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Developing the Market for Corporate Bonds in India

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Abstract

The corporate bonds market is not only underdeveloped in India in comparison with the equity market, but also considerably lags that market in point of time. Despite various efforts, the corporate bonds market has not expanded to any meaningful extent. In this paper, we identify the elements of an appropriate legal framework that undergirds a liquid and vibrant corporate bonds market. These elements are the proper and timely enforcement of contracts, a robust corporate insolvency framework, standardization and transparency in the primary markets, and greater protection against opportunistic behavior between creditors and borrowers. Our central argument in this paper is that the weaknesses in these elements in India amount to legal impediments that inhibit the smooth operation of the bonds market in India. Consequently, any reform process ought to address these legal impediments.

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Developing the Market for Corporate Bonds in India

I. Introduction

India's steady and increasing growth rate over the last two decades has primarily been financed by retained earnings and capital raised through equity offerings. This however, is unusual when compared to other countries because the corporate bonds market in India has had little role to play so far. The underdevelopment of the bonds market is directly reflected in the significant financing gap in industrial sectors, such as infrastructure development, which are crucial to maintaining and enhancing growth. Although Indian regulators have been taking multiple measures to rejuvenate the corporate bonds market in India, there is little progress on that front, even as Indian firms consider raising debt through international debt offerings.

The corporate bonds market in India has been the subject matter not only of academic studies, but also of various government-appointed committees that have made recommendations towards its enhancement. The existing literature, as well as committee recommendations, largely emphasizes the need for a more robust market microstructure and the reduction of various costs associated with the bonds market (namely, tax and stamp duty). In this paper, we adopt a somewhat different approach in order to identify the elements of an appropriate legal framework that undergirds a liquid and vibrant corporate bonds market. These elements are the proper and timely enforcement of contracts, a robust corporate insolvency framework, standardization and transparency in the primary markets, and greater protection against opportunistic behavior between creditors and borrowers. Our central argument in this paper is that the weaknesses in these elements in India, along with the microstructure and costs issues noted above, amount to legal impediments that inhibit the smooth operation of the bonds market in India. Consequently, any reform process ought to address these legal impediments.

In addressing this central thesis, this paper explores the causes and consequences of the underdevelopment of India's corporate bonds market from legal, economic, political and historical perspectives and suggests what further reforms may be essential to the development of the bonds market in light of the political and economic realities in which these reforms would occur. Our analysis also provides insights into why now may be a most opportune moment to push forward on the development of corporate bonds markets. We begin, in Section II, by examining why a corporate bonds market may be particularly valuable in India now. Section III explores what sorts of legal structures may enhance the growth of bonds markets and how many of those are missing or inadequate in India. This includes methods to expeditiously enforce contracts, a reliable and timely insolvency process, a special regime for bond offerings (both to the public as well as on a private placement basis), appropriate secondary market mechanisms for trading in corporate bonds, and necessary protective mechanisms for bondholders such as bond insurance, securitization and credit default swaps. Section IV surveys the trends and practices in the Indian bonds market, finding that the absence of the requisite legal structures in India constitutes a key factor for the lack of depth in the bonds market. In particular, the bond issuances witnessed in the market are those that involve comparatively lesser insolvency risk, thereby indicating that market participants are required to navigate around the legal impediments to the extent that the bond markets in fact operate in India. Section V discusses the political economy behind this current state of affairs focusing on why in a liberalizing economic environment attention was paid primarily to the equity markets rather than bonds market in India. This also provides the background for considering any further reforms. Section VI examines what reforms might be worth considering in light of our analysis. Section VII concludes.

II. Need for a Corporate Bonds Market

The weak state of the corporate bonds market in India is somewhat perplexing given the presence of a relatively well functioning (and growing) equity market. This is because debt is generally considered *less risky* than equity due, in part, to the priority debt has over equity in bankruptcy and due to the regular committed interest payments debt

receives where equity generally receives none. Thus, one would expect the less risky market to develop first and then, later, the riskier one, yet in India the opposite is true.[2] This state of affairs raises at least four questions, which will be explored in subsequent sections. *First*, why might it be important for a corporate bonds market to develop? *Second*, what are the legal impediments to the development of the corporate bonds market? *Third*, how have the market participants reacted to the legal impediments? *Fourth*, what were the political factors that led to the current state of affairs?[3] These factors will become critical when examining what steps we might realistically take at this point to enhance the corporate bonds market in India.

If there is a well functioning equity market, then why should policy makers, legislators and practitioners want a corporate bonds market? The simplest answer is that some investors may not be willing to provide capital to a firm in the form of equity and some owners may not want to share more than a certain amount of the profits with others.[4] The risks inherent in equity (e.g., getting paid last, no committed periodic payments) may be too much for some investors and they may prefer more committed periodic payments, a higher priority in receiving payments, and return of the principal amount at some point in time. This is the standard debt contract. If a firm cannot finance its activities solely through equity then the debt market is critical to help finance a firm's activities and support economic development and growth (Allen, Kraakman and Subramaniam, 2009).

Debt financing could, of course, be obtained in many ways, such as loans from banks or issuing bonds to investors. However, bond market financing is often lower in cost and easier to obtain than financing from banks, which may need to assemble a syndicate to finance a project (Mishkin, 2006). Further, the ability to resell and trade bonds not only adds liquidity for investors, but also allows for greater diversification than simple bank

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[2] Virmani (2001)(noting that firms accessing equity markets often need to have good reputations rather than collateral).

[3] Answers to these questions are important not only for India, but for other countries in a similar position.

[4] Since a substantial number of Indian companies are owned by controlling shareholders (known as promoters), it is likely to be in their interest to prevent dilution through issuance of corporate bonds rather than further equity.

financing (Goldman Sachs, 2007). The tradability also results in the provision of information to investors and the market about the firm (Mishkin, 2006).

