theirview

Building a corporate bond market

A separate bond-trading platform at NSE will only cover some distance in creating this important market in India

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Regulators and market intermediaries persist admirably in tinkering with the corporate bond market to make it a more vibrant source of fund raising. With the NSE opening a separate bond-trading platform today—and others presumably following soon—a broader array of investors can have direct access to trading. But electronic bond-trading platforms are not the norm in more developed bond markets and advances in what the Percy Mistry committee report called the bond-currency-derivatives (or BCD) nexus have a troublesome tendency to move one step forward and two steps back. It makes sense to take a closer look at the prospects for corporate bond exchanges in India.

The government bond market (known colloquially as the G-sec market) provides the benchmark for pricing corporate bonds, but we can use it here—especially its electronic bond-trading platform—as a benchmark for trading platform success. Before the G-sec platform, the Negotiated Dealing System Order Matching (NDS-OM), was introduced in 2005, everything was traded "over the counter", i.e. over the phone, with 80% of trades intermediated by brokers. Now, 90% of the G-sec market trades electronically with no broker needed.

When an electronic trading platform garners a significant volume of activity such as NDS-OM has, the benefits are obvious. Traders can see the depth of the market any time with buy and sell orders coming to the system with time stamps. By avoiding brokers they enjoy more efficient price discovery and save on commissions.

But the caveat about trading volume is moot. The G-sec market contains a sharp bifurcation between high- and low-volume securities because only about 20-25% of bonds trade regularly. The actively traded G-sec bonds have mostly migrated to NDS-OM, while less actively traded securities continue to be largely traded over the counter. Nonetheless, analysis indicates that liquidity improved significantly in both segments of the market when the electronic platform was introduced.

Does the NDS-OM experience suggest success for a corporate bond exchange? That may depend on how much corporate bond-trading volume can concentrate on a few securities. Bonds have much more variety than stocks, since the same firm may issue multiple bonds with varying coupons, maturity dates and covenants. This splinters the interest in any company's debt across its various bonds.

The G-sec market also contains a variety of coupons, maturity dates and covenants, but benefits from having one dominant issuer with 80% of outstanding bonds: the government of India. The corporate bond market has dominant issuers also, but there are around 20 of them. Further, G-sec trading is much more concentrated in only a few securities. The top 10 most-traded G-sec bonds captured 94% of all trading, versus only 57% for the top 10 corporate bonds.

This concentration limits the G-sec market's ability to provide the backbone to the rest of the BCD nexus. But for development of electronic trading, it provides a few securities with enough volume for NDS-OM to thrive.

State development bonds provide, perhaps, a more natural comparison within the G-sec market because of their size (about a quarter of Union government bonds outstanding), diversity of issue (about 27 states and Union Territories issue bonds) and relatively low liquidity. Despite these disadvantages, roughly 40% of state bonds trade on the NDS-OM platform. The new corporate bond platforms might be quite pleased to match this performance and capture 40% of trading.

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In their favour, these platforms may allow trading by a more diversified set of investors. On NDS-OM, provident funds and individuals must trade through constituent accounts with a primary NDS member, and foreign institutional investors (FIIs) are completely cut off. Provident funds and FIIs are major investors, so their direct access to trading may provide a real boost to a corporate bond platform compared to G-sec.

On the other side of this equation are banks, which are the most active investors in the G-sec market, but only small-time participants in the corporate bond market. For a variety of reasons—unrelated to the question of trading directly versus via a broker—banks prefer direct lending to a firm versus buying its bonds. So, the overall base of investors to support exchange-based trading in the corporate segment will remain smaller even after improving access.

Overall, the NDS-OM experience—especially the state bond segment—suggests these exchanges have a future. They may never dominate corporate bond market trading, but they are likely to find more success than, say, interest rate futures. Yet to truly thrive, the exchanges need the entire corporate bond market to expand.

This, in turn, depends on the success of much larger reform efforts than tinkering with trading platforms. Improving bankruptcy proceedings through the Companies Bill will help, as will harmonization of stamp duties across states. The former requires only a functional Parliament, but the latter shows no momentum whatsoever.

Reforms to facilitate the corporate bond market must be put on a war footing if there is any hope that the $200 billion corporate bond market can grow to make a meaningful contribution to India's $1 trillion infrastructure financing efforts. Private sector entities such as these new exchanges can only go so far without more concerted effort from the Union government and the states.

Comments are welcome at theirview@livemint.com

otherviews

The China syndrome

BORDERLINE

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The era of declining inter-state conflicts, if it ever existed in the post-Cold War period, is drawing to a close. The Israeli attacks on Syria, North Korea's nuclear sabre rattling, the Sino-Japanese tussle over disputed islands and the China-India confrontation in Aksai Chin are indicative of this trend. Significantly, from the alleged cyber attacks on the US to gunboat diplomacy in South China Sea and over the Senkaku islands to benign neglect of nuclear proliferation on the Korean peninsula and to the showdown with India in Depsang Valley, Beijing is at the centre of it all. On account of these episodes China's self-professed claim of a "peaceful rise" lies in tatters.

To be fair, not all of these are of China's making alone; others have also contributed. However, Beijing's inability to resolve these disputes through diplomatic and legal means and without resorting to muscle flexing is telling.

In the case of the recent confrontation with India, some reports suggest China's actions might have been in response to the stepped up Indian patrols and infrastructure development close to the Line of Actual Control (LAC).

By the provocative pitching of tents in the disputed area China probably wanted to send a message that such unilateral de facto moves along the LAC will be challenged. A related factor might be that China wants to assert its absolute claim over the Aksai Chin area; this would facilitate an eventual "swap deal" to settle the border—where China retains territory it already occupies and India keeps Arunachal Pradesh.

While the eventual swift and perceptibly amicable resolution of the eyeball-to-eyeball confrontation is welcome, it raised several concerns. According to one report, the price for the Chinese withdrawal was the dismantling of the troops bunkers by India. If this was the case, then India appears to have blinked.

What this and earlier episodes illustrate is that both China and India are still following the 1962 playbook where action by one side along the disputed boundary provoked a reaction by the other side leading to a wider conflagration. This was a dangerous play in 1962 and is even more dangerous now given the nuclear arsenals on both sides (which, incidentally and conveniently, appear to have been overlooked).

Besides, the 1993, 1996 and 2005 agreements to maintain peace and tranquility along the LAC and resolve the boundary question—assuming they were made in earnest—should have made these vintage 1962 moves redundant. Sadly, this has not been the case. As foreign minister Salman Khurshid observed during his Beijing visit "we need to do our own respective analysis as to why it happened and then, if such a thing was to happen again, ...we should be able to resolve it much quicker than we did this time".

One reason for the prolonged tension this time is that the implementation of the above agreements, especially the verification element, has been severely lacking. To prevent future recurrences of Depsang-like incidences, two steps need to be taken: first, in the short term, the 1993 and 1996 agreements need to be operationalized. Second, in the long term, the spirit and the letter of the 2005 agreement should be followed to settle the border once and for all, including mechanisms to deal with any disputes that might arise.

If Khurshid's visit leads to the establishment of a permanent mechanism to de-escalate such incidents, it would be a promising start. If not, then future recurrences, especially protracted ones, are likely to carry the ominous prospect of nuclear escalation as well. And that is a price that neither India nor China can afford.

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