality papers to the secondary market. A vibrant primary market leads to the growth of secondary market. However, due to existing lacunas, the growth of the market is hindered. The issues that need to be addressed for the development of the primary market in corporate bonds are listed below:

- **Enhancing the Issuer base:** (a) Currently corporate entities have no compulsions to access the market for raising funds. The corporate entities

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have been nurtured in a culture of approaching banks (earlier institutions) for meeting all their financing requirements. It would be in the interests of banks themselves that the corproates meet at least a part of their funding requirements through the bond route so that they have freedom to pass on part of their portfolio to others whenever it suits them. If a bank extends term loans it is stuck up with the borrower until the loan matures. It cannot easily reshuffle its portfolio of term loan assets to adjust its developing asset liabilities mismatches. Hence banks, as a group strategy, should consider advising their better credit rated corporate borrowers to meet a part of their term loan requirements in the form of bonds. RBI and Government may also consider suitably encouraging corporate borrowers to raise part of their term fund requirements in the form of bonds. To begin with it may be even 10percent of the fresh term loan requirements, which could be in the form of bonds rather than conventional term loans. (b) Banks in India raise funds from deposits and other short term markets. Due to requirement of capital adequacy ratio, the banks have been issuing long term bonds as their Tier II capital. Such Tier II capital bonds are often picked up by other banks. Unlike developed countries, there is no incentive for banks to access the market beyond the Tier-II bonds. Some of the banks have started looking at raising funds from international financial markets through issuance of bonds. It is desirable that instead of raising most of their resources through deposit mobilisation, banks may be encouraged raise money from the domestic debt market through issuance of medium and long-term bonds. Currently banks are engaged in project finance as development finance institutions have almost disappeared from scene/discontinued lending or have got transformed themselves into commercial/universal banks. Currently RBI allows banks to issue long-term bonds against their funding to infrastructure projects. Of late most of the banks have been very active in term lending to corporate sector for its expansion/diversification projects as also to some extent to fund new projects. RBI may consider allowing banks to raise resources by way of bonds to the extent of banks' term loan portfolio. The limit on resources that could

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be used by an individual bank could be worked out by working out the cash inflows arising out of the servicing of the debt by both corporate and non-corporate borrowers. Eligible limit for raising rupee resources by way of bonds for any bank may be determined by taking into account the loan portfolio of all loans with maturities of 3 years and more. This will have highly favourable impact on the development of the corporate bond market, as the presence of banks both as investors and fund raisers in the corporate bond market will send highly favourable message to the rest of the market. In so far as the banks are concerned this step will help in reducing their asset liability mismatches significantly. Retail investors may be expected to be attracted to the bonds floated by banks as they currently feel comfortable dealing with the banks. Banks' entry into the bond market as mobilisers of funds would greatly facilitate in bringing good quality paper to the market as the banks as a class enjoy better credit standing in the bond market in view of the fact that they are more closely regulated by the RBI. This may serve as a bait to attract retail investors to the bond market thereby eventually paving way for their entry into other segment of the corporate bond market, including that made up of private corporate manufacturing and infrastructure sector companies. It would also help greatly in providing quality paper to the market.

- **Market Makers:** Market makers play a very important role in development of any bond market. Currently, in Govt. securities market, primary dealers are performing such a role. Market makers provide psychological support as well as exit options to investors to buy or sell bonds whenever desired by the investors. The market making in corporate bonds is necessary as market is in a nascent stage and it would require the psychological comfort in the beginning. 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. A limited market making by these entities can help to strengthen the corporate bond market. Further, banks which are large investors in corporate bonds at present may also be encouraged to voluntarily market make the corporate bonds in which they have invested.

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- **Enhancing Investor Base:** (a) Globally provident and pension funds are large investors in corporate bonds. In India, these funds have been traditionally investing in Gilts for safety. Further, underdeveloped and illiquid conditions of the corporate bond market also do not attract these investors to invest in corporate bond market. Currently, these funds are allowed to invest only upto 10percent of the accruals in a year in private corporate bonds and 40percent of the corpus can be invested in bonds issued by public sector undertakings. As of March 31, 2004, the total corpus of statutory PFs including EPF is about Rs.1,75,000crores with an annual accretion of Rs.14500crores. The total amount invested in bonds issued by the Central PSUs, State Govt. PSUs (whose bonds guaranteed by the respective governments) and private sector corproates is about Rs.49000crores. Risk profile of a large number of the PSUs established by the state governments is not materially different from that of several private corporate sector companies. Hence, investment guidelines issued to PFs and EPFs need not discriminate between State Govt PSUs and private corporate sector entities. It would be in the fitness of things that rating quality as indicated by the recognised rating companies should become the main criteria for investment in corporate bonds and not category of bonds in terms of issuers. (b) Co-operative banks are permitted to invest upto 10percent of their deposits in bonds issued by PSUs 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 be helpful as cooperative banks have large deposits. (c) Retail investors should be encouraged to participate in the market through stock exchanges or to approach banks that would be willing to market make bonds from their own portfolio through their branch network. These investors may also participate in the market through mutual funds where the returns from mutual funds would not be taxed at the investor's end while direct investment would come under tax. Retail investors should be made to understand the risk in investing in bonds. However, retail investor would come to the market if the market is liquid and vibrant. (d) FII investment in corporate debt is limited at present to

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USD500million without any tenor restrictions. FII participation in debt market has helped many emerging markets and these FIIs would invest in debt market to diversify their portfolio. Currently they invest heavily in equities and have no mechanism to include debt in their portfolio. In order to encourage flow of foreign capital for investment in bonds, it would be desirable to remove the separate sub-limit stipulated for the corporate bonds at $500mn and permit FIIs to invest within the overall limit fixed for debt instruments including government securities.

- **Consolidation of Privately Placed Bonds:** Currently there are no regulations on the number of issues an issuer can make during any given period. There are instances of making a number of issues on the same day by a single issuer. Mostly structured obligations are issued as bonds and sold to a single party. It is necessary to consolidate the issuance process to create large floating stocks which would enhance liquidity in the market. It would facilitate cash management for issuers and investors and reduce back office work as less number of bonds are to be managed. This will also bring discipline in the market.
- The existence of many small issues from the same issuer is the fallout of the historical indifference to secondary market trading. As long as there was no secondary market trading, the size of the issue did not matter, and issuers preferred to raise whatever they needed at the moment. The Government Securities market faced the same problem, but this was addressed by re-issuing securities with a coupon and maturity of a similar but more liquid security. Similar effort is required for the benchmark issues in the corporate debt market. Re-issuance is not legally recognized and is considered a fresh issue of securities. As a result, re-issuing securities attracts stamp duty, thereby making the process commercially infeasible. Since no fresh securities are actually being issued, there should be no incidence of stamp duty on re-issued securities provided the maximum applicable stamp duty on the said issuance has already been paid.. Necessary amendments in the existing legislations to make re-issue and consolidation need to be made, and issuers

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should be encouraged to consolidate their various issues into a few large issues that can serve as benchmarks. Issuers should be encouraged to create larger benchmark issues by consolidating their existing bonds. Such a move at consolidation would enable creation of liquidity through lesser instruments instead of fragmentation of liquidity through multiple issuances.

- **Bond Primary Issuance Data Base:** A historical database on all corporate bonds issued is very important for an investor to take a valued decision. Today no such database is available in public domain. There is no centralized database to look at all credit rating information and credit migration history. The data on bonds are available in a totally fragmented manner. Hence, for the development of this market, it is necessary to create a centralized database of all bonds issued by corporates. This database should be available free of cost to all investors. This database should also track rating migrations. A stock exchange would be the best suited entity for maintaining this database as most of the information is already available with them at the time of listing. It would require having an interface between the stock exchange and the rating agencies for any subsequent rating updations. The purpose of creation of such a database being to ensure wider dissemination of information, the exchanges should be mandated to ensure that the same is available on a real time basis on their websites as also through other information vendors, media etc on a continuing and real-time basis.

Development of Secondary Market

68. A developed secondary market helps an investor to enter and exit from the market at any time he would like to. A robust secondary market would provide efficient price discovery mechanism, liquidity, zero settlement risk, etc. Well structured secondary markets in equity and gilts exist in India. But the secondary market for corporate bonds is very primitive in its functioning. There is very low liquidity and issues are fragmented. Few securities are traded though large number of outstanding securities exist in the market. Hence it is essential to frame guidelines that would help in putting in place a well structured secondary market. If the

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secondary market is made vibrant, it would greatly help the primary issuances market.

69. Demand for corporate debt will remain limited if an efficient secondary market does not exist. The secondary market provides price discovery, which in turn allows investors to price primary issues. A deep secondary market gives confidence to investors that they will be able to sell their securities when required, and help issuers reduce the spreads at which they are able to issue securities. A deep and liquid secondary market in corporate debt securities needs to be developed through transparent price discovery mechanism, appropriate clearing and settlement infrastructure, right types of intermediaries and a facilitative regulatory environment which ensures safe and efficient execution of transactions at the lowest possible cost. The secondary market for corporate debt at present does not have a proper system for near real time dissemination of price and trade related information. Consequently it suffers from an absence of proper price discovery. Unlike the equity and government securities markets, the corporate debt market does not possess an efficient and institutional clearing and settlement framework. Besides, there are no intermediaries who are prepared to give two way quotes. The TDS on coupon payments is an additional procedural burden on participants. An efficient secondary market which is vital for the development of the corporate bond market, essentially needs to integrate three vital components viz., systems for dissemination of trade related information in real time or near real time, an efficient and robust clearing and settlement system benchmarked to international best practices, and a transparent order matching mechanism with STP linkages to the clearing and settlement environment. To this end, a road map needs to be prepared with certain time lines to achieve the aforesaid goal in stages.

70. The following measures are required to be considered for the development of the corporate bond market:

- **Trade Reporting System**: Currently all trades executed in the market are not disseminated except those reported to the stock exchanges. There is a need to create historical database on corporate bond trading. If an electronic trading

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platform is available, then such data is collated and disseminated to the market. However, till such time a trading platform comes into operation and disseminates all the trade-related information to the entire market on a real time basis, a reporting system should be put in place. All entities, at least the regulated entities, should report their deals in corporate bonds to the reporting system. It should operate on lines similar to that of the TRACE of NASD in the US. These data will be of immense use to the market participants in trading and making decisions on their exposure to corporate bonds. It would also help regulators to have proper information on the market trends. As in any other market, buyers and sellers in the corporate bond market would like the assurance that they are transacting at the right price. Corporate bond market like government securities market has traditionally been an institutional market, and comparatively little trading has been done so far through order matching systems. As a result, only a few dealers are aware of the price at which the last deal took place. Bond markets worldwide have recognized this problem and many markets have made it mandatory for participants to report trades as soon as they are done. In India, the government securities market follows the same principle, and prices are available within a few minutes of execution and reporting. Of course, the gilt markets have now evolved into a stage of providing an order match alternative for trading. The current market for corporate debt suffers from a lack of price volume information for all secondary market trades. While some trades are reported on the WDM segment of the NSE, in the absence of any mandatory trade reporting requirement, all trades do not get reported on this segment. Dissemination of this information is vital for enhancing market transparency and efficiency, and to ensure better price discovery in the secondary market. The Committee also noted that other markets have developed similar systems for identical purposes. Appropriate systems need to be immediately put in place to capture all information related to trading in corporate debt securities as accurately and as close to execution as possible, and disseminate it to the entire market in real time.

- Currently, the national stock exchanges provide an efficient platform for dissemination of all information related to cash and derivatives market in equity.

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These exchanges also have systems of reporting of trades in corporate debt, even though the information available may not be complete. The reporting infrastructure already available with these exchanges could be fruitfully used to set up this platform quickly and in a cost effective manner. In case more than one stock exchange seeks to provide this information dissemination platform, it would be necessary to ensure coordination between the multiple platforms, in the same manner as it is now being done in the case of data related to book building. Creation of multiple reporting platforms should be facilitated to cater to the needs of the various kinds of market players – wholesale, retail, institutional, others etc. However the task of approving the reporting platforms and ensuring coordination among such multiple reporting platforms should left to SEBI.

- In order to be effective, such trade reporting to any one of the approved reporting platforms should be made mandatory for all regulated entities by their respective primary regulators. Unless all trades are reported and the information, which should be both complete and reliable, is made available in the public domain by such reporting platforms on a near real time basis, the information dissemination system will serve little purpose. Since much of the trading now takes place on a bilateral basis amongst institutional players such as banks, mutual funds, investment and insurance institutions, primary dealers, these institutions must have the ability to report the trades directly on the reporting platforms of their choice. In other words they should be able to access the systems directly to report trades regardless of whether the trades are brokered or not. However, due care needs to be taken to ensure that systems are in place to filter against reporting of the same trades through multiple platforms or by multiple agencies. Brokers also would need to be given access to such platforms in order to report trades for which they act as intermediaries. Thus to make the trade information dissemination complete, reliable and timely, two things need to be done – one to mandate all institutional entities to report trades to the system and second to provide a limited purpose direct access to them to report trades if the trade is not via a broker. In order to report trades directly to the system, and also to ensure that only those entities that are authorised to report trades do so, appropriate

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changes to relevant regulations, if necessary would have to be carried out. The details to be reported and the time of reporting should be specified by SEBI.