Corporate bonds markets are likely to have their greatest impact on businesses that have longer-term payoffs (e.g., infrastructure) because that is where investors may be most wary of equity's risks and where bank financing may not be as likely because that requires banks to carry a fair amount of risk for a longer period of time.[5] Equity investors generally prefer shorter time frames and larger returns than infrastructure normally offers.[6] Corporate bonds may reduce risk by granting a debt obligation (making it preferable to equity) and by allowing the spreading of risks amongst many investors (making it preferable to bank financing). Given the critical role in economic development that sectors such as infrastructure may play, it becomes imperative to explore the current state of the corporate bonds market in India.

The corporate bonds market in India represents about 2% of India's Gross Domestic Product (GDP). This stands in contrast to the equity markets where the ratio of stock market capitalization to GDP is 56% (McKinsey, 2006). This is unlike many other developed markets where the bonds markets are closer in size to, or larger than, the equity markets.[7] Indeed, in these developed markets we tend to see the bonds market predate the equity market instead of being something that lags behind as in India. This presents both the puzzle we are interested in exploring (the current state of the bonds market) and why that puzzle is important to explore (i.e., financing of firms, especially in sectors such as infrastructure). We begin our inquiry by asking what kinds of legal structures may aid in the development of a bonds market, and whether such structures in fact exist in India in the requisite form.

[5] Report of High Level Expert Committee on Corporate Bonds and Securitization (2005); Singh (2011).

[6] Singh (2011); Other Cites.

[7] Bond Markets (2011), Financial Markets Series, The City UK, available at: http://www.thecityuk.com/media/press-releases/global-bond-market-up-5-in-2010-to-record-95-trillion-more-than-two-thirds-the-size-of-equity-market/.

III. Legal Structures and Impediments

Prior scholarship has identified a number of legal structures that aid the development of debt markets and, relatedly, a corporate bonds market. We deal with each of these in this section.

A. *Enforcement of Contracts*

A bond is at its core a debt contract and usually provides for a number of contractual protections in its founding document (e.g., collateral as security, priority in bankruptcy, periodic interest payments). Thus, one of the first important legal structures would be whether lenders can obtain expeditious enforcement of the terms of debt contracts.

Enforcement of contracts is riddled with difficulties in India. This is primarily due to excessive delays in enforcement through an overburdened court system, and also due to prohibitive costs of bringing a civil action (Krishnan, 2010; Khanna, 2010). Often, borrowers have taken advantage of delays and other deficiencies in the country's court system to deny appropriate remedies to lenders, thereby increasing the risk perception of lenders to debt contracts, a matter that has also received the attention of the Supreme Court[8] (Singh, 2010). The World Bank, in its Doing Business Report, has ranked India consecutively for the last two years at 182 out of 183 countries (and only ahead of Timor-Leste) against the parameter of enforcing contracts (World Bank, 2012).

B. *Corporate Insolvency Regime*

Second, some of the most important provisions of a debt contract relate to when and how a lender can collect on any collateral or effectuate a secured claim. This is often through the process of insolvency, winding up and liquidation. Methods to expeditiously move a

[8] Indian Bank v. M/s Blue Jaggers Estates Ltd. 2010 (4) CTC 856, available at http://www.indiankanoon.org/doc/1728697/.

firm through this process so that the assets can be distributed to lenders would serve a valuable function in the development of credit markets.

The current regime for corporate insolvency in India is far from efficient, and has been subjected to considerable criticism. The World Bank ranks India at 128 for insolvency, although its ranking has improved from previous years (World Bank, 2012). As in the case of enforcing contracts, the insolvency process is met with significant delays, such that the liquidation of a company can take up to 10 years to complete (Shroff & Puri, 2006). Although a special body in the form of the Board for Industrial and Financial Reconstruction (BIFR) was set up under special legislation to enable recovery of sick industrial companies, the track record of the BIFR in ensuring timely recovery and rehabilitation of sick companies has been hardly successful (Shroff & Puri, 2006; Batra, 2003). Furthermore, when a company makes a reference to the BIFR, a moratorium automatically applies, thereby preventing creditors from initiating legal proceedings against the company, including for the recovery of debt or enforcement of collateral. Although the Reserve Bank of India has sought to ameliorate the situation by introducing an alternative corporate debt restructuring (CDR) scheme to encourage work-outs between borrowers and lenders that bypasses the delays of the judicial process, the schemes has met with mixed success. It is perceived to be favoring large lenders, leaving the small lenders vulnerable (Bhoir, 2011). Foreign lenders are not specifically covered, and have to opt in on a transaction specific basis (Singh, 2009). The dispersion of the corporate insolvency regime among several pieces of legislation and among different courts and regulatory bodies has further contributed to the failure of corporate insolvency process.

C. Standardization and Transparency

Third, given that bonds are designed to be tradable amongst debt investors their terms need to be sufficiently standardized to facilitate ease of trading. Similarly, sufficient disclosure is necessary so investors can price these terms. Non-standard terms (or opaque disclosure) would add uncertainty and make bonds less attractive as investments

and probably reduce their liquidity. The law can facilitate standardization and transparency in fairly direct ways by mandating it and then enforcing these requirements.

The current regime for corporate bonds in India hinders standardization in many ways. At the outset, foreign and domestic lenders are subject to differing regulations. Foreign lenders are required to comply with the RBI's guidelines on external commercial borrowings (ECBs), and have to bear a far more onerous burden than domestic lenders on terms such as interest rate caps, tenor of the loan, restrictions on the end-use of proceeds, and the like (RBI ECB Circular, 2011). While there has progressively been a liberalization of ECB policy (KPMG, 2011), the prevailing sentiment is that this is insufficient, and that further steps need to be taken (Adikesavan, 2011). In any event, the diversity in regulations among different types of bondholders affects standardization and reduces liquidity in trading corporate bonds.

