The Role of Innovation in the Indian Bond Market

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Key Messages

- **Innovations play a critical role in the Indian bond market, by**
  - Creating a bridge between project's credit quality and investor expectations through credit enhancement
  - Facilitating longer-tenure funding both for banks and corporates
  - Enabling banks to meet capital needs through regulatory-compliant instruments
  - Providing sophisticated risk mitigation tools to market participants
  - Helping corporates raise cost effective funding
  - Encouraging development of bond markets by attracting new investors
  - Enhancing financial inclusion by providing funding to priority segments of economy
  - Reducing the cost of securitisation transactions
- **Innovations help in achieving critical economic and social priorities by**
  - Funding infrastructure projects and housing
  - Supplying capital to the financial sector
  - Providing risk mitigation tools and long-term financing to sophisticated corporate sector
  - Enabling municipal corporations and SMEs to diversify their resource profile

Key Innovations in the Debt Market and How Do They Help?

Key innovations and their benefits (1)

1 Innovative credit enhancement mechanisms create a bridge

- This allows issuers/ projects with moderate creditworthiness to access bond market
- Investors' expectation of a high credit quality is bridged by using credit enhancement
- Examples include:
  - Partial guarantee mechanisms
  - Securitisation of annuity transactions
  - Commercial Mortgage Backed Securities (CMBS)
  - Infrastructure Debt Funds (IDFs)

2 Innovative instruments facilitate long-tenure funding

- Enable better asset liability matching for banks
- Enhance financial flexibility for corporates by reducing refinancing risks
- Examples include:
  - Infrastructure bonds for banks with minimum regulatory pre-emption
  - 50-year bonds with bullet maturity issued by M&M in 2013

Key innovations and their benefits (2)

3 Innovative capital instruments allow banks to meet capital needs

– Banks have to maintain a minimum threshold of capital as per the Basel III norms

– Examples include:

  - Tier I capital bonds under Basel III that contain riskier features
  - Tier II bonds under Basel III with (limited) risk of principal loss

4 Innovations provide risk mitigation tools

– Enable bond market participants to better manage risks to their exposures

– Examples include:

  - Interest Rate Futures (IRFs)
  - Credit Default Swaps (CDS)

5 Innovative instruments help in raising cost effective funding

– By using new benchmarks, and/ or

– By instilling greater discipline in usage and flow of cash from stronger counterparty

– Examples include:

  - Inflation indexed bonds issued by L&T in 2013
  - Future flow securitisation by IOT Utkal in 2014

Key innovations and their benefits (3)

6 Structural innovations help in developing the bond market

- By attracting new investors to the bond market
- Example includes:
  - A high-yield segment of the bond market invests in instruments issued by real estate developers
  - A segment of bond market with a good presence of retail investors (in the form of HNIs)
  - Innovation in form of strong security creation and enforcement mechanisms for builders

7 Innovations enhance financial inclusion

- By providing cost-effective funding to priority segments of the economy
- Example includes:
  - Multi-originator securitisation transactions of MFIs, which enables several MFIs to join together to access bond market

8 Innovations reduce the costs for issuers in securitisation transactions

- By enhancing the attractiveness of securitisation transactions for issuers, while protecting the interest of investors as well
- Example includes:
  - Resets of credit enhancements introduced in 2014

Innovations for Seven Key Sectors and Priorities of the Economy

Infrastructure sector

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Innovations for the sector

- Partial guarantees
- Infrastructure Debt Funds through the NBFC route (IDF-NBFCs) and the MF route
- Annuity securitisations

Impact of innovations

- Enable refinancing of infrastructure projects through bond market
- 2 IDF-NBFCs (both rated by CRISIL) have begun operations – assets to cross Rs.1,000 crore
- CRISIL rated first annuity securitisation transaction for roads in 2010

Looking ahead

- Total funding needs expected to be large at Rs.30 lakh crore over 5 years
- Scale-up of existing IDFs critical
- Attracting long-term global investors to the sector important
- Explore credit enhancement from multilateral institutions, BRICS Bank, etc.
- Consider setting up bond guarantee fund

Financial sector

Innovations for the sector

- Tier I and Tier II Capital bonds under Basel III (Banks)
- Infrastructure bonds with minimum regulatory pre-emption (Banks)