- The existing infrastructure available with the national exchanges could also be used to set up such reporting platforms for dissemination of information related to trading in corporate debt securities, quickly and in a most cost effective manner.
- **Trading Platform**: Currently the trades in corporate bonds are executed in three different ways: (i) directly between participants where a bilateral trade is settled through central bank money using cheques and transfer of securities through depository mode; (ii) through a broker who brings a buyer and a seller together and helps them to execute a deal and finally he is obliged to report the deals to the stock exchange where he is registered; (iii) through the equity market segment at the exchange where corporate bonds are traded in an anonymous order book system and the settlement happens through the clearing house/corporation with novation. However, the last method is not much popular as this mechanism is better suited to retail investors, who, however, are yet to make their presence felt in this market. First two methods are used frequently by institutions as money and securities are directly exchanged among the buyers and sellers. In order to develop this market, it is required to put in place a trading platform that would cater specifically to the institutional buyers and sellers. Globally, this market has been functioning as an over-the-counter market. The justification for a separate trading platform for the institutional investors has been recently recognised by SEBI. Stock Exchanges have been permitted to set up such a platform where individual trades of the value of Rs50million and more can be executed without disturbing the price discovery process in the other wing of the market. In fact the need for such a separate institutional platform is more than justified given the fact that the bond market all over the world is essentially a wholesale or institutional market, with negligible presence of the retail investors.
- Globally, considerable efforts are being put in to ensure that such institutional or wholesale markets become more transparent, function efficiently, and have as low transactions costs as possible. A platform like the EUREX-Bond is a good example of this type. EUREX-Bond is a cost effective platform as it runs for the

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benefit of all its trading members. To develop the Indian bond market, it may be desirable to extend similar freedom to the institutional investors in corporate bonds to set up their own trading platform, which would put in place an anonymous order matching system in corporate bonds. This trading platform would co-exist with the exchange platforms. The management and ownership structure of such a platform is very important; even though it is owned by the institutions it should be managed in such a way that it avoids all conflicts of interests. Clearing Corporation of India Ltd (CCIL) is good example in this regard. Although it is owned by banks and institutions, (which are PSU banks, Indian private sector banks, foreign banks, private and public sector insurance companies, primary dealers, etc.) it is professionally managed entity avoiding all conflicts of interests and functioning in the best interests of all its members, many of whom are not even its shareholders. The CBLO platform of CCIL can be taken as a role model for such trading platform.

- Once the trade reporting and the first phase of clearing and settlement systems are implemented successfully, and the market participants gain experience, the market would be ready to migrate to an online order matching platform on the lines of NDS-OM. This trading platform can be set up by the stock exchanges or jointly by a group of regulated institutions like banks, financial institutions, mutual funds, insurance companies, etc. Such a trading platform, providing order matching in corporate debt security, would effectively be performing the functions of an exchange to a limited extent and would need the permission of SEBI. However keeping in view that trading in corporate debt security is unlike trading in equity which is provided by a traditional stock exchange, a trading platform for corporate debt security would have to recognize the need for two different categories of members, one who will trade on their own account and other who will do agency business. Type A will be members who trade on their own account and Type B (brokers of stock exchanges) will be members who execute trades on account of other parties. Type A membership characteristically will be limited to RTGS participants who would usually be banks and financial institutions. There is need for a separate window in the trading system restricted

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only to Type A category members comprising exclusively of regulated institutions like banks, financial institutions, mutual funds, insurance companies, provident/gratuity funds, etc undertaking proprietary trading in corporate bonds. Such Type A market participants would also have the option of reporting trades through a Type B member if they do not opt for membership of the exclusive institutional trading window envisaged above. This flexibility would enable the institutional participants to become members of the platform without being a broker in the true sense. The criteria and responsibilities would have to be defined clearly for these two types of members. This may perhaps need suitable changes in the relevant legislations, unless the existing legislations already provide for the special classes of membership.

- Success of such a trading platform will lie in its ability to bring together all the relevant regulated institutional participants like banks and financial institutions to trade among themselves. If any of the participants who can significantly contribute to the demand and supply are unable to join the trading platform, it will not succeed and active trading in a transparent manner will not fructify. It is therefore important that regulators of various participants grant necessary approvals to enable their regulated entities to participate freely in the corporate bond market and also to take up such limited membership of the platform for the purpose of own trading.
- Such a trading platform can be set up by the stock exchanges or jointly by a group of regulated institutions such as banks, financial institutions, insurance companies, mutual funds for trading amongst themselves. But any trading platform other than being provided by a stock exchange, providing order matching in corporate debt security, would effectively be performing the functions of an exchange to a limited extent and would need the permission of SEBI. As it is necessary to avoid multiplicity of regulators for entities taking limited purpose membership for trading on their own behalf in the proposed trading platforms, the responsibility of regulating their activity in corporate bonds through trading platforms will vest with SEBI.

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- **Order Collection and Bidding**: It is in the interest of issuers to promote widespread ownership of their bonds. However, the current private placement process does not favour investors who want only a small portion of an offering. It would be useful to provide an option to issuers to allow a limited portion of their issue to be subscribed through a process of non competitive bidding by qualified investors, including small PFs, trusts and retail investors. Current regulations do not provide for such a platform. The current market practice for private placement of debt involves the collection of bids from selected parties and allocation to investors through a process supervised by the managers to the issue. In contrast, the process of initial sale of government securities follows an auction process implemented on an electronic platform. It is desirable to provide issuers with the choice of an electronic auction platform built on the lines of the Government Securities platform. Such a platform will be especially attractive to public sector issuers including banks and PSUs who would like a price discovery process modeled on the government securities market. SEBI may consider the formulation of appropriate enabling regulations for the setting up of and licensing of a platform for non competitive bidding and order collection for say upto ten percent of an issue as also for the facilitation of an electronic bidding process for the primary issue of bonds and securitized assets.
- **Clearing & Settlement System**: A trade reporting system is only the first step towards the development of secondary market in corporate bonds. It is essential that the trade reporting system closely ties into the clearing and settlement system, so that the accuracy and integrity of trades reported is validated and their settlement thereby ensured. The trades in the secondary market are currently bilaterally settled amongst the participants. In the interest of overall market risk mitigation, it is essential that the clearing and settlement of trades in this market is also handled in line with global best practices in settlement with well established clearing and settlement procedures through recognized clearing and settlement agencies.
- Currently there is no structured settlement system in the market for corporate bonds. The settlement risk is relatively high in case of direct and brokered deals

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reported to the stock exchanges. Only small proportion of trades executed through anonymous trading system of stock exchanges have a well structured settlement system with proper risk guarantee of settlement. In the case of settlement of trades executed in OTC market the sellers are at higher risk than buyers as they give instructions to depositories for transfer of securities first and then receive cash later. In short there is no DVP mode of settlement in respect of the OTC trades where both sides to the settlement should be protected as in the case of the settlement guarantee of the clearing corporation. Presently the Govt. securities market has a well structured settlement system with novation and netting benefits. It is necessary to put in place a settlement structure that would eliminate the settlement risk to all parties to the trades. A clearing corporation needs to be put in place to provide DVP mode of settlement whereby the clearing corporation provides iron-clad guarantee of settlement. The clearing corporation should provide the process of novation (guarantee of settlement) and only net settlement obligations should be settled. This would help in economising scarce resources of the market participants in the debt market. Through the process of novation it becomes possible to significantly bring down the requirements of cash balances of trading members, thereby saving their costs of transactions. In the absence of adequate liquidity in the corporate bond market the clearing corporation may find it difficult to do novation both on the side of cash and securities. If there is a shortfall in delivery of securities it may not be possible for the clearing corporation to buy securities in the market to complete guaranteed settlement. However this could perhaps best be done in phases beginning with the adoption of DVP I system and using the experience to migrate within in a reasonable time frame into DVP-III system. The DVP I settlement will work as follows. For DVP1 settlement, instructions from buyers and sellers will be matched periodically by the settlement system intra day, and funds and securities will be settled on a transaction by transaction basis with deliveries taking place through the clearing agency. For DVP III settlement, net funds and securities obligations will be calculated and the clearing agency will play the role of central counter party for settlement.

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- The clearing corporation should put in place a good risk management mechanism in the settlement of corporate bond trades. Although the basic principles of guaranteed settlement of G-sec trades and corporate bond trades are same, the risk of corporate bonds is considerably higher on two counts. In the case of G-secs there is no credit risk while even the triple-A rated corporate instruments are not entirely free from credit risk. Secondly, there is much higher level of liquidity in G-secs than in the corporate bonds; hence market price risk is much higher in the case of corporate bonds. In view of these two distinguishing features of the corporate bonds the clearing corporation will have to charge much higher levels of margins when it plans to offer settlement guarantee. The clearing corporation will no doubt adopt ***value at risk*** (VAR) method for computing margin levels on corporate bonds; however, it will immediately face many difficulties in applying VAR methodology because of the lack of liquidity in the bond markets and also absence of trade information history stretching over much longer period of at least three years to build meaningful VAR system.
- The regulated institutional participants in the debt market would benefit a great deal if their fund accounts at RBI could be accessed by the clearing corporation for settling their deals so that they do not have to go through the settlement banks. Since most of the investors in the corporate debt market are currently banks they would be highly uncomfortable to maintain their settlement accounts with one or more commercial banks, which may be designated by the clearing corporation as clearing banks. It may be noted in this context that both NSE and BSE have designated some commercial banks as their settlement banks through which all the funds pay-ins and pay-outs are executed. Such a model of settlement may not be liked by the banks, which are trading in the corporate bond market. They would prefer their fund transactions pass through their current accounts maintained by them with the RBI. In order to facilitate smooth clearing and settlement process, the clearing corporation that would settle the deals in corporate bonds would require an access to funds account of the participants with RBI. Such a clearing corporation could be designed on the pattern of Clearing Corporation of India Ltd. (CCIL) which clears and settles all the G-sec deals in

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the books of RBI where all its members maintain their current accounts. The clearing agency would also need to facilitate clearing by banks and other institutional players with suitable access to the RTGS mechanism. This will mitigate the risks associated with pay-in and pay-out process. Once that happens, funds settlement will be effected through RTGS instructions initiated by the clearing member settling the trade. All RTGS members will have the ability to settle their payment obligation through their own RTGS interface without the need to go through another clearing bank. Non RTGS members will have to appoint a clearing bank to perform funds and securities settlement.

- The clearing and settlement of trades in the corporate bond market should follow the IOSCO standards and the global best practices in settlement with well established clearing and settlement procedures through recognized clearing and settlement agencies. The clearing agency viz., a clearing corporation or clearing house that would begin the clearing and settlement in phases by initially offering DVP I system and use the experience to migrate within a reasonable time frame into DVP III system.
- **Reducing Shut Periods**: The current shut period in corporate bonds is very long and needs to be reduced in line with the government securities. While trading in corporate bonds just before the coupon date, buyers and sellers have to transfer a part of the money through cash and trading during shut period would mean the present holder to receive the interest net of TDS. Reduction in shut period would reduce this incident.
- **Unified Conventions**: Currently market does not follow a unified convention of day count. This creates confusion in the market as an investor need to know the day count convention in a bond to fairly price the same. FIMMDA, being the representative of the banks and institutions, should take a lead role to put in place unified market conventions to be followed. In view of extensive application of computerised systems in trading and settlement processes, it is desirable that market opts eventually in favour of an actual/actual basis.
- **Repo in Corporate Bonds:** The repo in corporate bonds does not exist today though there was a move to introduce the same earlier by RBI. The entire repo

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transaction in the market is on the government securities. Repo allows recycling of the securities as the holders of the securities can borrow funds in the market to invest in other opportunities. The supply of government papers in the market is very large and finding an underlying instrument for creation of repo is not a major issue in the current scenario for all those banks which are holding excess SLR securities. Introducing repo on corporate papers will however benefit the private sector banks and some of the foreign banks which have large portfolio of corporate bonds and do not have excess holding of SLR securities. Hence a mechanism of creating repo on corporate papers may be introduced. It will give an opportunity to investors who have corporate bonds to recycle the same and borrow money against these securities. However, repo settlement should follow the same mechanism as of outright deals on corporate papers. The clearing corporation should settle the repo charging adequate risk capital. To start with, the Repo in corporate bonds may be settled on DVP-II basis.

- A well developed corporate debt market supports a community of dealers willing to offer quotes and inter dealer brokers who support trading between the brokers. Without such a dealer network, buyers and sellers will find it very difficult to transact. Unlike the equity market, the bond market does not have day traders who provide liquidity, and dealers are expected to fulfil this role. Dealers need to hold stock in order to provide liquidity, and be able to borrow securities for sale in case they do not have the stock in their own inventory. The only specialist dealers in the Indian debt market are the Primary Dealers for government securities. PDs have been instrumental in reshaping the secondary market for government securities and they can play a similar role in the corporate debt market. Since dealers hold their positions only for trading and work on narrow bid ask spreads, it is important for them to fund the positions efficiently. In India, this becomes difficult because regulated entities are not allowed to borrow in repo against corporate bonds. Despite this handicap, PDs and other dealers were active in the corporate bond market as long as interest rates were going down and there was a capital gain to be made from the stocks in the inventory. However, with a tendency towards hardening of interest rates, there is no incentive for dealers with

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capital constraints to provide liquidity to the market. In addition to the capital efficiency issue, PDs also face restrictions on how much of their portfolio can be invested in corporate bonds and securitized assets. Corporate bond investments cannot be funded from money borrowed in call and repo, and a minimum of Rs.50crore of the net worth should be invested in Government Securities. Securitized assets cannot be greater than 10percent of the non SLR portfolio. These restrictions place constraints that are difficult to manage and it appears to be a reason for PD like participants for not playing an important role in the market. Therefore, it is necessary to introduce a set of mechanisms for addressing this through reducing settlement risk, improving liquidity and reducing the cost of holding positions. One such mechanism is a lending and borrowing mechanism in corporate debt securities and the other is the introduction of tripartite repo contracts which would be cleared and settled by the approved clearing agency. In addition to improving the liquidity in the secondary market, these mechanisms will also enable the clearing corporation to improve risk management and accept more and more securities into DVP III settlement. RBI may therefore consider the feasibility of framing suitable regulations to enable market making of corporate bond through the use of TP repos for funding positions. Issuers may be allowed to buy back and redeem a portion of the issue set aside for the purpose and also allow short sale as and when permitted for other debt instruments and securities lending and borrowing to facilitate netting and DVP III settlement. A detailed write up on Repo on Corporate bonds is given in Annexure-II to this document.