In terms of issuing corporate bonds and trading in them, although significant steps have been taken to create separate securities regulation and a disclosure regime for corporate bonds, it has not stimulated that market. In 2008, the Securities and Exchange Board of India issued a separate set of regulations for issue and listing of corporate bonds in the form of the SEBI (Issue and Listing of Debt Securities) Regulations, 2008. A separate set of listing requirements and a format of the listing agreement were prescribed for corporate bonds. However, facilities such as a shelf prospectus and "on-tap" issuance of bonds are available only to certain banks and financial institutions that are primarily in the public sector (Companies Act, 1956, s. 60A), and this appears to constitute a significant impediment in the use of the public offering route for corporate bonds. For example, the availability of a shelf prospectus facility would be advantageous for companies to access funds from the bonds market as and when they require funding, and that too without significant procedural hurdles, except for updating the prospectus in order to make it current. The present emphasis on private placements significantly undermines the goals of standardization and transparency.

Moreover, among overseas investors, only the foreign institutional investors (FIIs) registered with SEBI are eligible to invest in the corporate bonds market. That leaves other institutional investors without access to that market, thereby impeding its liquidity.

Other forms of standardization include the creation of a market for credit default swaps (CDSs), which will also introduce an element of transparency through information that participants in the market will generate. It also acts as a useful risk-sharing mechanism, by shifting risks from issuers who are affected by issues of insolvency risk we discussed earlier and on to more creditworthy institutions such as banks and financial institutions who are market makers of CDSs. The Reserve Bank of India's introduction of a CDS market has the objective of uplifting the corporate bonds market by, among other things, addressing the issue of risk transfer, which would also include risks arising out of a weak corporate insolvency regime (RBI CDS Circular, 2011).

Another recent effort at standardization is the introduction of a specialized regime for a corporate bonds market in the infrastructure sector. To meet the heavy demand for financing in that sector, the Government has granted tax benefits (Budget, 2010). While it is indeed the case that the bonds market is quite heavily populated by infrastructure lenders (many of whom are either owned or backed by the Government, or at least the more credible private industrial groups), the key motivation for investors appears to be to avail of tax benefits.[9]

D. Creditor Protection

Fourth, contractual provisions can provide some protection to the parties, but no contract covers every possible contingency. Because there will inevitably be areas for opportunistic behavior not covered by the contract there is a risk that one party may be able to behave opportunistically with the other. If left unchecked this would tend to increase the interest rates charged (to account for this risk) or perhaps lead to no debt

[9] More generally, the Government of India has paved the way of the establishment of infrastructure debt funds in order to enhance the flow of debt funds into long-term infrastructure projects (Ministry of Finance, 2011).

contract. The law can step in through the use of certain rules and standards to reduce the costs of such opportunistic behavior. For example, restrictions on dividends and equitable doctrines such as equitable subordination serve, in part, to prevent shareholders of a firm from borrowing money from creditors and distributing that money to themselves (via dividends) and declaring bankruptcy (Allen, Kraakman and Subramaniam 2009). Similarly, veil piercing doctrine can be used to protect creditors against opportunistic behavior by debtors in how they (under)capitalize their firms (Allen, Kraakman and Subramaniam 2009). These protections again require court enforcement and adjudication, which raises concerns given the delays in the Indian judicial system.

In light of the delays in adjudication and the posture of the India bankruptcy and labor laws, we might expect there to be impediments to the development of a corporate bonds markets in India. There may also be other impediments from time to time (low returns and so forth), plus issues of market microstructure. Indeed, Thomas (2006) has identified a number of market microstructure issues in the debt markets that are not addressed with the vigor seen in equity markets – these are reproduced below.

Table 1: Lags in Institutional Development in the Indian Debt Market

Institution	**Original Development**	**Adoption for Debt Market**
Electronic Trading on a Single Platform	Equity Markets (1994), Commodity Futures (2004)	11 years after adoption in the equity markets (2005)
National Access to Trading	Equity Markets (1994), Commodity Futures	Not there in debt markets.
Clearing Corporation	Equity Markets (1996)	3 years after equity markets (1999).
Independent Regulator	Equity Markets (1992), Insurance (1999).	Not present and not considered.
Competition Between Exchanges	Equity Markets (1994), Commodities (2004)	Absent in debt markets.
Entry Barriers	Removed for Equity (1994), Commodities (2004).	Barriers present

These legal impediments and structures should make it difficult for Indian firms to raise debt capital through bonds markets and indeed that is what we witness. Creation of the necessary market microstructure for corporate bonds, despite a lag in comparison with equity markets, is by itself inadequate to boost the corporate bonds market without appropriately addressing the legal impediments we have discussed.

IV. How are Indian Firms obtaining Debt Financing through the Markets?

The portrait just painted seems rather bleak for Indian firms keen to raise debt capital from bonds issuances. However, in spite of this, we have seen a handful of Indian firms being able to raise debt capital from bond issuances – sometimes within India and often overseas. This raises an important question – how are these firms managing to overcome the legal and other impediments just discussed? Learning how these firms have been able to raise debt capital may provide useful insights into the kinds of reform efforts or other business practices one should explore to enhance the corporate bonds market in India. Our analysis suggests that firms which successfully issue bonds, and investors who invest in those bonds, find suitable alternatives to deal with the legal impediments discussed earlier, particularly the risk posed by a lax corporate insolvency regime in India.

A. Supply Side of the Bonds Market

At the outset, there are distinct trends evident from the development of the bond markets in India on the supply side (i.e. from the perspective of issuers who raise funds): (i) the market for government securities eclipses the corporate bonds market; (ii) the corporate bonds market itself is dominated by government-owned companies rather than those within the private sector; (iii) bond offerings are undertaken substantially through private placements rather than through a public offering process; and (iv) Indian companies are increasingly resorting to the international bond markets to raise long-term financing.