Impact of innovations

- Initial success in raising Basel III capital bonds, despite riskier features
  - Rs.5,000+ crore Tier I bonds issued
  - Rs.20,000+ crore Tier II bonds issued
- Infra bonds to enable better ALMs
  - Benefits to banks expected to be ~75 bps (compared to similar tenure deposits)

Looking ahead

- Banks, NBFCs, and HFCs are the largest user of corporate bond market (70% of annual issuances)
- Ongoing need to build investor comfort for Tier I bonds of banks under Basel III
- Initiate a discussion for banks to use securitization for greater capital efficiency
  - Retail and infrastructure loan exposures offer a good potential for securitisation

Corporates

Innovations for the sector

- 50-year bullet maturity bonds (M&M)
- Inflation indexed bonds (L&T)
- Future flow securitization (IOT Utkal)
- Perpetual (or hybrid) securities
- Interest rate futures and credit default swaps

Impact of innovations

- Enable higher-rated corporates to raise cost-effective long-tenure funds from the corporate bond market regularly
- Hybrid instruments provide benefit to the capital structure
- Tools to mitigate risks available

Looking ahead

- Further expand participation of corporates in the bond market
  - Enhance access of 'A-rated' corporates to the bond market
  - Significantly increase usage of innovative instruments and risk mitigation tools
  - Will enable in reducing the dependence of bond market on the financial sector
- Enhance the competitiveness of rupee bonds vis-à-vis foreign currency loans (ECBs and dollar bonds)

Real estate and housing

Innovations for the sector

- CMBS
- Stronger security creation and enforcement mechanisms coupled with proper control on cash flows for residential projects

Impact of innovations

- Issuance of initial few CMBS transactions (2 are rated by CRISIL)
- Good acceptance of high-yield paper from real estate developers by HNI investors

Looking ahead

- Scale-up usage of CMBS instruments for income generating leased commercial assets
- Enable setting-up Real Estate Investment Trusts (REITs)
- Encourage investor participation in residential mortgage securitization transactions
  - Suitable for long term investors like insurance companies and pension funds

Financial inclusion

Innovations for the sector

- Multi-originator securitization for MFIs
- Securitisation of retail loans by NBFCs
- Reset of credit enhancement in securitisation transactions

Impact of innovations

- Enables MFIs to access bond market
  - First listed securitisation transaction had multiple originators
- Provides cost-effective funding to priority segments of the economy
- Credit enhancement in ~10 CRISIL rated transactionds already reset

Looking ahead

- Introduction of differentiated banks
  - Small finance banks
  - Payment banks
- Addressing the taxation issues pertaining to securitization

Municipal corporations and SMEs

Municipal corporations (Munis): Looking ahead

- Munis are among the largest segment of issuers in the bond markets globally
- Encouraging strong munis to access bond market critical
- Credit enhancement can be in the form of
  - Escrow of future property tax collections
  - Pooled municipal finance structures
- Sebi has recently issued proposed regulations for debt securities by munis

SMEs: Looking ahead

- SMEs represent an important segment of India's economy
  - Loans to SMEs stood at >Rs.10 lakh crore as at March 2014 (15% of banks' advances)
  - Enhancing their competitiveness will be critical for the success of 'Make in India'
- Securitisation of trade receivables can provide greater funding to SMEs
  - Loans to SMEs will need to be aggregated, a role that can be played by say SIDBI

Innovation and Regulatory Agenda for the Future

Regulatory support critical for the innovation agenda

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- **Scaling-up of existing innovations critical**
  - Size of existing IDFs and usage of CMBS instruments needs to be expanded
- **Continue with innovations, while maintaining focus on systemic stability**
  - Bond guarantee fund and REITs
  - Securitisation by banks to enhance capital efficiency; Securitisation of SME trade receivables
- **Develop investor comfort with innovative tools and instruments, such as**
  - Tier I bonds of banks under Basel III and residential mortgage securitization transactions
- **Diversify and expand the investor base in the bond market**
  - Attract long-term global investors, especially to the infrastructure sector
- **Others**
  - Enhance the competitiveness of rupee bonds vis-à-vis foreign currency loans
  - Improve access of A-rated corporates, munis, and SMEs to the bond market
  - Explore credit enhancement mechanisms from multilateral institutions, BRICS Bank, etc.
  - Address taxation issues pertaining to securitization

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