- In order to improve secondary market trading, repos in corporate bonds may be permitted by RBI to be operated by the proposed clearing entities for corporate bonds;
- As corporate debt securities are governed by the SCRA and SEBI regulations in this regard, the entities handling the clearing and settlement of these securities will therefore have to be recognized entities under the SEBI framework; SEBI will frame suitable regulations for the clearing and settlement of corporate bonds. However, in the case of trading, clearing and settlement of repos in corporate debt

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securities, appropriate regulations will be framed by RBI in consultation with SEBI.

- The entities that will provide the trade matching system could also provide a repo facility on lines of CBLO for Government Securities. The activity relating to a platform for trading in repo on corporate bonds in lines of CBLO and /or its settlement will be regulated by RBI.
- **Introduction of Interest rate derivatives:** Currently interest rate derivatives are available in exchange traded interest rate futures and OTC interest rate swaps (IRS) and forward rate agreements (FRA). The regulators have already revised the earlier guidelines on exchange traded debt derivatives and allowed a new product. The same is yet to be introduced by stock exchanges. Steps should be taken to introduce these products as it would provide avenues to hedge the risk of holding a physical bond to a large extent.
- **Reduction in Market Lot**: As per the new SEBI guidelines, the minimum market lot of corporate bonds in wholesale debt market is Rs.1million. This limit is considered to be too high for some of the market participants who are forced to trade in the wholesale segment (if the same security is not available for trading in the equity market segment). Hence the minimum lot criteria should be revised and much lower limit, say Rs.1 lakh, should be put in place.
- **Bond Insurance:** Bond Insurance plays a very dominant role and eliminates default risk for the investors. In developed markets, bond insurance has been found to be very popular. This helps in building investor confidence in the market. There is no bond insurance in India. For bond insurance to be operative, it is required to have a well maintained database that would not only provide the details of bonds issued but the history of defaults of corporate bonds. Default history will be able to help in determining the premium to be charged by the entity that provides bond insurance. There is a need to look at bond insurance as a viable option in developing the corporate bond market. To kick start the market, initially bonds issued by PSUs and Banks and large corporates in India with the highest possible credit rating can be covered under bond insurance and once the market stabilizes, it would move to other rating categories. It is expected to have a

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very stabilizing effect on the market. Annexure to this chapter gives a detailed write up on Bond Insurance.

- **Securitization:** The need of asset securitisation is being felt in three major areas in the Indian context - Mortgage Backed Securities (MBS), Infrastructure Sector and other Asset Backed Securities (ABS). It is observed that FIs / banks have made considerable progress in the financing of projects in housing and infrastructure sector. It is therefore necessary to develop securitisation and other allied modalities so that banks and FIs could offload their initial exposure and make room for financing new projects. With the introduction of financial sector reforms in the early nineties, banks and FIs, particularly the NBFCs are entering into the retail business in a big way generating large volumes of homogeneous classes of assets (auto loans, credit cards etc.) leading to the attempts for ABS by a few players in the Indian financial sector. However, there were a number of legal, regulatory, psychological and other issues, which needed to be sorted out to facilitate the growth of securitisation. The extant law provides for securitization of debt by Asset Reconstruction Companies and National Housing Bank. However, the securitized debts are not included under Securities Contract Regulation Act (SCRA) and hence can not be listed in a stock exchange for trading. Secondary market trading is not possible since these instruments are not listed in stock exchanges. Recently Governement of India has decided to suitably amend SCRA to define securitized assets as a security which can be listed in the stock exchanges and traded as any other marketable instrument. Currently in India securitized papers are issued in Pass through Certificates (PTCs) form in which the SPVs are managed by a governance structure in the form of Trustees due to tax efficiency. If a corporate structure is used to issue securitized papers, the corporate entity has to pay the tax and hence does not serve the purpose of securitization. The aspects relating to securitization are discussed in detail in the next chapter of this report.
- **Credit Enhancement Mechanism:** Credit enhancement encompasses a variety of provisions that may be used to reduce the credit risk of an obligation. Techniques of credit enhancement include:

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a. Collateralization: One or more parties may agree to post collateral. Collateral levels may be fixed or vary over time to reflect the market value of different parties' obligations.

b. Third party loan guarantees: A parent company or other third party may be contractually bound to meet the obligations of one party should that party default.

c. Credit insurance: An insurance policy may provide for compensation in the event that a party defaults.

Credit enhancement helps the market for corporate bonds grow in a healthy manner. Steps should be taken to encourage credit enhancement in India. In a securitization structure such enhancement is already provided through the pooling of assets and the sale of separate tranches of such pooled assets with different ratings suitable to the risk preference of different investors. Such mechanisms could be extended to bonds issued by SPVs of State governments or other SPVs which are set up for ensuring financing of infrastructure and other riskier activities. The State Government itself or the Central Government or other willing players including bond insurers could underwrite some of the tranches so as to enhance the credit rating of such tranches. The Infrastructure SPV being mooted by the Govt. of India and the Planning Commission could also provide such credit enhancement. These tranches could then be placed with relatively risk averse long term investors such as provident funds, insurance companies etc. provided the concerned regulators allow investments in such securities as per suitable rating and listing criteria.

In addition to the above it would be useful to review following three key regulatory issues.

First, with respect to CAR guidelines in case of normal credit enhanced debt instruments where the credit enhancement is provided by banks and financial institutions in the form of guarantees, RBI prescribes that the guarantees have a 100percent risk weightage. Assuming a CAR of 9percent, the capital consumed is approximately Rs.9 crore for a fully guaranteed debt of Rs.100 crore. However the investor in the debt is also asked to provide for capital of Rs.9 crore at a CAR of

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9percent. This results in double counting of capital requirement. Accordingly, it is recommended that the investor should be asked to have a risk weightage of only 20percent on debt instruments which are backed by guarantees from banks/FIs.

Second, as per the draft guidelines (dated April 4, 2005) of RBI on securitization of standard assets by banks and FIs, banks and FIs are required to write off all first and second loss credit enhancements provided, with such write offs being in addition to the CAR maintained by the investor in the securitized paper. This would result in consumption of a lot of capital across the banking system and be a potentially serious impediment to securitization. For example, consider a Rs.100crore pool that is securitized along with a credit enhancement of 15percent (Rs.15crore). The total capital consumption in the system assuming no securitization would be Rs.9crore (assuming CAR of 9 percent and 100percent risk weightage). However, with securitisation, as per the RBI guidelines, not only would the issuing bank or FI need to set aside Rs.9crore as CAR against this pool of assets, but the holder of the PTC would also need to provide the same amount of capital of Rs.9crore and the credit enhancer would be required to write off the entire enhancement of Rs.15crore from his capital. This would result in double counting of capital requirements from a systemic point of view. Further, in those instances where the issuer of securitized paper is also the credit enhancer, the draft RBI guidelines would result in the anomalous situation whereby the issuer needs more capital to securitize his assets than not to securitize his assets. The draft RBI guidelines maybe revised to reduce the capital requirements in such instances to avoid this anomaly.

Today investments in credit enhanced CLOs and CDOs are not recognized instruments for important market participants such as insurance companies and provident funds. Further these participants are also not allowed to provide credit enhancements for such CLOs and CDOs and thus there is limited understanding and appetite for such papers. The regulators for such participants viz. IRDA for insurance companies and EPFO/ pension fund regulator may come out with specific notifications to include credit enhanced CLOs and CDOs as approved investment avenues.

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- **Specialized Debt Funds for Infrastructure Financing:** There exists a strong case for creation of specialised long term Debt Funds to cater to the needs of the infrastructure sector. A regulatory and tax environment that is suitable for attracting investments from QIBs is key for channeling long term capital into infrastructure development. Today, most banks lack in–house capacity to evaluate project finance risk. As such, they provide debt financing for infrastructure projects largely only to the extent that they are able to participate in loan syndicates led by a handful of specialists. Typically syndications are done for discreet assets and so the participating banks do not easily get diversified exposure to the infrastructure sector. Facilitating the creation of infrastructure focused Debt Funds and making it easier for banks to participate in such funds would allow much larger volumes of debt financing from the banks to be deployed to infrastructure development while distributing the associated risks more evenly across a greater variety of projects. Specifically in this regard, it would be useful to tackle some regulatory changes as follows:

  - Enabling registration of Rupee Debt Funds within the SEBI Venture Capital framework would go a long way towards meeting the above objectives. This would involve issuing a notification extending the purview of SEBI's Venture Capital Regulations 1996 to include Rupee Debt Funds for infrastructure financing. These modified regulations should allow domestic QIBs to commit capital to the corpus of close ended Infrastructure Debt Capital Funds and such funds should have the ability to invest in the long term (minimum five years) debt of infrastructure SPVs or other entities engaged in infrastructure development, as well as in non-convertible preferred stock and structured finance such as CLOs and CDOs.
  - RBI may look into the feasibility of not treating investments by banks in such closed ended debt funds as capital market exposure. IRDA may consider to include investment in SEBI registered Debt Funds as "approved investments" for insurance companies. SEBI registered Debt Funds may be accorded "pass through" status on the lines accorded to SEBI registered Venture Capital Funds.

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- As in the case of SEBI Registered VC Funds (which are subject to a restriction on the maximum that they can invest in listed equities), registered debt funds may also be required to invest a maximum of 33.33percent of the investment funds in listed debt securities.
- Also, as in the case of registered VC funds that have the option to list themselves after a certain number of years from the date of closing, Rupee Debt Funds too should be given the option to list themselves on Stock Exchanges after a period of one year from financial closure. This would provide a liquidity option to those investors that do not want to be tied up for the life of the fund.
- The CBDT could notify to ensure that SEBI registered Debt Funds receive the same tax treatment as VC Funds. Specifically, "pass-through" benefits under sections 115u and 10 (23FB) of the Income Tax Act 1969 ought also to apply to registered Debt Funds.
- In order not to restrict bank participation in the proposed Debt Funds it is important that investments in these registered Debt Funds are not subjected to "capital market" exposure limits that the RBI applies to equity investments for banks. Further, investments in SEBI registered Debt Funds should be treated in the same manner as bank investments in bonds and/ or debentures and should be accorded the same risk weightage as applicable to normal infrastructure credit.
- So as to encourage widest possible participation for domestic financial institutions, the Insurance Development Regulatory Authority, the Central Board of Trustees of the EPFO and the proposed pension fund regulator should modify their respective investment guidelines to permit insurance companies, provident and gratuity funds, and pension funds respectively to invest/ commit contributions to SEBI registered Infrastructure Debt Funds.
- Finally, at a stage considered appropriate by RBI, FIIs may also be allowed to participate in SEBI Registered Infrastructure Debt Funds. This could be done by modifying SEBI's foreign VC Regulation 2000 to extend its purview to cover Debt FIIs such that these are allowed to invest/ commit contribution to rupee denominated Infrastructure Debt Funds registered with SEBI along the same lines as that suggested for domestic QIBs above.

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- **Fiscal Concession for Municipal Bonds and Infrastructure SPVs:** The recommendations submitted by the various Committees appointed by the Government to review interest rates on small savings instruments need to be implemented to ensure that interest rates paid on small savings instruments are aligned with market rates. The resultant fiscal savings could be used to provide tax benefits for municipal bonds and for credit enhancements to bonds issued by SPVs for infrastructure development. Municipal bonds may be given some fiscal support with such support taking the form of bond insurance or providing credit enhancement so that municipalities are encouraged to issue bonds for development of urban infrastructure either on stand alone or on pooled basis. A plan should be drawn for developing this market in India.

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Bond Insurance

Bond insurance is an unconditional promise by the insurer to meet the principal and interest payment obligations of the issuer, should the issuer be unable. An issuer can enhance its creditworthiness by purchasing bond insurance from a private company. Normally in US market, it is treated as a guarantee by a bond insurer of the payment of the principal of and interest on municipal bonds as they become due should the issuer fail to make required payments. Bond insurance typically is acquired in conjunction with a new issue of municipal securities, although insurance also is available for outstanding bonds trading in the secondary market. In the case of insurance obtained at the time of issuance, the issuer of the policy typically is provided extensive rights under the bond contract to control remedies in the event of a default. Normally issuers that meet certain credit criteria can purchase municipal bond insurance policies from private companies. The insurance guarantees the payment of principal and interest on a bond issue if the issuer defaults. Bond ratings are based on the credit of the insurer rather than the underlying credit of the issuer. A municipal bond insurance policy may result in significant interest cost savings, depending upon the issuer's underlying credit and market conditions at the time of the bond sale. Interest cost savings are attributable to the higher bond rating as well as enhanced liquidity for insured bonds. Municipal bond insurance emerged in 1971. Since that time, the number of insured issues has grown astronomically. In 1980, only 3percent of bond issues were insured compared to over 40percent in 2002. With growing popularity, the number of insurers also increased. AMBAC, the first insurer, was latter joined by other triple-A rated insures. There are presently five insurers rated triple-A by the three major rating agencies. Recently, insurers with claims paying ability that is lower than triple-A have entered the market. These companies offer opportunities for insuring bond issues that are too small, unusual or do not meet AAA insurers' criteria.