First, it is clear that there is a wide discrepancy between the growth of the government debt market and the corporate debt market. While India's government debt market is comparable to that of several other emerging economies, its corporate bond market is insignificant (Asunscion-Mund, 2007). For example, in 2007, it was found that trading in the secondary market for government bonds constituted 99% of turnover in the secondary markets, thereby dwarfing in significance the market for corporate bonds (Chakrabarti, 2010). In that sense, the government bond market may have a tendency to crowd out the market for corporate bonds (Luengnaruemitchai & Ong, 2005). This suggests that investors have greater comfort in holding and trading government bonds compared to corporate bonds. While they are willing to take an investment risk on the sovereign, the same is not true of the risk on corporate entities in the private sector. This reflects substantially on the weak corporate insolvency regime, which is a significant legal impediment.

Second, even within the corporate sector, a clear trend emerges regarding the identity of bond issuers. For instance, a substantial number of issuers in the corporate bond markets are either companies owned or controlled by the Government (and referred to in India as public sector undertakings (PSUs)) or companies in the infrastructure sector. PSUs are generally owned substantially by either the Central Government or a state Government, which also provides substantial financial and non-financial backing to the PSUs. PSUs have substantially dominated the corporate bond market with the result that there are only a handful of top-tier private companies that have bonds outstanding. A substantial majority of corporate bond offerings in recent years have involved PSUs (Asunscion-Mund, 2007; Chakrabarti, 2010; Rajaram & Ghose, 2011), whereby investors either obtain a government guarantee as security for the PSU's performance of obligations under the bond offering or an implicit assurance that the government will take measures to prevent any failure of the issuer (Shah, Thomas & Gorham, 2008). The fact that the government stands behind the PSU issuer is a source of immense comfort to investors, thereby causing them to flock towards PSU paper as opposed to private corporate paper. Investing in PSUs provides investors with the benefit of minimal exposure to potential

insolvency of the issuer, a clear workaround to avoid a legal impediment that results in the shallowness of the corporate bonds market.

Third, most corporate bonds are placed privately to select investors, being banks and financial institutions. Only a few issuers adopt the public offering process. Tables 2 and 3 contain a comparison of the private placements and public offerings in corporate bonds of Indian companies over the last few years.

Table 2: Number of Placements/Offerings

Year	Private Placement	Public Offering
2008-09	1041	1
2009-10	1278	3
2010-11	1404	10
2011-12	976	6

Source: SEBI

Table 3: Issue/Offer Size

(in Rs. crores)

Year	Private Placement	Public Offering
2008-09	173281.18	1500
2009-10	212634.92	2500
2010-11	218785.41	9451.17
2011-12	135589.95	4388.68

Source: SEBI

Private placements can be carried out in a timely manner that is also cost-effective. They involve placements to a limited number of identified investors, who are usually institutional investors such as banks, finance companies, insurance companies, pension funds, mutual funds, and the like. There is no requirement for a prospectus, which also

reduces the exposure of issuers and their directors and officers to potential liability for misstatements. On the other hand, a public offering is a time-consuming process that is also expensive. Although the disclosure and filing requirements in India have been progressively simplified for debt offerings (as compared to equity offerings),[10] that has not stimulated a robust public offering market for corporate bonds. It appears that the public offering requirements for corporate bonds (despite their simplification) are more onerous than a private placement. Available data indicate that even the modest public offering market is populated by issuers that are either banks or financial institutions owned or backed by the government or private companies that are in the financial sector (raising funds for on-lending to their customers) (SEBI, 2011). There is a dearth of a more versatile issuer community that includes manufacturing firms.

The distinction between a public offering and private placement of securities is specified under the Companies Act. Any offer or invitation made specifically to less than 50 investors is considered a private placement, while a more general invitation is considered a public offering.[11] Since a substantial part of bond offerings are taken up by institutional investors (who are limited in number), issuers find it attractive to stay within the confines of a private placement. This is perhaps attributable to the lack of standardization and transparency in the bonds market, as private placements are less opaque with no statutory disclosure requirements that apply to them. Since the institutional investors are small in number and likely to be repeat players in the private placement segment, aspects of mutual trust and reputation play a greater role than matters of disclosure mandate by statute or regulation.

As we shall see later, factors such as risk perception and issues surrounding the corporate insolvency regime have a significant role to play in determining the type of investors that

[10] For example, an offering document for corporate bonds needs to be filed in draft form with the stock exchanges, and SEBI does not directly participate in the review process. *See*, Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008, Reg. 6(1). However, in the case of an equity offering, the draft offering document must be filed with SEBI for its review. *See*, Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009, Reg. 6(1). Moreover, the disclosure requirements for a public offering of corporate bonds are less onerous than that for equity offerings.

[11] Companies Act, 1956, §67(3).

participate in the corporate bond market. Since it is largely the institutional investors that are capable of assuming the risk in the bonds market, and there is a virtual absence of retail investors from the arena, issuers naturally tend to gravitate towards the timely and cost-effective private placement process as there is no distinct advantage in adopting the public offering route.

This also has a direct knock-on effect on secondary trades in the corporate bond markets. The private placement phenomenon ensures the concentration of bonds in the hands of institutional investors, many of whom hold them to maturity. Even when trades occur, they are among the relatively small group of institutional investors, thereby limiting liquidity in the secondary markets. A wider distribution of bond holdings among a larger number of investors through a public offering process is expected to infuse greater liquidity in the secondary markets, but that trend is absent in the Indian markets, primarily due to legal impediments such as the lack of standardization and transparency and more specific reasons such as the wider availability of the shelf prospectus, as we have discussed earlier.

Fourth, a number of Indian companies have also accessed bond funding from the international markets. Although these bond offerings are marketed more widely than private placements in the domestic markets, the bonds are placed largely with institutional investors. They are not offered to retail investors. These international offerings are not registered with securities regulators such as the U.S. Securities and Exchange Commission, but they rather avail of specific exemptions under the U.S. securities regulations, such as Rule 144A and Regulation S. In terms of distribution and reach, these bond offerings are similar to private placements, except that their investors are located internationally rather than within India.