Bond insurance is normally purchased through a one time payment of a premium at the time of the bond closing. Not all issues qualify for insurance. Each insurer has its own credit criteria, although the categories reviewed are essentially the same as those used by

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the rating agencies. The process of insuring a new issue begins with the issuer submitting documentation for review. If the issue qualifies for insurance, the policy may be purchased by "direct purchase" or "elective bidding". In a direct purchase, the issuer purchases the insurance policy directly from an insurer. Elective bidding allows bidders to choose whether or not to insure an issue at the time the bonds are competitively sold. In an elective bid, each bond dealer submitting a bid assesses whether the acquisition of insurance will result in a better bid. If the winning bidder submits a bid with insurance, the bidder pays for the insurance policy. The ratings generally reflect the claims paying ability of the bond insurer. Insured bonds do not automatically receive these ratings. Generally, insurers do not recommend or require ratings from any particular rating agency. The issuer must determine which, if any, ratings it will purchase for the insured bonds. The issuer is also responsible for paying the rating fee to each rating agency that assigns ratings to the bond issue.

Bond insurance was first introduced in 1971; one of the leading insurance companies American Municipal Bond Assurance Company (AMBAC) created municipal bond insurance. AMBAC was formed in 1969 as a subsidiary of Mortgage Guaranty Insurance Corporation (MGIC), the company that created private mortgage guaranty insurance. In 1971, AMBAC received regulatory approval to underwrite municipal bond insurance and subsequently John Nuveen & Co. Inc. sold the first insured bond issue on behalf of Greater Juneau Borough Schools in Alaska. From 1971 through 1990, the financial guaranty industry was made up mostly of insurance for municipal bonds. Since 1990, the financial guaranty industry has grown to include guaranty of many types of asset-backed obligations as well as obligations issued outside of the United States. In over 30 years of underwriting financial guaranty risk, aggregate industry losses have remained well below 0.10percent of principal insured.

Features of Bond Insurance

- The obligation is unconditional, irrevocable, and not subject to cancellation by the insurer even if the financial condition of the issuer worsens in the future
- Unlike a letter of credit, this obligation lasts for the life of the bond issue

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- Issues covered by bond insurance receive the insurance company's rating, typically a AAA rating
- Investors may still distinguish between a true AAA issue and an insured AAA issue with an underlying double or single A rating
- The actual amount of the savings from the lower interest rate depends on the level of interest rates, and the interest rate spreads between grades of bonds
- Generally, the bonds must already be investment grade (BBB or higher) for insurance to be provided.

Insurance adds several value-enhancing features to bonds:

- Safety: With insurance, an investor has a backup source of payment to rely on if the primary payer, the issuer, cannot meet its obligations.
- Quality: Insured bonds automatically receive the highest rating available, Triple-A, based on the Triple-A claims-paying ability of the insurer.
- Ratings strength: Municipal bond insurers are highly regulated by state insurance departments and closely monitored by the major rating agencies, which historically have reaffirmed their Triple-A ratings at least once a year.
- Liquidity: Large volumes of Triple-A rated, 100percent-insured securities are traded every day in the US secondary market. Investors who wish to sell their insured bonds before maturity usually find a ready market for such highly rated securities.
- Yield: In most cases, Triple-A insured municipals offer slightly higher yields than Triple-A uninsured securities.
- Opportunity for even higher earnings: There are certain types of municipals—for example, revenue bonds and structured issues—that pay higher yields than conventional general obligation bonds. However, many investors are unfamiliar with such securities. By guaranteeing timely payment of interest and principal, insurers enable investors to purchase them with confidence.
- Pre-selection of issuers and issues: Before an insurer agrees to guarantee a municipal security, its underwriters rigorously analyze the issuer and the specific issue.

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- Surveillance: The performance of every insured issue is monitored to final maturity by the insurer that provided the insurance. Surveillance teams make on-site visits to issuers and require a variety of financial reports, which are carefully analyzed for any sign of credit deterioration.

Advantages

- The primary advantage for the issuer is an improved credit rating on the issue. Issues covered by bond insurance receive the insurance company's rating. As a result of obtaining a better rating with the bond insurance, the issue will carry a lower interest cost.
- Bond insurance is a tool that greatly simplifies an otherwise complicated security arrangement so that investors can understand and evaluate the risks involved.
- Insurance also provides greater liquidity for issues in the secondary market, for bonds of unknown or infrequent issuers.

Disadvantages

- Issuers must pay an insurance premium to obtain insurance coverage. Unless the savings resulting from reduced interest costs exceed the cost of the insurance, this form of credit enhancement is not useful.
- The main draw back is in case the insurance company itself is down graded.
- Only bonds with investment grade rating (BBB or above) are eligible for bond insurance.

Insurance Premium

The premium companies charge for bond insurance generally range from 0.1percent to 2percent of combined principal and interest payable over the life of the issue. The premium reflects costs to the insurer, profitability considerations, market conditions, and competition. Costs incurred by the insurer include rating agency capital requirements and servicing costs such as administration, data processing, reporting, and credit oversight.

Bond Insurance Today

Today, the industry is made up of about 50percent municipal obligations and 50percent asset-backed obligations. Foreign business represents about 15percent of new business

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written, but is an increasing amount of new business. Foreign business is growing rapidly today because capital markets in developed countries have begun to grow and financial guaranty insurance is a key tool in the securitisation of these growing markets.

The bond insurance industry guarantees payment on $2.7 trillion in principal and interest with $32.3 billion in claim paying resources. Ratings agencies including Moody's, Standard and Poor's and Fitch view this as well capitalised. Studies of past depressions show that if a prolonged depression did occur, losses on $2.3 trillion diversified, high credit quality financial obligations may amount to approximately $23 billion, leaving the financial guaranty industry today with over $9.0 billion of excess capital. In the history of bond insurance, annual losses have never exceeded $200 million in any year and the likelihood of approaching a number 100 times this amount is remote.

In the aggregate, the bond insurance industry covers $1.5 trillion in principal. In 2003, the industry had aggregate net income of $1.9 billion. The industry dividend payout ratio is approximately 20percent, leaving $1.6 billion of new capital in the business. Today, the bond insurance industry has more capital backing each policy written than ever before.

The average credit rating quality and diversification of guarantees written are at an all time high. The average credit quality rating of municipal bonds guaranteed is approximately A, even after considering recent negative credit quality migration in the general market. The average investment quality of asset-backed obligations is approximately AA. Today, the average return on equity for the four major AAA-rated companies is over 13percent. This is high when you consider that over 80percent of annual earnings come from investment income and amortisation of unearned premium reserves.

Global Bond Insurance Companies

AMBAC Assurance Corporation

Financial Guaranty Insurance Company

Financial Security Assurance Inc.

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MBIA Insurance Corporation

XL Capital Insurance (The newest AAA bond insurer)

ACE Guaranty Corp (The newest bond insurer)

Radian Asset Assurance Inc. (formerly Asset Guaranty Insurance Co.)

American Capital Access (ACA

State insurance commissions regulate the bond insurance companies. Standard Poor's and Moody's rate the insurance companies themselves. They are evaluated on their ability to withstand both systematic economic decline, with its related financial stress, as well as the financial stress of individual losses unrelated to a recession or depression. The rating agencies consider the insurer's level of capitalization, future access to capital, cash flow, diversity of the insured portfolio, and the quality of the portfolio. The main insurance agencies have all been rated AAA.

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<u>Annexure - II</u>

REPO market

Introduction

A repo market is an important constituent of a well functioning corporate debt market. Secondary market trading cannot take place unless there are enough dealers offering quotes in the market. Since dealers operate with funded portfolios, they will be able to offer quotes at low spreads only if they are able to carry their stocks at a low cost. Repos allow them to do this by enabling them to borrow against the securities in their inventory.

The success of the government securities market owes a lot to the work done by Primary Dealers appointed by RBI. PDs have access to both call and repo market for their funding. As more and more participants have been phased out of the call market, the dependence on repos has grown. Today, direct market repos and third party repos are both important sources of finance for dealers in government securities.

The absence of a similar arrangement for corporate repos acts a serious dampener for this market. Banks are currently not allowed to enter into repo contracts on securities other than government securities. This puts corporate bonds at a considerable disadvantage. As a result the secondary market for corporate bonds remains dormant. The use of tripartite repos overcomes many of the systemic risk concerns that arise out of direct repos, and a product on the lines described below will result in the creation of secondary market liquidity for corporate bonds.

Product Specification

Corporate Repo Market

It is proposed to create a new segment on the exchanges called the Corporate Repo Market (CRM). A new type of instrument called the Repo Certificate (RC) will be traded in the proposed segment. RCs will be notional certificates created by the clearing corporations on the basis of collateral created by the deposit of approved securities with it. The total value of certificates held will be determined by valuing the collateral and applying haircuts on the basis of an approved process.

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Participants

The proposed segment will admit two types of participants – those who trade only on their own behalf, and those who trade on behalf of themselves as well as others. Banks and other institutions will be admitted in the first category and the rest in the second category. The entry criteria, including capital requirements will be separate for the two classes of members suitably factoring in the difference in their nature of activity and risk.

Approved Securities

The underlying collateral for the RCs will be corporate bonds, public sector bonds including bank bonds and any other instrument that satisfies quality and liquidity criteria laid down for the collateral. A valuation framework will be put in place for the securities admissible as collateral, and a procedure will be implemented for setting and changing haircuts to the market value.

Trading and Settlement of Repo Certificates

The Repo Certificates can be traded between participants. The sellers of the certificates will be borrowers and the buyers will be lenders. Settlement will have two legs – the lender (buyer) will pay the consideration to the borrower (seller) on T+0 in an end of day settlement. The repayment will be done at end of day T+1, and will consist of the amount borrowed plus the interest. Each trade will create these two fund settlement obligations for the participant. The clearing entities will act as the counterparty and will net off the obligations arising at the end of each day. There will be a single cash settlement for each member every day that nets the repayments falling due on that day and the fresh borrowing for the current day.

Creation and Liquidation of Collateral

All collateral will be held and transferred through demat accounts with the depositories. The participant will transfer securities to the clearing corporation's designated demat account, and provide proof of the transfer. After verifying the transfer, the clearing corporation will credit the collateral to the participant's account and update the total collateral available.

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Liquidation of collateral will also be an intra day activity. The member will make an online request, identifying the collateral that it wants to withdraw. The system will verify that the existing position is covered after releasing the collateral and automatically generate a transfer request to credit the securities to the member's account. Once the transaction has been passed, the securities can be made available for sale.

Margining and MTM

An appropriate system of initial and MTM margins will have to be created to protect value of collateral. RCs will accept a wide range of securities as collateral, and keeping track of the quality and value of collateral will be key to the success of the product. Unlike government securities, that can always be liquidated, it may be difficult to readily liquidate corporate bonds, especially when there are re-rating events or credit events. It may also help to create back to back arrangements with other financial institutions to de-risk the clearing corporation in case of defaults.

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CHAPTER IV

Asset Backed Securities Market

1. Securitisation in its basic form is the process by which assets or interests in assets are sold, or otherwise transferred, to a SPV, which is funded by the issue of securities secured primarily by these assets. It is the process of pooling and repackaging of homogenous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing asset or pool of assets. The pool of assets collateralises securities. There are four steps in a securitisation: (i) SPV is created to hold title to assets underlying securities; (ii) the originator or holder of assets sells the assets (existing or future) to the SPV; (iii) the SPV raises funds, with the help of an arranger / investment banker, by issuing securities which are placed with investors; and (iv) the SPV pays the originator for the assets with the proceeds from the sale of securities. The touchstones of securitisation are:
    - Legal true sale of assets to an SPV with narrowly defined purposes and activities
    - Raising of funds by the SPV by issue of securities to the investors, either representing beneficial interest in the underlying assets ("pass through securities") or representing a senior or subordinated interest in the cash flows realized from the underlying assets ("pay through securities")
    - Reliance by the investors on the performance of the assets for repayment - rather than the credit of their Originator (the seller) or the issuer (the SPV)
    - Consequent to the above, "Bankruptcy Remoteness" from the Originator.
2. Apart from the above, the following additional characteristics are generally noticed:
    - administration of the assets, including continuation of relationships with obligors
    - support for timely interest and principal repayments in the form of suitable credit enhancements

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- ancillary facilities to cover interest rate / forex risks, guarantee, etc.
- formal rating from one or more rating agencies.

3. A securitisation transaction generally involves some or all of the following parties: (i) the initial owner of the asset (the originator or sponsor) who has a loan agreement with the borrowers (obligors); (ii) the issuer of securitized instruments, who also is the SPV (iii) the arrangers / investment bankers who assist in structuring the transaction and marketing the securities, and who may also underwrite the securities for a fee; (iv) the rating agencies, who assess credit quality of certain types of instruments and assign a credit rating for a fee; (v) the credit enhancer, possibly a bank, surety company, or insurer, who provides credit support through a letter of credit, guarantee, or other assurance; it is not uncommon for the originator to provide a cash collateral to enhance the rating; (vi) the servicing agent, usually the originator, who collects payments due on the underlying assets and, after retaining a servicing fee, pays them over to the security holders; (vii) the trustee, who deals with issuer, credit enhancer and servicing agent on behalf of the security holders for a fee; (viii) the legal counsel, who participates in the structuring of the transaction for a fee; and (ix) the swap counterparty who provides interest rate / currency swap, if needed.

Securitization: The Global Scenario

4. Securitization has emerged as one of the dominant means of capital formation through out the world, and particularly in the US, Canada, Europe, Latin America and South-East Asia. Each year billions of dollars of securitization transactions are structured by a wide range of entities like financial institutions, auto financiers, leasing companies, credit card issuers, infrastructure and insurance companies, governments and local authorities. Total market value of all outstanding MBS at the beginning of 2004 was reported to the National Secondary Market Conference at over USD 2.75 trillion. This is much larger than the market value of outstanding asset-backed securities The MBS market overtook the market for US Treasury notes and bonds in 2000.
5. According to Thomson Financial League Tables, US issuance was:

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a) 2004: USD 729 billion (1,121 issues)

b) 2003: USD 904 billion (1,203 issues)

c) 2002: USD 767 billion (980 issues)

d) 2001: USD 586 billion (837 issues)

6. More than 75percent of global securitization volumes are accounted far by the US. Both institutional and individual investors partake in this vast market. US investors also participate in the securitization issues of other major markets such as Europe and Japan. The US markets are very liquid, innovative and sophisticated. In the US, the market for CDOs had grown phenomenally from $1bn in 1995 to $234.5bn in 2002. The US securitization market has grown beyond $5 trillion, providing necessary liquidity to US financial institutions and their customers, both individuals and businesses. SPEs are critical components of this process. Clarity on regulations relating to securitisation such as capital relief, taxation, bankruptcy remoteness etc. and their general acceptance in the marketplace has facilitated the growth of the market.

Securitisation in India

7. Securitisation as a financial instrument has been existing in India since the early 1990s – essentially as a device of bilateral acquisitions of portfolios of finance companies. There were quasi-securitisations for quite a while where creation of any form of security was rare and the portfolios simply moved from balance sheet of one originator over to that of another. These transactions often included provisions which provided recourse to the originator as well. Now, loan sales is common through the direct assignment route, which is structured using the true sale concept. Securitisation of auto loans was the mainstay of the Indian securitization market through most the 1990s. Since 2000, residential mortgage backed securities has fuelled the growth in the market.

Form of security

8. In the early stage of securitization in India, creation of transferable securities in the form of pass-through certificates (PTCs) was the most common form of securitization. PTC has almost become synonymous with securitisation in India and most market practitioners do not envisage issuance of notes or bonds as a

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securitised product. There are PTCs which have a specific coupon rate, there are structured PTCs and PTCs have different payback periods. Many PTCs are essentially derived debt instruments but they are not called as such. For bilateral deals, which take shape through direct assignments, there is usually an investors' representative.

Asset classes

9. Over time, the market has spread into several asset classes – while auto loans and residential housing loans are still the mainstay, there are corporate loans, commercial mortgage receivables, future flow, project receivables, toll revenues, etc that have been securitised.

Motive for securitisation

10. For most cash transactions, capital relief does not sound like a very significant motive since the volumes are too small to have any tangible impact on the regulatory capital of the securitisers. Banking sector is an active investor though some of the new private sector banks have become originators for securitisations. Thus the primary motive for most securitisers would be the skimming of excess spreads; for some, liquidity needs are obvious.

Indian Structured Finance Market Trend[9]

11. Issuance of structured finance products grew by 121percent in 2004-05 over the previous year. Only asset backed securities grew by 176percent to Rs.22300crore during the year and it accounted for 72percent of the structured finance market (Rs.8100crore in 2003-04).
12. The average deal size (Rs.290crores in 2004-05) in the issuance market has increased substantially as the number of deals grew only by 41percent (Rs.150crore in 2003-04). The ABS deals were mainly backed by assets such as cars, commercial vehicles, construction equipments, two-wheelers and personal loans. This market grew substantially due to the growth of bank lending during the year.

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[9] This section has been drawn from the ICRA publication of July'05

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13. About 64percent of the ABS issuances involve multiple tranches of PTCs, each with a different tenure. Time tranching is an effective means of structuring PTCs with different tenures. This helps the issuer address the needs of different investors with different investment horizons. Certain struvtures also involve allocation of the monthly pool principal/cashflow to various PTC tranches in a round-robin fashion.
14. The mortgaged backed securities market grew by 13percent in 2004-05. The MBS issuance deals worth of Rs.3340crore were reported during the year. The long tenure of the MBS paper together with the lack of secondary market liquidity deters certain investors from investing in it. Also, the stamp duty issues have had an adverse impact on the growth of the MBS market in view of the differential stamp duty implications in the event of a liquidation of a property in a securitization – unfriendly state.
15. Corporate loan securitization has been lower than the retail securitization. Table – IV-1 gives the trend in structured finance volumes.

Table-IV-1: Trend in structured finance volumes (Rs. Crore)

Type	2001-02	2002-03	2003-04	2004-05
ABS	1290	3640	8090	22290
MBS	80	1480	2960	3340
CDO/LSO[10]	1910	2430	2830	2580
PG[11]	400	190	0	1600
Others	0	40	50	1000
Total	3680	7770	13920	30820

Nature and form of credit enhancements:

16. Subordination is a commonly used form of credit enhancement though cash reserves is equally popular. Since asset backed securities are still new, investors have a preference for AAA or AA rated instruments. Most transactions in the market are either AAA or AA. Multi-class issuances with several rated tranches

[10] CDO/LSO – Corporate Debt Obligation and Loan sell-Off
[11] Partial Guarantee Structures

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are uncommon. Apart from subordination and cash reserves, over-collaterlisation, guarantees, recourse etc are used as the other forms of enhancement. The extent of enhancements is relatively very. However, of late most originators are providing dollar for dollar on all credit enhancement. Since cash reserves do not amortise in line with the principal outstanding on the transactions, they are typically more efficient than subordinate strips and are hence being increasingly used in ABS transactions.

Legal structure:

17. In 2002, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 (SARFAESI Act) was enacted. This law has basically been viewed as a law relating to enforcement of security interests and has been used for sale or securitization of non-performing loans (NPLs) by banks and financial institutions in favour of asset reconstruction companies (ARCs) registered with RBI under SARFAESI Act, or in favour of trust established by such ARCs.
18. Most securitisations in India adopt a trust structure – with the underlying assets being transferred by way of a sale to a trustee, who holds it in trust. A trust is not a legal entity in law – but a trustee is entitled to hold property which is distinct from the property of the trustee or other trust properties held by him. Thus, there exists isolation, both from the property of the seller, as also from the property of the trustee. Therefore, the trust is the special purpose vehicle (SPV). The SPV issues securities which are either "pass through securities" or "pay through securities". In case of pass through securities, the investors holding them acquire beneficial interest in the underlying assets held by the trustee. Whereas, in case of pay through securities, investors holding them acquire beneficial interest only in the cash flows realized from the underlying assets, and that too in the order of and to the extent of the obligation contracted with the holders of the respective senior and subordinated tranches of pay through securities. Under either scenario, the legal ownership of the underlying assets continues to vest in the trustee.

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Regulatory compliances:

19. **Legal Issues:** Stamp duty is one of the major hindrances to the development of securitization in India. Stamp duty is payable on any instrument which seeks to transfer any rights or receivables, whether by way of assignment or novation or by any other mode. The instrument of transfer attracts stamp duty at an *ad valorem* rate, which ranges from 0.1percent to 8percent, and this varies from state to state. Therefore, the process of transfer of the receivables from originator to SPV involves an outlay on account of stamp duty, which can make securitisation commercially unviable in several states. Besides this, depending on how the transaction is structured, there is a risk of stamp duty being levied on issue of securitized instruments to investors by the SPV. If the securitized instrument is issued as an instrument evidencing indebtedness, it would be a debenture or a bond and would consequentially be subject to stamp duty. On the other hand, if the instrument is structured as a pass-through certificate that merely evidences title to the receivables, such instrument itself would not attract stamp duty since it is not an instrument provided for specifically in the charging provisions. Regardless of this position, the ambiguity that can arise as more and more complicated instruments get structured is a deterrent to the growth of this market. The prospect of a levy of stamp duty twice on the same underlying receivables can make securitization deals uneconomical. States that seek to earn revenue could introduce new Articles in the charging provisions of Stamp Duty laws to cover such instruments. There needs to be a consensus across states akin to the inter-state agreement on value-added tax to ensure that this market is not impeded. In addition to stamp duty, the instrument must be registered under the Indian Registration Act, 1908, which imposes additional costs to the transaction.
20. The varying duty rates on assignment of loans or debts, in various states have been summarized in the Annexure to this Chapter. Most PTCs and SRs are now issued in dematerialized form with NSDL or CDSL, upon payment of stamp duty on the PTC/SR allotted, and thus, the PTCs and SRs are credited to the Demat account of the allottees. Thereafter, in terms of the section 8A of the Indian Stamp Act as substituted by the Finance Act, 2000, transfer of dematerialized PTCs and

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SRs held through the depositories under the Depositories Act is exempt from Stamp Duty, not withstanding anything contained in any central or state law. Thus, the issue of stamp duty incidence is limited to the instrument of assignment of loan or debt and the issuance of PTCs and SRs (at the time of their dematerialization).

21. Among the regulatory costs, the stamp duty on transfers of the securitized instrument again can prove to be a major hurdle. The instrument of transfer of financial assets is, by law, a conveyance, which is a stampable instrument. Many states do not distinguish between conveyances of real estate and that of receivables, and levy the same rate of stamp duty on the two. Some States have announced concessional rates of stamp duty on actionable claims, limiting the burden to 0.1percent, but there is no clarity as to whether this concession can be availed for assets situated in multiple locations. The lack of clarity relating to stamp duty has in a way shaped the market – players have limited transactions to such receivables as may be transferred without unbearable stamp duty costs. The SARFAESI law intended to resolve the stamp duty problem, but owing to its flawed language, did not succeed. Inherently, stamp duty being a concurrent subject, specifically calls for a consensual legal position between the Centre and the States.

    To promote healthy growth of securitization market, the central government should consider establishing an appropriate institutional process to evolve a consensus across States on the affordable rates and levels of stamp duty on debt assignment, PTCs, security receipts (SRs).

22. Another important aspect that hinders the growth of securitization in India is the lack of effective foreclosure laws. The existing foreclosure laws are not lender-friendly and increase the risks of mortgage-backed securities by making it difficult to transfer property in cases of default.

23. The Reserve Bank of India has a set of guidelines for banks relating to their transactions under the SARFAESI law but that contains only an opaque reference to capital relief. There are no clear guidelines on capital relief. However, it is generally felt that if a transaction attains off balance sheet treatment, it will result

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into capital relief. There are no specific capital implications on account of retention of subordinated tranches, though in practice, there are substantial junior stakes or over-collateralisations present in every transaction.

Taxation:

24. *The Issue in Current Mortgage Backed Securitisation (MBS) & Non Performing Loans (NPL) Securitisation Structures*

a) The tax treatment of MBS SPV Trusts and NPL Trusts is unclear. Currently, these SPV trust structures are proceeding on the basis that the investors (that is, PTC and SR holders) would pay income-tax on the income distributed by the SPV Trust, and on that basis, the trustee would make income pay outs to the PTC holders without any payment or withholding of tax. This view is based on legal opinions regarding assessment of investors instead of trustee in representative capacity under sec.160 of the Income-tax Act and on the basis that the trust deeds provide for the possibility that a super majority of investors (usually, 75percent in value) can revoke their contributions to the SPV Trust, thereby assuming that the provisions of section 60 to 63 of the Income tax Act would be attracted.

b) However, the above view is yet to be judicially adjudicated, and therefore does not represent the final position on law. This leaves open an arguable possibility of the SPV Trust being taxed as an Association of Persons (AOP) on the premise that, by agreeing to participate in the SPV Trust conceived solely for the purpose of inviting such participation for an investment in MBS/NPL Trust, the investors "come together for a common purpose of earning income". This could be viewed as giving rise to an AOP that is taxable as a distinct tax entity. As an AOP, the applicable tax rate on all the income of the SPV Trust would be the maximum marginal rate applicable to any of the PTC holders under the Finance Act for the relevant year. And, thereafter, the share of such income distributed to the PTC holder would not form a part of their taxable income [in accordance with the provisions of proviso (a) to section 86 read with section 67A read with section 167B(2) of the Income-tax Act, 1961].

c) A limited life vehicle such as the MBS SPV Trust or the NPA SPV Trust cannot live with such basic tax uncertainty particularly when it can give rise to tax

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litigation that can last for many years beyond the life of the SPV Trust, exposing the Trustee to contingent tax liabilities that it has no viable means to recover from the beneficiaries once the life of the SPV Trust has expired and the PTC holders or SR holders paid off.

25. Trust Taxation under Income tax Act: Historically Single Level Tax

a) It needs to be emphasized that Indian Income Tax Law has always envisaged taxation of an unincorporated SPV such as a Trust at only one level, namely either the Trust SPV level, or the Investor/Beneficiary Level. Hence, any explicit tax pass thro regime if provided in the Income tax Act does not represent conferment of any real tax concession or tax sacrifice, but merely represents a position that the Investors in the trust would be liable to tax instead of the Trust being held liable to tax on the income earned by the SPV Trust.

These tax uncertainties would be satisfactorily resolved in the following ways:

a) Provide an explicit tax pass thro treatment to securitization SPVs and NPA Securitisation SPVs (namely, trust SPVs set up by ARCs registered with RBI under SARFAESI) on par with the tax pass thro treatment applied under the tax law to SEBI registered Venture Capital Funds under section 10(23FB) read with section 115U of the Income tax Act. For this purpose, SEBI may frame appropriate regulations for registering Securitisation SPVs. RBI may frame appropriate regulations for registration of NPA Securitisation SPVs; and

b) SEBI should consider the possibility of modifying the Mutual Fund Regulations to permit wholesale investors (to be defined to mean an investor who invests not less than Rs 50 lacs in the scheme) to invest in and hold units of a closed-ended passively managed mutual fund scheme whose sole objective is to invest its funds into PTCs and SRs of the designated MBS SPV Trust/ NPA Securitisation Trust. Under this structure, there would be certainty that it is the investors, as holders of units of the mutual fund scheme, who would be liable to pay tax on the income distributed by the mutual fund. Further, there would be no tax dispute about the MBS SPV Trust or NPA Securitisation Trust being treated as an AOP as the mutual fund scheme would be the sole PTC holder of all the PTC issued by the MBS SPV Trust (and a single investor cannot give rise to an "association" of

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persons). Also, there would be no ambiguity about the tax exempt character of income accruing to the mutual fund scheme as the sole PTC and SR holder, in view of the provisions of sec.10(23D) of the Income-tax Act; and

c) recognizing the wholesale and QIB character of investors in securitization Trusts, there should be no withholding tax requirement on interest paid by the borrowers (whose credit exposures are securitized) to the securitization Trust. Similarly, there should be no requirement of withholding tax on distributions made by the securitization Trust to its PTC and/or SR holders. However, the securitization Trust may be required to file an annual return with the Income-tax Department in which all relevant particulars of the income distributions and the identity of the holders of PTCs and SRs may be included. This will safeguard against any possibility of revenue leakage.