Within international bond offerings, a substantial portion of them pertain to convertible bonds. These are marketed under a specific regulatory regime available for foreign

currency convertible bonds (FCCBs),[12] wherein the investors will have the option to convert their debt exposure into equity of the issuer company at a predetermined price. The advantage for companies issuing such instruments is that the issue of convertible instruments internationally falls within the foreign direct investment (FDI) regulations promulgated by the Government of India. Non-convertible or redeemable bonds fall within the external commercial borrowings (ECB) regime that is far more onerous as it contains stipulations regarding the maximum amount of cost (interest and other) that companies can incur in payments to investors, minimum tenure, and also end-use restrictions. This has historically made FCCB issuances more attractive for Indian companies.[13]

The trend towards issue of convertible bonds bears enormous implications regarding the ability of investors to manage insolvency risk. For convertible bonds, corporate insolvency has less of an impact. In case of an issuer's insolvency, the bondholders will simply convert their instruments into equity and obtain control over the company. Such an option is not available in the case of non-convertible bonds where the investors will be compelled to hold on to the instruments and seek to recover using the regular time-consuming and uncertain insolvency procedure. The importance of insolvency risk in this transaction structure is evident from the types of companies that have accessed the international bond markets. While the non-convertible bonds segment is populated exclusively by "blue chip" companies where insolvency risk is low, the FCCB segment has been utilized by companies across the spectrum (Babu & Sandhya, 2009; CITES).[14]

[12] Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993.

[13] However, the FCCB route has become unattractive lately due to depressed market conditions as several investors holding FCCBs have been unable to convert into equity shares as those are trading at a price which is at a substantial discount to the conversion price.

[14] However, convertible bonds too are fraught with certain difficulties. They are not only subject to extensive regulation, but the conversion factor may cease to be attractive in case of falling markets when the market price of the underlying shares is less than the conversion price. This scenario has played out in the Indian convertible bond market following the global financial crisis (Punj, 2011).

B. *Demand Side of the Bonds Market*

The investors in the corporate bond markets are predominantly banks and financial institutions, with limited participation by retail investors. It has been observed that the "buyers of corporate bonds are almost the same as buyers of [Government of India] bonds" (Shah, Thomas & Gorham, 2008). These include banks, insurance companies, mutual funds and provident funds, and increasingly foreign institutional investors.[15] Several investors such as banks, pension funds, insurance companies and trusts are limited by the extent to which they can invest in corporate bonds. They are restricted either by quantitative limits or by minimum rating requirements for the bonds. This is driven by the need to limit exposure of these investors to corporate debt, as unlimited exposure is deemed too risky for investors in those funds, many of whom either perform a public role or a fiduciary role.

For example, the pension fund manages the monies of employees and retirees, while public life insurance companies, such as the Life Insurance Corporation of India, manage monies for the insured and small-savers. Therefore, while the corporate bonds market is largely utilized by institutional investors, there are additional restrictions imposed on individual investors, again to protect against the risk of non-performance of obligations under the corporate bonds. Here too, the risk of insolvency is predominant. Of course, recommendations have been made to remove restrictions on pension funds and insurance companies from investing in the corporate bonds markets, but that is likely to receive traction only if the legal impediments surrounding the bonds market are attenuated. For example, a more robust and efficient corporate insolvency framework would provide a greater source of comfort such that investors using public funds and savings may be permitted to invest in corporate bonds. Without such a framework, there is insufficient incentive for regulators to relax investment requirements.

In the context of a lax regime for corporate insolvency, one method of addressing risk would be to pass on the risk to another more credible entity through alternate methods. A

[15] *Id*. The limit for foreign institutional investment in Indian corporate bonds is gradually being enhanced.

market for such risk-shifting is gradually emerging in India. For example, one option would be to provide investors with the ability to down-sell their bondholding. This is possible through structures of securitization and asset-reconstruction that have acquired some level of popularity in the Indian context. The other option would be to create a market for credit-default swaps (CDS), which would protect investors who are risk-averse. The CDS mechanism has been made operational in India, with effect from December, 2011. It is too early to determine whether this is likely to have a measurable impact on the take-up of corporate bonds in the Indian markets. In any event, it is important to note that these are only temporary solutions to addressing the problems arising out of a lax corporate insolvency regime.

A study of the trends and practices in the Indian bonds market suggests that the legal impediments discussed earlier (and particularly the weak corporate insolvency regime) appears to hold back the development of these markets. Even where firms have issued corporate bonds, and investors have in fact invested in them, suitable workarounds have been devised such that the adverse effects of the legal impediments are made tolerable to certain groups of investors.

V. How did this State of Affairs arise – the Political Economy of Bonds

Market Reform

The legal and other impediments to the growth of the corporate bonds market in India are only part of the story. Other important questions are: what led to the current set of laws, and perhaps more importantly, what factors kept the law from being reformed? Understanding the political economy of regulation in this area is important in order to obtain a better understanding about what things can, realistically, be reformed to encourage the bonds market.[16]

[16] There is a substantial literature on the determinants of financial markets ranging from the legal origins of a country to a series of political and economic factors. La Porta, La Silanes, Schleifer and Vishny (1997, 1998); Roe, 2006; Rajan & Zingales, 2003; Armour & Lele, 2009.

Prior scholarship has found that a number of factors contributed to the weak financial markets in India post-Independence (Thomas, 2006; Khanna, 2009; Others). In particular:

- The stronger labor oriented protections both in the labor laws and bankruptcy laws appeared designed, at least in part, to protect employment. However, these also placed limits (perhaps unintended) on the ability of capital to re-adjust in a timely manner to changing circumstances. This would have hampered the attractiveness of providing capital. Of course, given the economic situation in India at the time of Independence (few individuals with capital to invest, resource constraints, and many individuals in need of employment) it seems unsurprising that labor was favored and the negative effects on capital understandable (Roe, 2006; Howson & Khanna, 2011).

- The state becoming the primary provider of capital (both debt and equity), where the state was not much focused on its investment turning a profit, leading to weak oversight of management by the primary provider of capital (Khanna, 2009; Goswami, 2003).

- Even where the law might be less protective of labor or current management, the ability to enforce contractual provisions would have been stymied by the delays in the judicial system and bankruptcy processes (Khanna, 2009; Goswami, 2003; Anant and Mitra, 1998).

These factors, in combination with the others,[17] led to weak financial markets post-Independence.[18] However, when liberalization officially began in 1991 the Government

[17] These other factors included (i) weak competition because of a large state owned sector and impediments to entry for domestic and foreign firms, which weakened competitive pressures on firms for raising capital, (ii) low amounts of capital contributed by promoters and management raising the specter of moral hazard and (iii) inadequacies and problems in how interests were recorded which would have further complicated enforcement of contractual provisions. *See* Khanna (2009); Goswami (2003).

[18] Thomas (2006) argues that India's financial system was fairly free until the early 1970s, but not used as much for fund raising given the state of the economy and the Government's role as a capital provider. Soon after that began the wave of nationalizing banks and the Centre taking a larger role in managing the

of India had a choice about how it would de-regulate (and re-regulate, perhaps) the financial markets. It chose to focus on equity markets rather than debt markets – why this happened is the matter of primary interest in this section.[19]

To understand this choice we need to examine what were the options the Government was likely considering and which ones would have made the most political and economic sense at the time. In 1991, the key concern was increasing foreign investment given that India was staring at a balance of payments crisis (Panagariya 2008, Singh 2011, Others). However, policymakers would prefer a method to obtain this outcome that most pleases (or least displeases) powerful constituents, interest groups and voters. In light of these considerations let us consider what equity market and debt market liberalization would have meant.

Liberalizing the equity markets would likely benefit many incumbents compared to liberalizing the debt markets. To explore this, let us assume that there are two broad types of industries – manufacturing and services. Service based industries would tend to prefer equity market liberalization because most service companies do not have substantial collateral they can pledge to obtain debt financing. Moreover, even the incumbents in the services sector would probably prefer equity given the high growth in their sectors and their need for capital to take advantage of it (with little collateral to use for debt) (Armour & Lele 2009; Singh, 2011).

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financial markets. See Thomas (2006); Rajan & Zingales (2003). By the end of the decade most of the financial sector was under the close control of Government and even the equity side (which had larger private sector involvement) was still heavily impacted by the Government, which set prices for issuances and was the largest investor (via the Unit Trust of India). Thomas (2006). This lead to the financial sector being dominated by state owned banks, other financial institutions which were required to buy primarily government securities, with the stock market being a closed system, the existence of heavy financial regulations and most private parties being able to access finance only through the Government. Thomas (2006).

[19] The Government could also pursue asset securitization (offering shares of ownership in specific sets of government owned assets to private investors). But in 1991 this would not have solved the core problems because the Government would be selling its important and valuable assets in a context where purchasers knew the Government needed capital – this is similar to a fire sale and is unlikely to generate very high values (Singh (2011)).

On the other hand, because manufacturing companies often have collateral (e.g.. plants, factories) they might prefer debt market liberalization. However, the incumbents in manufacturing would probably prefer to deny access to debt capital to new entrants who have collateral. Indeed, because raising capital in equity markets generally requires some reputation and good past performance, it might tend to be biased against new entrants relative to debt markets – something incumbent manufacturers might favor given the slower growth rate in manufacturing relative to services at this time. [20]

In light of this, we would expect service sector firms (both incumbent and new) to prefer equity markets over debt market liberalization. Further, incumbent manufacturers (of which there are many in India) would also generally prefer equity markets over debt market liberalization. That leaves only new entrants in manufacturing preferring debt market liberalization. Thus, we would expect that business interests in India would tend to favor equity market over debt market liberalization. In fact, when corporate governance reform in the equity markets was proposed it met with virtually no opposition from incumbent firms – indeed, the incumbent firms wholeheartedly embraced the reform and in fact recommended the first voluntary code of corporate governance before the Government proposed any reforms.[21] Moreover, Singh (2011) finds that incumbent firms benefited the most from equity market liberalization.

Another critical issue is what laws would need to be reformed to liberalize the debt and equity markets and what kind of opposition might this generate. To liberalize the equity markets required pulling the Government out of certain matters and creating some measure of additional protection (whether through legislation or regulation via the Securities & Exchange Board of India (SEBI)) for equity investors. This would involve some constraints on management and controlling shareholders (promoters). Given that controlling shareholders (i.e., incumbent firms) largely favored liberalizing equity markets over debt markets one might expect there to be greater room for negotiation and agreement here.

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[20] *See* Armour & Lele (2009); Singh (2011).
[21] Black & Khanna (2007).

On the debt market side, the reforms would need to include ways to enhance enforcement of contractual protections and speed up bankruptcy. This requires changes to the bankruptcy laws, labor laws and judicial enforcement. The last of these could be addressed in some measure through separate tribunals or the use of regulatory bodies, but the first two would involve a fairly bruising debate.

At the time the official liberalization began in 1991, the ruling coalition at Centre was fairly weak and the Congress-led coalition Government of Prime Minister Rao was able to stay in power only with the support of the Communist parties (Panagariya 2008; Singh 2011). The base of these parties were the labor unions and thus any change to the labor laws (or the bankruptcy laws) that enabled a quicker way to dismiss labor would have met with considerable opposition and opposition that could have had a significant influence on the balance of power.