Accounting rules:

26. The Institute of Chartered Accountants of India has issued a guidance note on accounting for securitisation. Guidance notes are issued by the Research Committee of the Institute and are recommendatory rather than mandatory. But where a method is recommended, it is expected to be followed, unless there are reasons not to. Generally, off balance sheet treatment is allowed, if risks and rewards are transferred. Gain on sales is computed based on the components approach underlying the US accounting standard. Originators are required to estimate the fair value of retained interests, and retained liabilities and apportion the carrying value of the asset in proportion of such retained and transferred interests.

Securitisation in NHB

27. Support to Mortgage Backed Securitisation has been a major policy initiative of the Government as manifested in its National Housing and Habitat Policy announced in 1998. The policy has enjoined upon National Housing Bank (NHB) to play a lead role in starting mortgage backed securitisation and development of a secondary mortgage market in the country. A major milestone in creating a framework for such transactions has been the amendment of the National Housing Bank Act, 1987 by the Government of India. The National Housing Bank

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(Amendment) Act, 2000 has come into force from June 12, 2000, which, inter alia, provides for creating Special Purpose Vehicle (SPV) Trust by NHB for taking up such transactions and issuing MBS in various forms.

28. NHB has been playing a lead role in starting up Mortgage Backed Securitisation and development of a Secondary mortgage market in the country. NHB launched the pilot issues of Mortgage Backed Securities (MBS) in August 2000 in the Indian financial market, followed by other MBS issues cumulating to Rs.664 crores.

Mortgage Backed Securities in India

29. The transactions between parties in the housing finance sector can be broadly classified as those relating to 'primary residential mortgage market' and 'secondary residential mortgage market'. The primary mortgage market activity mainly comprises creation of mortgages as a result of transactions between the borrowers and primary lenders. The primary lenders create mortgages against loans provided by them to the purchasers of houses. The mortgages held as assets, generate cash flows represented by repayments of both principal and interest, on the loans.

30. The secondary mortgage market mainly involves the conversion of mortgages into tradable financial instruments and the sale of these instruments to prospective investors. The cash flows which come as repayments from the borrowers to the originators, can be transferred to a third party with simultaneous transfer of assets to an intermediary agency (SPV) designated for the purpose of managing the bought over pool of mortgages. These cash flows are passed on to the investors by the SPV. In the process, the mortgages are converted into securities which are tradable financial instruments and sold to investors. The secondary mortgage market is thus made up of securities which are backed by mortgages (MBS) and refers to the transactions between the issuers and investors.

31. Once the securitised mortgages are sold by the originators viz., the primary lending institutions, they are either de-recognized in the originator's books of account and presented in a specific manner. All future transactions in the mortgage backed financial instruments then take place in the secondary mortgage

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market, depending up the depth of the market. The overall liquidity in the capital market and housing finance system would increase with the number of transactions among investors in the secondary mortgage market.

32. Supportive fiscal measures and the policies of Reserve Bank of India (RBI) have established a systemic framework for specialised mortgage finance in the country and the sector has been witnessing steady growth in recent years. ICRA estimates the existence of securitized debt to the extent of about Rs30820crores as of March.05. In the recent past, with the emergence of the capital market as the central pool of resources for sectoral development, securitisation not only offers a viable and sustainable market oriented sourcing mechanism with the potential of integrating housing market with the domestic as well as the international capital markets, but also brings in a range of specializations, resulting in efficient and cost effective structures and practices. A vibrant securitized debt market would help in:
    - Improving Capital Adequacy Ratio (CAR) through transfer of risk weighted assets;
    - Aiding Asset Liabilities Management and helps long term source for deployment in housing sector;
    - Enabling better spread management, and facilitates improvement of return on assets and return on equity;
    - Enabling new source of fee based income;

Enabling Provisions in NHB Act for Mortgage Backed Securitisation and Secondary Market Development:

33. In terms of Section 14 (ea) of the said Act, NHB has been specifically authorised to purchase, sell, or otherwise deal in any loans or advances secured by mortgage or charge on the immovable property relating to Scheduled Banks or Housing Finance Institutions (HFIs);
34. Section 14 (eb) of the NHB Act allows NHB to create one or more Trusts and transfer loans or advances together with or without securities therefor to such Trust(s) for consideration;

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35. As per Section 14 (ec), NHB is authorised to set aside loans or advances, and issue or sell Mortgage Backed Securities (MBS) based on such loans or advances so set aside, in the form of debt obligations, Trust Certificates of beneficial interest or other instruments whatever name called, and to act as Trustee for the holders of such securities.
36. Section 18A of the NHB Act facilitates the transfer of MBS issued by National Housing Bank to securitise the loans granted by Scheduled Banks and HFIs, without Compulsory Registration, both at the time of issue of securities by NHB and at the time of their transfer by the investors.
37. Further, in order to instil confidence among the investors in the securities issued by NHB, the Bank acting as a trustee or otherwise in the transaction relating to securitisation of loans has been authorised to recover the dues as arrears of land revenue in terms of Section 18B of the NHB Act.

Speedier Foreclosure Mechanism:

38. To provide for introduction of a speedier recovery mechanism a new chapter (VA) has been added to the NHB Act. This chapter provides for appointment of recovery officers of approved institutions and procedures for the recovery of housing loan dues from defaulting borrowers. This chapter also proposes for establishment of appellate tribunal to hear appeals against the orders of recovery officers.
39. The dues of defaulting borrowers of Scheduled Banks are also included for the purpose of recovery process under Chapter VA of the NHB Act. Besides, in terms of Section 36C of the NHB Act, Scheduled Banks have been defined as approved institutions, which imply that officers of scheduled banks would also be eligible for being appointed as recovery officers.

    There is no reason why a similar generic provision cannot be provided for to cover securitisation of various classes of assets.
40. Securitized assets only make up small portion of the Indian debt market but their popularity is on the rise. securitization is one of the latest financial innovations in Indian markets. In the framework for securitization, Banks and FIs are not permitted to create special purpose vehicles (SPVs) or special purpose

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establishments (SPEs) for undertaking such transactions. The law contemplates establishment of a securitization company or reconstruction company and its registration with Reserve Bank of India (RBI). Such a company in turn formulates schemes, and sets up (scheme-wise) separate trusts. A securitization company can also act as an asset reconstruction company, and vice versa.

41. The purpose of securitization is to avoid mismatch between assets and liabilities of Banks/FIs. The lending company sells its loans to the investors through the SPV. The company securitizing assets can acquire financial assets from Banks/FIs, by issuing debentures, bonds or entering into any arrangements with the lenders/issuers. Once the company takes over the financial assets, it will be treated as lender and secured creditor for all purposes. It may then devise a separate scheme for each of the financial assets taken over. Qualified institutional buyers (QIBs) will invest in such a scheme. The QIBs include FIs, banks, insurance companies, trusts, asset management companies, provident funds, gratuity funds, pension funds and foreign institutional investors (FIIs). The company will issue security receipts to QIBs, which represent undivided interest in such financial assets. The company will realize the financial assets and redeem the investment and payment of returns to QIBs under each scheme. Any disputes among banks, FIs, securitization or reconstruction companies and QIBs shall be compulsorily referred for conciliation or arbitration under the Arbitration and Conciliation Act, 1996.

42. RBI issued draft guidelines to securitization companies and reconstruction companies on 18 December, 2002, soliciting views of banks, FIs and others. RBI subsequently finalized the guidelines taking into account the feedback received. The guidelines and directions provide for different aspects of securitization and asset reconstruction relating to registration, owned funds, permissible business, operational structure for giving effect to the business of securitization and asset reconstruction, deployment of surplus funds, internal control systems, prudential norms, disclosure requirements etc. for the smooth formation and functioning of securitization and re-construction companies. In addition to the guidelines and directions, which are mandatory, RBI also issued guidance notes of a

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recommendatory nature covering aspects relating to acquisition of assets, issue of security receipts, etc.

Listing of PTCs on Stock Exchanges: Issues & Suggestions

43. Currently, the SCRA definition of "securities" does not specifically cover PTCs. While there is indeed a legal view that the current definition of "securities" in the SCRA includes any instrument derived from, or any interest in securities, the nature of the instrument and the background of the issuer of the instrument, not being homogenous in respect of the rights and obligations attached, across instruments issued by various SPVs (unlike shares that are standard instruments under company law), has resulted in a degree of discomfort among exchanges listing the instruments. However, this issue is limited to PTCs only and does not extend to SRs. [Notably, SRs are specifically included in clause (ic) of section 2(h) of the definition of "securities" in SCRA].

With a view to remove any ambiguity in this regard, the Central Government should consider notifying PTCs and other securities issued by securitization SPVs / Trust as "securities" under SCRA, in exercise of its parts under section 2(h)(id) of SCRA.

Issues under SARFAESI and Suggestions

44. Until recently, there was some ambiguity about whether or not ARCs and Securitisation Companies (SCs) registered with RBI could establish multiple SPV Trust (of which the ARC or SC is a trustee and manager). This ambiguity has been removed through a specific provision in the form of sec.7(2A) of SARFAESI inserted by the Enforcement of Securities Interest and Recovery of Debts Laws (Amendment) Act 2004 with effect from 11 November 2004. In view of this, it should now be possible to unambiguously adopt the trust SPV structure even under SARFAESI Act for MBS, ABS or NPL securitization.

41. The current definition of "Security Receipt" (SR) u/s.2(zg) of SARFASEI Act envisages SR to be evidence of acquisition by its holder of an undivided right, title or interest in the financial asset involved in the securitization. While this definition is appropriate and sufficient for securitization structures where the securities issues are all "pass through securities". However, where the Trust SPV

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intends issuing "pay through securities" with different classes or tranches having senior or subordinated rights to the cash flow from realization of financial assets, the current definition of a "Security Receipt" may prove legally inadequate.

It is therefore suggested that the Central Government may consider possibility of proposing an appropriate amendment to the definition of "Security Receipt" in sec.2(zg) of SARFAESI Act. The amendment should enable the SR to also be an evidence of the right of its holder to the cashflows from realization of the financial asset involved in securitization (as differentiated from a right in the financial asset itself).

42. The construct of the SARFAESI Act is such that it enables SRs to be issued to and held by qualified insttutional buyers (QIBs) only. Currently, the definition of QIB in Sec.2(u) of SARFAESI Act includes banks, insurance companies, Public Financial Institutions (PFIs), SFCs, SIDCs, MFs, FIIs, PFs, Gratuity Funds, and Pension Funds. The definition, however, does not include NBFCs or other bodies corporate, unless they are notified either by Central Government as "financial institution" u/s.2(m)(iv) or by SEBI u/s.2(u) of SARFAESI Act. In order to deepen the market for SRs, there is a need to broad base the "buy side" investor base that qualifies to invest in SRs. Currently, due to the lack of depth, the NPL Trusts set up by ARCs mobilize funds by issue of SRs to the very banks and institutions which eventually sell the NPLs to the NPL Trust and receive back the amount invested in SRs, as a consideration for assignment of the NPL. The recent announcement of permitting FIIs to invest into SRs subject to an aggregate limit of 49percent in each tranche may help to somewhat deepen the market. At the policy level, investment in SRs could be viewed on the same footing as investment in private equity, with perhaps relatively lower risk return trade off than that in private equity investment.

    In the light of the above, with a view to deepen the investor base of QIBs which can invest in SRs, it is suggested that large sized NBFCs and non-NBFCs bodies corporate established in India with net own funds in excess of, say, Rs.50 crores, may be permitted to invest in SRs as QIBs. Similarly, private equity funds registered with SEBI as venture capital funds may also be permitted to invest in

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SRs within the limits that are applied for investment by venture capital funds into corporate debt instruments. These changes could be brought about through appropriate notification by the central government in exercise of its power u/s.2(m(iv)) of SARFAESI Act or through notification by SEBI in pursuance of its powers u/s.2(u) of SARFAESI Act.

43. For securitization SPVs other than NPL securitization, on account of the amendments to Sec.7(2A) of SARFAESI Act with effect from 11 November 2004, it should now be possible to utilize the Trust SPV structure by securitization companies being established and registered with RBI under SARFAESI Act.

    As suggested at para 25(b) above, SEBI should consider the possibility of modifying the Mutual Fund Regulations to permit wholesale investors (to be defined to mean an investor who invests not less than Rs 50 lacs in the scheme) to invest in and hold units of a closed-ended passively managed mutual fund scheme whose sole objective is to invest its funds into PTCs and SRs of the designated MBS SPV Trust/ NPA Securitization Trust. This, coupled with the ability of securitization trust SPVs (whether set up by the securitization company registered under SARFAESI or otherwise) to issue PTCs and SRs to mutual funds would enable development of a wholesale market for securitized assets outside QIBs.

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Annexure: Stamp Duties Across States

STATE	RATE OF STAMP DUTY	REMARKS
Andhra Pradesh Assignment: The Govt of A.P. has reduced the stamp duty with which an instrument of securitisation of housing loans, assignment of debt on house loans (with or without underlying securities in the nature of movable or immovable property) chargeable under Article 35 (b) of the Schedule 1-A to the said Act, to fifty paise for every hundred rupees or part thereof of the housing loan securitised or debt on housing loan assigned. The stamp duty payable on assignment for other kinds of debt shall be five rupees for every one hundred rupees for the first Rs. 1,000, and for every Rs. 500 or part thereof in excess of Rs. 1,000 twenty- five rupees.	Registration Fees : Registration fees shall be reduced to 0.025percent in respect of instrument of securitisation of loans, assignment of debt or house loans (with or without underlying securities in the nature of movable or immovable property). Declaration of Trust: Maximum of Rs. 200/-.	Stamp Duty already reduced
Assam	8.25percent	For agreement value exceeding Rs.1,50,000/-.
Union Territory of Delhi	Assignment: 5percent of the consideration amount set forth in the instrument Declaration of Trust: 5percent of the consideration amount set forth in the instrument	
Goa	8percent	For value more than Rs.1,000/-

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Gujarat Assignment: The stamp duty with which an instrument of securitisation of loans or of Assignment of Debt with underlying securities is chargeable is reduced to, subject to maximum of Rs. 1,00,000/-, seventy-five paise for every Ra.1000/- or part thereof the loan securitised or debt assigned with underlying securities	Registration fee: Maximum of Rs. 20,000/- Declaration of Trust: Subject to a maximum of Rs. 100/-	Stamp Duty already reduced
Haryana Assignment: Approx 12.5percent for conveyance amounting to sale of immovable property and 6.25percent for other conveyances	Declaration of Trust: Rs. 45/-	
Himachal Pradesh	8percent	Value exceeding Rs.1,000/-
Karnataka Assignment: If relating to Assignment of Receivables by the originator to the SPV, or by whatever name they are called, in the process of securitisation, the stamp duty shall be one rupee for every one thousand rupees or part thereof subject to a maximum of Rs. 1,00,000/-.	a. Registration Fees: 1percent b. Declaration of Trust: Rs.500/-	Stamp Duty already reduced
Kerala Assignment: Six rupees for every Rs. 100 or part thereof of the amount or value of the consideration for such conveyance. However, conveyance of immovable property situated within the Municipal Corporations or Municipalities shall be stamped at Eight rupees fifty paise for	Declaration of Trust: Rs. 6 for every Rs 100 or part thereof of the amount or value of the consideration for such conveyance. However, conveyance of immovable property situated within the Municipal Corporations or Municipalities shall be	

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every Rs. 100 or part thereof of the amount or value of the consideration for such conveyance.	stamped at Eight rupees fifty paise for every Rs. 100 or part thereof of the amount or value of the consideration for such conveyance.	
Madhya Pradesh/Chattisgarh Assignment:Stamp duty of 7.5percent of amount of debt assigned Registration Fees: 0.8percent of market value	Declaration of Trust: If there is disposition of property, 4percent on the market value of the property settled. In any other case, the stamp duty is Rs.500/-	
Manipur	7percent	On market value of property or the agreement value whichever is higher.
Maharashtra Assignment: The duty with which an instrument of securitisation of loans or of Assignment of Debt with underlying securities is chargeable under clause (a) of article 25 of Schedule I to the said Act, is reduced to fifty paise for every Rs. 500/- or part thereof, of the loan securitised or debt assigned with underlying securities, subject to maximum of Rs. 1,00,000/-, and in case of instrument of Assignment of Receivables in respect of use of credit cards to Rs. 2.50/- for every Rs.500/- or part thereof.	Registration Fees: 1percent or subject to a maximum of Rs.30,000/-. Declaration of Trust: If the declaration of trust involves disposition of property, the declaration to be stamped at Rs. 1,00,000/-.	
Meghalaya	i. upto Rs.50,000/- - 4.6 percent ii. more than Rs.50,000/- and upto Rs.90,000/- - 6 percent iii. more than Rs.90,000/- and upto Rs.1,50,000/- - 8percent	Of agreement value

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	iv. more than Rs.1,50,000/- - 9.9percent	
Nagaland	7.5 percent	Of the value
Orissa	14.7 percent	Of Agreement Value.
Punjab Assignment:6percent in case of immovable property and 3percent otherwise	Declaration of Trust: Rs. 45/-	
Rajasthan Assignment: Stamp duty of 11percent of market value in case of immovable property and 0.5percent in case of movable property	Registration:1percent Declaration of Trust: Rs. 60/- and the registration fees payable on declaration of trust is Rs. 60/-	
Tamil Nadu Assignment: Stamp duty on securitisation is available only for housing finance at 0.1percent subject to maximum of Rs.1,00,000/-. For conveyance of immovable property situated within the Chennai Metropolitan Planning Area and the Urban agglomeration of Madurai, Coimbatore, Salem and Tiruchira-palli and the City of Tirunelveli, the stamp duty shall be Eight rupees for every Rs. 100/- or part thereof of the market value of the property which is the subject matter of conveyance For conveyance of any other property, the stamp duty shall be Seven rupees for every Rs. 100 or part thereof of the market value of the property which is	Registration Fees: 1percent on value of asset Declaration of Trust: Rs.180/-	Of market value.

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the subject matter of conveyance		
Tripura	5 percent	Of the value.
Uttar Pradesh/Uttaranchal Assignment:Stamp duty of 8percent of amount of debt assigned	Declaration of Trust: 1percent Registration Fees: 2percent of market value, subject to a maximum of Rs. 5000/-	There are 2percent additional charges under specific acts
West Bengal Assignment: The stamp duty chargeable under the said Act on any instrument evidencing assignment of debt (whether unsecured or secured by any movable or immovable property) for the purposes of securitisation of such debt, shall be reduced to one-tenth of one per centum of the amount of stamp duty by which such instrument is chargeable, or Rs. 1,00,000/-, whichever is less.	Registration Fees: The registration fee payable on any instrument evidencing assignment of debt (whether unsecured or secured by any movable or immovable property) for the purposes of securitisation of such debt, shall be reduced to one-tenth of one per centum of the registration fee payable for such instrument , or Rs. 30,000/-, whichever is less. Declaration of Trust: Rs. 25/-	Stamp Duty already reduced

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CHAPTER V

SUMMARY OF CONCLUSIONS & RECOMMENDATIONS

This chapter summarizes the conclusions and recommendations of the Committee based on its report contained in the foregoing chapters. For the sake of convenience and easy reference, these are being presented concisely and have been grouped under various topics as discussed in the earlier Chapters.

Development of Primary Market

1. Stamp Duty

1.1 There is an urgent need to address the issue of differential stamp duties levied by various State Governments on debt instruments. The stamp duty on partly secured (including partly secured by registered mortgage) and unsecured debentures should be made uniform across all States and be linked to the tenor of the securities, with an overall cap. The cap should also take into account the re-issuance. As stamp duty is a State subject, the Government may coordinate with the State governments to bring uniformity in the application of stamp duties on corporate bonds.

2. TDS

2.1 TDS rules for corporate bonds should be similar to the ones applicable to Government Securities. The Government may bring appropriate amendments to legislation for removing applicability of TDS on corporate bonds.

3. Enhancing Issuer Base

3.1 In order to incentivise corporates to raise a part of their requirements through bonds, the time and cost for public issuance and the disclosure and listing requirements for private placements should be reduced and made simpler;

3.2 Banks should be allowed to issue bonds of maturities of over 5 years for ALM purpose and not only for the infrastructure sector as at present;

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3.3 Given the growing requirement of capital at banks, appropriate regulatory limits may be set for the banks when they subscribe to bonds issued by other banks, thereby also encouraging other entities to subscribe to bonds issued by banks.

4. Market-Makers

4.1 A market-making scheme for corporate bonds should be evolved by the market participant(s) willing to do so, including large intermediaries – such as banks, primary dealers and investment banks. A suitable framework needs to be put in place that incentivises efficient market-making and considers support mechanisms that market-makers need for this purpose including permission to undertake repos in corporate bonds.

5. Listing of Issues

5.1 For already listed entities, there is a strong case for disclosures to be substantially abridged. They may be required to make only some incremental disclosures every time they approach the market with a fresh issue either to the public or through a private placement but should include rating rationale in their disclosure document. For unlisted companies issuing bonds to institutional investors/QIBs, rating rationale should form the basis of listing;

5.2 Companies, that have no securities listed at the exchanges or have listed only privately placed bonds but which wish to make a public issue, should be subjected to stringent disclosure requirements, as the securities are being offered to the retail investors and there is no information on the issuing entity available in the public domain. Accordingly, the present requirements of Chapter VI of SEBI DIP Guidelines should as such be made applicable with necessary adaptations as relevant to a debt instrument. The rating rationale should additionally be made a part of the disclosure document;

5.3 Non-compliance with the listing agreement should not result in only suspension or delisting of securities, as that would necessarily harm the small investors, but lead to a heavy penal action against the promoters/directors of the defaulting company;

5.4 There is a need to strengthen the role of debenture trustees, and also provide for more accountability on their part. SEBI should encourage the growth and

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development of professional trustee companies. Debenture trustees should ensure that information on rating downgrades is made available to all investors. Moreover, a press release should be issued by the concerned debenture trustee whenever there is a default by a corporate. All information/ reports, including compliance reports filed by the companies and by the debenture trustees should be made public and be put up on the websites of the companies, debenture trustees and stock exchanges. 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;

5.5 Companies should pay interest and redemption amounts, in respect of corporate bonds issued by them, to the concerned depositories who would then pass them on to the investors through ECS/warrants. This would generate accurate public announcements about defaults and improve transparency about soft defaults;

5.6 It may be made mandatory for the issuers to get the privately placed bonds listed within 7 days from the date of allotment, similar to the norms applicable to public issues. SEBI should issue suitable guidelines in this regard;

5.7 The credits to the demat account within 2 days from the date of allotment should be made mandatory. SEBI should issue suitable guidelines in this regard.

6. Enhancing Investor Base

6.1 The scope of investment by provident/pension/gratuity funds and insurance companies in corporate bonds should be enhanced and rating should form the basis of such investments rather than the category of issuers;

6.2 Investment guidelines issued to such entities should provide for fungible/common limits in respect of different issuer categories such as PSUs and private sector corporate entities;

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6.3 Retail investors should be encouraged to participate in the market through stock exchanges. Such investors should also be encouraged to participate in the corporate bond market through mutual funds;

6.4 One of the ways to enhance the investor base is through allowing a separate higher limit for FIIs on a yearly basis in corporate bonds. However, it is recognized that this has implications for managing the capital account and RBI, as such, may review this matter at an appropriate stage;

6.5 In order to encourage banks to invest in corporate bonds, investment in corporate bonds should be considered as part of total bank credit while computing credit-deposit ratio by banks.

7. Consolidation of Privately Placed Bonds

7.1 Consolidation of the issuance process to create large floating stocks is required to enhance market liquidity. There should be a guideline limiting the number of fresh issuances that would include re-issuance of the existing bonds by a corporate in a given time period (say over a quarter). Any new issue should preferably be a reissue so that there are large stocks in any given issue, thereby helping to create secondary market liquidity;

7.2 Issuers should be encouraged to consolidate their various existing issues into a few large issues which can then serve as benchmarks;

7.3 Legal impediments to consolidation, if any, should be examined and removed;

7.4 Re-issuance of the same security should be included for the purpose of the cap suggested for stamp duty, in order to encourage re-issuance.

8. Bonds Primary Issuance Database

8.1 The immediate creation of a centralized database of all bonds issued by corporates is an absolute necessity. This database should also track rating migrations. The stock exchanges would be best suited for maintaining this database as most of the information is already available with them at the time of listing and only a suitable interface would need to be put in place between the stock exchanges and the rating agencies for any subsequent rating migrations This database should be made available free of cost to all the investors.;

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8.2 SEBI may prescribe appropriate enabling regulations for the setting up and licensing of platforms for non-competitive bidding and order collection for say upto 10percent of an issue as also for the facilitation of an electronic bidding process for the primary issuance of bonds and securitized assets on the lines of what is already available on the exchanges.

8.3 Development of Secondary Market

8.3.1 There is a need to develop a transparent and efficient secondary market for corporate bonds, incorporating the global best practices and systems to the extent they are relevant and consistent with the Indian securities market. SEBI, being charged with the responsibility of development and regulation of corporate bonds market, should provide the necessary regulatory framework.

8.3.2 The following roadmap is suggested to this end.

9. Trade Reporting System

9.1 Steps should be taken to immediately establish a system to capture all information related to trading in corporate bonds as accurately and as close to execution as possible, and disseminate it to the entire market in real time;

9.2 It would be cost effective to use the existing infrastructure available with the national exchanges for dissemination of information related to trading in corporate bonds. SEBI should frame detailed guidelines for setting up of such reporting platforms and should ensure coordination among them;

9.3 The concerned regulators of the various entities, who are party to transactions in corporate bonds, should mandate them to report specified details of each transaction within a specified time to the trade reporting system. The details to be reported and the time of reporting and the regulations governing usage of this platform should be specified by SEBI;

9.4 In order to provide direct access to regulated institutions such as banks, insurance companies, mutual funds, etc to the trade reporting system, suitable changes in the existing regulations should be made by SEBI.