Second, if labor law and bankruptcy law reforms were off the table in 1991 then we would expect that manufacturing would not grow all that fast (because its ability to adapt to changing circumstances might be impeded by the absence of reforms in these sectors). This would have resulted in manufacturing not becoming a large source of growth and further undermining the prospects of debt market liberalization (Dobbs, 2010) because those most likely to benefit from it were unlikely to grow that fast given the constraints under labor law and bankruptcy law.

Finally, India's past experience with debt prior to the reforms may have led policymakers to prefer liberalizing equity markets. The debt build up of the 1970s and 80s (see Virmani, 2001; Virmani, 2006) was substantial and there seemed to be a strong sense that the debt was not always used effectively. By 1989 reports indicated that short-term debt was at a precipitous level and recommendations were forwarded to reduce the ratio of short-term debt to total debt. Against this background, the notion that India should enhance the bonds market seemed unlikely in 1991.

While this was happening, the 1990s also witnessed an increase in the investment in India by Foreign Institutional Investors (FIIs) and increasing use of Global Depository Receipts (GDRs), but a slower increase in Foreign Direct Investment (FDI) (Ahluwalia, 1999). FII and GDR investment is largely in the form of equity and would have reinforced the primacy of the equity markets. This kind of path dependence, given the pre-existing skepticism about increasing debt, would have pushed policymakers towards more reforms in the equity markets rather than the debt markets (Pierson, 2000).

In light of the preferences of incumbent firms and India's political and economic realities of the time, reforming the equity markets seemed a much better course of action. However, few things remain static. By the early 2000s, it was becoming increasing clear that for India to maintain a healthy growth rate the country's infrastructure needed to be improved and the manufacturing base needed to expand and grow.[22] Both of these would benefit from the development of a corporate bonds market.

However, reforms in the debt space have primarily focused on methods to address delays in enforcement of debt contracts in the courts (Armour & Lele (2009)). For example, the Recovery of Debts Due to Banks and Financial Institutions Act 1993 established Debt Recovery Tribunals (DRTs). The DRTs were designed to avoid the delays with court enforcement for debt in excess of Rs. 10 lakhs owed to banks and financial institutions, but their implementation was stalled due to constitutional challenges, such that the enacting legislation was not constitutionally sound until 2002. Another reform was also targeted at avoiding judicial enforcement of debt – the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act 2002 (SARFAESI). This, like the legislation enacting DRTs, was targeted at protecting banks and financial institutions by giving them powers to enforce their claims extra-judicially. SARFAESI also permits banks and financial institutions to exit from their loans by selling them to an investment entity specializing in distressed debt. This provided for exit rather than

[22] *Creaking, groaning, A Special Report on India*, The Economist (Dec. 11, 2008). Available at: http://www.economist.com/specialreports/displaystory.cfm?story_id=12749787; T.C.A. Anant and Ram Singh, *Law and Economics of PPP Contracts for Expressways in India*, Draft (2009).

enforcement. As with DRTs, SARFAESI also faced constitutional challenges that delayed its implementation.

However, once these constitutional challenges were overcome both DRTs and SARFAESI went into effect. The early studies on these reforms suggest that they did increase the protection creditors received. However, the creditors that were protected were banks and financial institutions not the regular creditors (e.g., bondholders) and thus we would not expect much change in the bonds market (except probably a drop due to some firms realizing that banks may be more willing to lend given the reforms and opting for that rather than bond issuances). Indeed, that is precisely what we witness - the bond issue market dropped in size from 2001 onwards but bank debt nearly quadrupled during the same time. [23]

Reforms to the broader insolvency process or for general creditors have been few and far between and have faced even lengthier delays in implementation. The Companies Act was amended to change corporate reorganization so that BIFR's powers would be transferred to the newly formulated National Company Law Tribunal (NCLT). The NCLT is designed to avoid the statutory moratorium (much maligned under SICA) and to enhance the qualifications of those presiding over the process. However, these reforms have themselves become embroiled in Constitutional challenges and we are still awaiting reforms to NCLT that would satisfy Constitutional scrutiny. The Companies Bill, 2011, presented in the Indian Parliament on December 14, 2011, reintroduces the move towards establishment of the NCLT. However, even if implemented there seems to be substantial doubt that these reforms would actually enhance the system relative to SICA (World Bank, 2007).

The experience with debt market reforms reinforces the political economy issues we discussed earlier. *First*, there has been little attempt to reform the labor laws and attempts to change the bankruptcy process are seen as being unlikely to succeed and

[23] Armour & Lele (2009)(It appears that corporate bonds dropped from roughly Rs. 30 Billion to Rs. 13 billion between 2001 and 2008, while bank credit rose to Rs. 8,700 billion from Rs. 2190 Billion during the same period (RBI Tables, 2008, 49 & 81)).

much delayed with court challenges and implementation issues. Given the political constraints in India, this is not altogether surprising. Indeed, the reforms have occurred largely in methods to get around court enforcement concerns and that to in sectors where there are organized and influential interest groups (e.g., banks and financial institutions). If those interested in the growth of the bonds market were able to similarly coalesce then methods to workaround court enforcement problems for bondholders may be plausible politically.

In addition, as Armour and Lele (2009) point out, the equity market reforms have largely been in the regulatory space whereas debt market reforms in the legislative space. The difference in approach has also influenced implementation issues. Regulatory reforms are usually conducted by a Government Agency that responds to somewhat different pressures than the legislature. Further, regulatory agencies usually enforce their rules internally (and with some possibility of appeal to courts) rather than primarily through courts. This not only results in faster rules and rules based on more experience with the markets, but also quicker implementation and enforcement. These have benefited the equity markets. Perhaps some kinds of regulatory changes in the debt market may also be able to capture the "magic" seen in the equity markets. However, until these reforms are explored the Indian corporate bonds markets continue to sputter.

VI. Regulatory Reforms

Although our primary objective in this paper is to explore some of the reasons why the corporate bonds market in India continues to be underdeveloped, in this section we set out some of the normative aspects emanating from our research. We focus on some of the reforms that may be introduced to overcome the legal impediments we have identified earlier.

At the outset, the reform process must extend beyond addressing issues pertaining to the market microstructure and reduction of costs (through tax benefits, elimination of stamp duties and the like). The focus must be trained upon developing the underlying legal

framework that can hold a vibrant and robust bonds market. Apart from enhancing contractual enforcement mechanisms (which will generally benefit commercial activity in India, apart from just debt contracts such as corporate bonds), the reform efforts may focus on overhauling the bankruptcy process. Although the establishment of the NCLT, which is being pursued through the Companies Bill, 2011, will address issues of delays and inefficiencies as it would be a specialized body, what is required is bankruptcy reform on a substantive basis. Currently laws relating to corporate insolvency are fragmented, as they traverse different pieces of legislation such as the Companies Act, the SICA, the RDDB Act and the SARFAESI Act. There is a dire need for comprehensive bankruptcy legislation, on the lines of the Bankruptcy Code in the United States.

Of course, the reform process will not be without obstacles. It is true that the political economy explanations for the bankruptcy reform process (that we discussed earlier) suggest that there are hardly any incentives, if at all, for incumbents to push for changes in bankruptcy laws in a manner that benefits creditors such as bondholders. However, given the current state of the Indian economy and its need to generate billions of dollars of funds to finance its infrastructure, which is crucial to sustaining its growth, the motivational factors that affect incumbents may be different this time around. If the political economy explanations for the last two decades suggest a vacillation of preferences between services (equity) and manufacturing (debt), where services seem to have outscored manufacturing resulting in the present scenario, we predict that the entry of the infrastructure sector may well play the role of a game changer re-inducing the necessary incentives for the creation of a debt market generally, and corporate bonds market more specifically.

The benefits of bankruptcy reform are several. One may anticipate that a robust legal framework will enable more privately-owned companies to access the bonds market, which will cease to be crowded out by government and PSU issuers. Even on the international arena, such a framework will enable more Indian firms to issue non-convertible bonds as opposed to convertible securities that could unnecessarily dilute

existing owners. On the supply side, a robust framework for bankruptcy will incentivize sector regulators to permit regulated investors such as pension funds, insurance companies, trusts, and the like (all of whom have tremendous financial capacity and resources) to invest in corporate bonds with little restrictions or none. This will likely make the corporate bonds market more broad-based. Moreover, a robust bankruptcy regime will obviate the need for, or at least reduce reliance upon, risk-sharing mechanisms such as CDS and securitization, which will acquire only secondary importance.

Admittedly, while bankruptcy reform is the optimal solution, it is likely to be challenging from a political economy standpoint if it is to be effected in a timely manner. Therefore, emphasis may also have to be placed on temporary solutions that operate in the near-term. These include more efficient contract enforcement mechanisms and structures for sell-down of bonds. Contract enforcement can be enhanced by making the benefits of DRT and SARFAESI available to all bondholders rather than only to specific banks and financial institutions. This might at least temporarily minimize risk to bondholders, particularly of the retail variety. Other options for securitization or asset reconstruction under SARFAESI must equally be made applicable widely as they would benefit bondholders to sell down and provide an apt exit mechanism.

Next, the reform process must consider introducing a greater level of standardization and transparency in the corporate bonds market. More specifically, making available facilities such as shelf-prospectus to all issuers (and not only to specific banks and financial institutions) will help stimulate primary markets for corporate bonds. Enabling a shift from private placements to public offerings will enhance disclosures in bond offering documents, and ensure the availability of information regarding the issuer to the markets thereby enabling greater participation by retail investors in addition to the institutional ones. Standardization and transparency, and broader primary markets would automatically bring about liquidity in the secondary markets. This would provide an opportunity for issuers to tap into the bond markets more broadly, and for investors to take advantage of the benefit of diversifying their portfolio and minimizing their risk.

Finally, the institutional aspects of reforms cannot be undermined. While the success of the equity markets can be attributed to one single regulator, i.e. SEBI, the reform process on the bonds side is more complicated. Although key reforms such as the bankruptcy process necessitate a legislative change, other aspects such as standardization and transparency can be implemented by SEBI. Moreover, since part of the bonds market is also within the domain of RBI, on matters such as CDS and securitization, reforms call for concerted action between SEBI and RBI. The coordination of financial sector regulation between the Government of India and these two regulators through the Financial Stability and Development Council (FSDC) might aid a coordinated reform process. The involvement of other financial sector regulators such as the Insurance Regulatory and Development Authority and the Pension Fund Regulatory and Development Authority will help address some of the supply-side issues concerning the corporate bonds market. Admittedly, the reform process involving the corporate bonds market is likely to be more complex than the same process for the equity market (which was achieved within a relatively short span of time), but available mechanisms can be deployed to bring about a change, at least incrementally, although not radically. Although a comprehensive reform process is likely to be onerous, the more temporary solutions for the near-term that we discussed can possibly be achieved through the establishment of a separate regulatory agency, or by even conferring powers to SEBI to deal with some of these incidental aspects of the bonds market.

VII. Conclusion

The corporate bonds market is not only underdeveloped in India in comparison with the equity market, but also considerably lags that market in point of time. Despite various efforts, the corporate bonds market has not expanded to any meaningful extent. This is so even though the financing needs of the Indian economy, particularly in the infrastructure sector, are severe and that a robust bonds market may typically be in a position to meet those needs. In this paper, we find the existence of several legal impediments that may have been playing a significant role in the inertia facing the corporate bonds market.

Factors such as a lax corporate insolvency framework and the lack of standardization and transparency in the bonds markets have contributed to the suppression of activity in both the primary as well as secondary markets. Any regulatory reform ought to strike at the root of these fundamental concerns. Failing this, the unavailability of the corporate bonds market will impede the financing of key sectors, such as infrastructure, which could have an adverse effect on growth and sustainability of the Indian economy.

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