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10. Clearing and Settlement System

10.1 The clearing and settlement of trades in this market must follow the IOSCO standards and the global best practices by way of well established clearing and settlement procedures through recognized clearing and settlement agencies;

10.2 The clearing and settlement agencies may provide the clearing and settlement services in phases by initially offering DVP I (gross trade by trade settlements) and use the experience to migrate within a reasonable time frame into DVP III (netted settlements) systems. In the first instance, in order to ensure DVP settlements of corporate bonds in accordance with international best practices, RBI may consider issue of grant of suitable access to the concerned clearing and settlement entities to the RTGS system ;

10.3 In order to improve secondary market trading, repos in corporate bonds may be permitted by RBI to be operated by the proposed clearing entities for corporate bonds;

10.4 As corporate bonds are governed by the SCRA and SEBI regulations, the entities handling the clearing and settlement of these securities will have to be recognized entities under the SEBI framework and SEBI will frame suitable regulations for the clearing and settlement of corporate bonds. However, in the case of trading, clearing and settlement of repos in corporate bonds, appropriate regulations will be framed by RBI in consultation with SEBI.

11. Order Matching Trading System

11.1 As market participants gain experience with trade reporting and the first phase of clearing and settlement systems, efforts should be made to develop online order matching platforms for corporate bonds. Such trading platforms can be set up by the stock exchanges or jointly by regulated institutions like banks, financial institutions, mutual funds, insurance companies, etc. SEBI would frame specific guidelines for setting up such trading platforms. Any platform, other than the one offered by a stock exchange would effectively be performing the functions of an exchange to a limited extent and as such would need the specific approval of SEBI;

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11.2 The Committee recognizes the need for more than one category of member viz., some who will trade on their own account and/or some who will do agency business. The membership criteria and responsibilities would be significantly different between the various types of members. The provisions of the relevant legislations/regulations may be reviewed and appropriate amendments made thereto, if necessary, for the purpose. As it is necessary to avoid multiplicity of regulators for entities taking limited purpose membership for trading on their own behalf in the proposed trading and clearing platforms, the responsibility of regulating their activity in corporate bonds through trading platforms will vest with SEBI while the primary regulation of these institutions will continue to vest with their respective primary regulators.

11.3 Appropriate approvals may be considered by concerned regulators to enable free participation on the trading platform through limited membership by the concerned entities for the purpose of their proprietary trading.

12. Phased Implementation of Recommendations relating to Trade Reporting, Clearing & Settlement and Order Matching System

12.1 The above recommendations would be best implemented in a phased manner. In Phase I, the trade reporting and dissemination system would be implemented and trades reported through the reporting systems will be accepted for clearing and settlement by the approved clearing entities. DVP I clearing could be offered for all corporate bonds and DVP III offered for those instruments that have sufficient liquidity;

12.2 In Phase II, measures for improving liquidity and reducing costs will be introduced. This will include the introduction of tripartite repo contracts in corporate bonds, securities lending and borrowing and other mechanisms for reducing settlement risk. This will allow DVP III settlement to be offered for a larger universe of corporate debt securities;

12.3 In Phase III, the above trade reporting could migrate to STP enabled order matching systems as well as DVP III settlements.

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13. Reduction of Shut Period

13.1 The current shut period in corporate bonds is very high and needs to be reduced and aligned to that for Government Securities. While trading in corporate bonds just before the coupon date, buyers and sellers have to transfer a part of the money through cash and trading during shut period.

14. Unified Market Convention

14.1 FIMMDA, being the representative of the banks and institutions, should take a lead role to put in place unified market conventions to be followed for corporate bonds. The standardized practice of 30/360 day count convention, followed for dated Government Securities, may be made mandatory for all new issues of corporate bonds. For existing bonds, the existing terms may have to be observed unless agreed to by issuers and holders. A suitable road map may be finalised to migrate interest payment conventions across all fixed income instruments, including government securities, to an actual/actual basis.

15. Repos in Corporate Bonds

15.1 RBI may allow Repos in corporate bonds as already announced in the earlier monetary policy. It will give an opportunity to investors who have illiquid corporate bonds to recycle the same and borrow money against these securities.

15.2 The entities that will provide the trade matching system could also provide a repo facility on lines of CBLO for Government Securities.

15.3 The activity relating to trading in repo on corporate bonds in lines of CBLO and / or its settlement will be regulated by RBI.

16. Introduction of Interest Rate Derivatives

16.1 Currently, the interest rate derivatives market is confined to the OTC market with only a handful of participants. Large corporates are active participants in this market. There is no mechanism for dissemination of trades and prices. Steps may be taken to introduce reporting system in the market and ensure real time dissemination of information. Simultaneously steps may be taken to immediately introduce the revised and approved exchange traded derivative products which have been pending for a long time.

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17. Reduction in Market Lot

17.1 The minimum market lot criteria of Rs.10lakhs for trading in corporate bonds at the stock exchanges should be reduced to Rs.1lakh to enable better access to smaller investors.

Development of Securitized Debt Market

18. Stamp Duty on Securitized Debt

18.1 To promote healthy growth of securitization market, the Central Government should consider establishing an appropriate institutional process to evolve a consensus across the States on the affordable rates and levels of stamp duty on debt assignment, PTCs and security receipts (SRs).

19. Taxation

In order to resolve the uncertainty in taxation issues pertaining to securitized papers, the following measures are suggested:

19.1 The Central Government should provide an explicit tax pass through treatment to securitization SPVs and NPA Securitisation SPVs (namely, trust SPVs set up by ARCs registered with RBI under SARFAESI) on par with the tax pass through treatment applied under the tax law to SEBI registered Venture Capital Funds under section 10(23FB) read with section 115U of the Income tax Act. RBI and SEBI may frame appropriate regulations in this regard.

19.2 SEBI should consider the possibility of modifying the Mutual Fund Regulations to permit wholesale investors (to be defined to mean an investor who invests not less than Rs 50 lacs in the scheme) to invest in and hold units of a closed-ended passively managed mutual fund scheme whose sole objective is to invest its funds into PTCs and SRs of the designated MBS SPV Trust/ NPA Securitisation Trust.

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19.3 Recognizing the wholesale and QIB character of investors in securitization trusts, there should be no withholding tax requirement on interest paid by the borrowers (whose credit exposures are securitized) to the securitization trust. Similarly, there should be no requirement of withholding tax on distributions made by the securitization trust to its PTC and/or SR holders. However, the securitization trust may be required to file an annual return with the Income-tax Department in which all relevant particulars of the income distributions and the identity of the holders of PTCs and SRs may be included. This will safeguard against any possibility of revenue leakage.

20. Listing of Securitized Debt

20.1 With a view to remove any ambiguity in this regard, the Central Government should consider notifying PTCs and other securities issued by securitization SPVs / Trust as "securities" under SCRA, in exercise of its powers under Section 2(h)(id) of SCRA.

21. Issues under SARFAESI and Suggestions

21.1 It is suggested that the Central Government may consider possibility of proposing an appropriate amendment to the definition of "Security Receipt" in Sec.2(zg) of SARFAESI Act. The amendment should enable the SR to also be an evidence of the right of its holder to the cashflows from realization of the financial asset involved in securitization (as differentiated from a right in the financial asset itself).

21.2 With a view to deepen the investor base of QIBs which can invest in SRs, it is suggested that large sized NBFCs and non-NBFCs corporate bodies established in India with net own funds in excess of, say, Rs.50crores, may be permitted to invest in SRs as QIBs. Similarly, private equity funds registered with SEBI as venture capital funds may also be permitted to invest in SRs within the limits that

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are applied for investment by venture capital funds into corporate bonds. These changes could be brought about through appropriate notification by the central government in exercise of its power u/s.2(m(iv) of SARFAESI Act or through notification by SEBI in pursuance of its powers u/s.2(u) of SARFAESI Act.

21.3 SEBI should consider the possibility of modifying the Mutual Fund Regulations to permit wholesale investors (to be defined to mean an investor who invests not less than Rs 50 lacs in the scheme) to invest in and hold units of a closed-ended passively managed mutual fund scheme whose sole objective is to invest its funds into PTCs and SRs of the designated MBS SPV Trust/ NPA Securitization Trust. This coupled with the ability of securitization trust SPVs (whether set up by the securitization company registered under SARFAESI or otherwise) to issue PTCs and SRs to mutual funds would enable development of a wholesale market for securitized assets outside QIBs.

22. Credit Enhancement Mechanism

22.1 Steps should be taken to introduce credit enhancement in India for corporate bonds. In a securitisation structure such enhancement is already provided with pooling of assets and selling tranches of the pooled asset with different ratings so that the investors can acquire the assets according to their risk preference. Such mechanisms could be extended to bonds issued by SPVs of State governments or other SPVs which are set up for ensuring financing of infrastructure and other riskier activities. The State Government itself or the Central Government or other willing market participants, including bond insurers, could underwrite some of the tranches so as to enhance the credit rating of such tranches. The Infrastructure SPV being mooted by the Ministry of Finance and the Planning Commission could also do the same. These tranches could then be placed out with relatively risk averse long term investors such as provident funds insurance companies etc. provided the concerned regulators allow investments in such securities as per suitable rating and listing criteria.

22.2 CAR guidelines issued by RBI need to be reviewed with the objective of reducing unnecessary double counting of capital requirements for credit enhanced debt instruments. In this context, it is recommended that the investors be required to

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have a risk weightage of only 20percent on debt instruments which are credit enhanced through guarantees from banks/FIs, in consideration of the fact that the guarantor themselves are already required to have a 100percent risk weightage.

22.3 The draft guidelines (dated April 4, 2005) of RBI on securitization of standard assets by banks and FIs need to be reviewed. In those instances where the issuer of securitized paper is also the credit enhancer, the draft RBI guidelines would result in the anomalous situation whereby the issuer needs more capital to securitize his assets than not to securitize his assets. The proposed requirements for capital consumption need to be suitably reduced to avoid this anomaly.

22.4 Credit enhanced CLOs and CDOs should be included as approved investment avenues. Today, investments in credit enhanced CLOs and CDOs are not recognized instruments for important market participants such as insurance companies and provident funds. Further, these participants are also not allowed to provide credit enhancements for such CLOs and CDOs and thus there is very limited understanding and appetite for such papers. The regulators for such participants, viz. IRDA for insurance companies and EPFO/ pension fund regulator, should come out with specific notifications for the same.

23. Specialized Debt Funds for Infrastructure Financing

There exists a strong case for creation of specialised Debt Funds to cater to the needs of the infrastructure sector. In this regard it would be useful to address some regulatory changes as follows:

23.1 Enabling registration of Rupee Debt Funds within the SEBI Venture Capital framework would go a long way towards meeting the above objectives. This would involve issuing a notification extending the purview of SEBI's Venture Capital Regulations 1996 to include Rupee Debt Funds for infrastructure financing. This modified regulations should allow domestic QIBs to commit capital to the corpus of close ended Infrastructure Debt Capital Funds and such funds should have the ability to invest in the long term (minimum five years) debt of infrastructure SPVs or other entities engaged in infrastructure development, as

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well as in non-convertible preferred stock and structured finance such as CLOs and CDOs.

23.2 Similar to the case of SEBI Registered VC Funds (which are subject to a restriction on the maximum that they can invest in listed equities), registered debt funds could also be required to invest a maximum of 33.33percent of the investment funds in listed debt securities.

23.3 Also, as in the case of registered VC funds that have the option to list themselves after a certain number of years from the date of closing, Rupee Debt Funds too should be given the option to list themselves on Indian stock exchanges after a period of one year from financial closure. This would provide a liquidity option to those investors that do want to be tied up for the life of the fund.

23.4 The CBDT may notify to ensure that SEBI registered Debt Funds receive the same tax treatment as VC Funds. Specifically, "pass-through" benefits under Sections 115u and 10 (23FB) of the Income Tax Act 1969 ought also to apply to the registered Debt Funds.

23.5 In order not to restrict bank participation in the proposed Debt Funds, it is important that investments in these registered Debt Funds are not subject to "capital market" exposure limits that the RBI applies to equity investments for banks. Further, investments in SEBI registered Debt Funds should be treated in the same manner as bank investments in bonds and/ or debentures and should be accorded the same risk weightage as applicable to normal infrastructure credit.

23.6 So as to encourage the widest possible participation for domestic financial institutions, IRDA, the Central Board of Trustees of the EPFO and the PERDA should modify their respective investment guidelines to permit insurance companies, provident and gratuity funds, and pension funds respectively to invest/ commit contributions to SEBI registered Infrastructure Debt Funds.

23.7 At a stage considered appropriate by RBI, foreign debt should be allowed to also participate in SEBI Registered Infrastructure Debt Funds. This could be done by modifying SEBI's foreign VC Regulation 2000 to extend its purview to also cover Debt FIIs such that these are allowed, without any upper limit, to invest/ commit

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contribution to rupee denominated Infrastructure Debt Funds registered with SEBI along the same lines as that suggested for domestic QIBs above.

24. Fiscal Concession for Municipal Bonds and Infrastructure SPVs

24.1 The recommendations submitted by the various Committees appointed by the Government to review interest rates on small savings instruments need to be implemented to ensure that interest rates paid on small savings instruments are aligned with market rates. The resultant fiscal savings could be used to provide tax benefits for municipal bonds and for credit enhancements to bonds issued by SPVs for infrastructure development.

24.2 Municipal bonds may be given some fiscal support with such support taking the form of bond insurance or providing credit enhancement so that municipalities are encouraged to issue such bonds for development of urban infrastructure either on stand alone or on pooled basis. A plan should be drawn for developing this market in India.

1. Dr.R.H.Patil	Chairman
2. Ms. Usha Thorat	Member
3. Ms. M.H. Kherewala	Member
4. Shri U.K.Sinha	Member

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5. Shri Pratip Kar	Member
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8. Shri C.B.Bhave	Member
9. Ms. Chitra Ramakrishna	Member
10. Shri Rajeev Lall	Member
11. Shri Prithvi Haldea	Member
12. Shri C.E.S.Azariah	Member

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Public comments are invited on the recommendations of this Report latest by the 10th of February, 2006. These can be sent at: ssaksena@nic.in and/or anu_guru@nic.in.

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