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The Indian Bond Market

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1. Introduction

The Indian bond market covers main types of bonds, namely, Government bonds, corporate bonds, tax-free bonds, banks' and other financial institutions' bonds, tax-savings bonds and tax-savings infrastructure bonds.

In terms of magnitude, the total Indian bond market is one of the largest in Asia and outstrips similar markets of all emerging economies except China and South Korea. When compared to other economies, however, it is of the magnitude of only 27% of the Chinese bond market and 69% of the Korean bond market, as on 31 December 2012.[2] Figure 1 shows the percentage of outstanding bonds to GDP for a range of countries. India has one of the lowest bond-to-GDP ratios, especially for corporate bonds, which is the second-lowest, after Indonesia's.

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[2] India Bond Market Roadmap, Asifma, Oct, 2013. Available at: http://www.asifma.org/uploadedFiles/News/ASIFMA%20-India%20Bond%20Market%20Roadmap%20 Draft_wCo ver.pdf

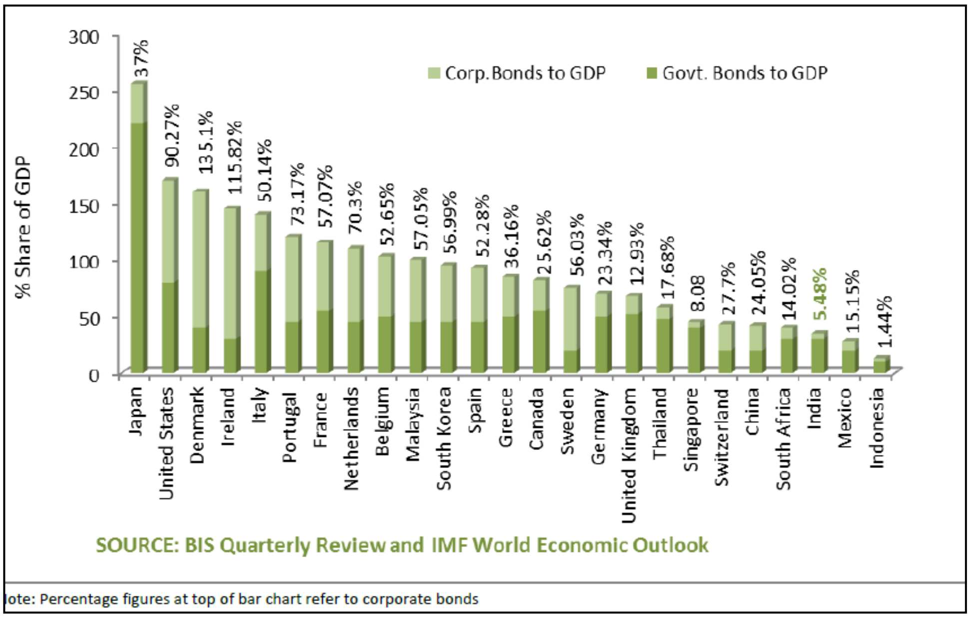

Figure 1: Share of bonds outstanding to GDP as in September 2013

Compared to its size, the Indian government bond market is considerably larger than most East Asian countries' bond markets. It has grown exponentially in the past few years due to the efforts taken by the Government and the Reserve Bank of India (RBI), and it is probably one of the biggest in Asia. In 2011, it was the fastest growing government bond market in the region - at 32.1%.[3] It stood at USD 792 billion, as of September 2012.

However, as can be seen in Figure 1, the Indian corporate bond market ranks among the lowest at 5.48%. Even in absolute terms, the number is miniscule when compared to India's economic size, which gives an indication of its underdevelopment. The R H Patil Committee report in 2005 pointed out that the corporate debt market was at the infancy stage both in terms of microstructure and market outcomes. But even several years and official reports later, the state of the Indian corporate bond market remains gloomy.

This paper tries to explain the main characteristics of the Indian government and corporate bond markets and what has contributed to the poor development of the latter. It goes on to show that an opportunity, which has arisen in the Indian bond market due to inflation, could not only help diversify and deepen the government bond market but also have positive spill-over effect on the corporate bond market; the paper also focuses on the issue of inflation-

[3] Asian Bonds Online 2011 Bond Market Liquidity Survey. Available at: http://asianbondsonline.adb.org/surveys/liquidity_survey_2011/abo_2011_bond_market_liquidity_survey.pdf

indexed bonds. However, for various reasons mentioned in the paper, this opportunity is not being well-tapped by the government. This paper concludes by giving a few recommendations to improve the issuance of these bonds and tone up other regulatory matters concerning the bond market.

1.1 Importance of a Healthy Bond Market

Broadly, a healthy bond market is one that is competitive, has a huge and diverse investor base and a secondary market with liquidity. It is a platform the government uses to generate funds for its infrastructure and urbanisation projects, while corporations use it for their growth. These aspects require long-term investments from investors, who would in turn be inclined to participate in a deep and liquid market. Banks are ideally not supposed to be the major players in a bond market because of the long duration of relevant projects which causes an asset-liability issue. As indicated by the RBI, the global financial crisis in 2008 was a déjà vu of past crises like the Asian financial crisis in 1997 that highlighted the need to reduce over-reliance on weak banking sectors in financing the corporate sector. Also, if, for other reasons, banks have to tighten lending, the bond market would be seen as the alternative source to raise capital for investment. Hence, retail investors constitute an important part of this market; it's a great way of channelizing the growing pool of people's savings and helping the overall development of the economy.

A healthy bond market attracts more buyers and sellers, and, in the long run, benefits the government, corporations and investors and the economy of the country. It would ensure the following:

- Corporations can have access to a competitive alternative source of funding, compared to the banking sector. They can also use bond issuance as a signal of financial strength, since a healthy balance sheet is a pre-requisite for issuing bonds.[4]
- Smaller firms will be able to afford funds from both the bond market and banking sector, which are currently dominated by larger firms and hence too expensive for them.

4 "Deepening India's bond markets", Ashima Goyal, Hindu Business Line, 11 February 2013

- More investors will enter the market with issuance of attractive corporate bonds. This gives them an alternative to traditional deposits at banking institutions and helps deepen the market further.
- With the introduction of more bonds and with more participants in the market, the government would be able to borrow more cheaply as the yield spreads[5] would reduce.

1.2 Indian Government Bonds

According to some scholars, a healthy government bond market is actually a pre-requisite for the development of a corporate bond market because it provides the benchmark yield curve and a low default-risk asset for portfolio management.[6] However, post-1992 the government, in order to finance deficit, started relying heavily on borrowing from the market rather than monetising the deficit as a safer long-term policy. This is the reason for the stimulated issuance and growth and for the dominant presence of government securities (G-Sec) in the Indian bond market. Some of the prominent issues affecting the Indian G-Sec market are:

No diversity of participants:

Through the statutory liquidity ratio (SLR), every commercial bank of India has to invest a certain amount of its credit portfolio in government-approved securities, before lending out to customers. The objectives are to ensure the solvency of commercial banks and to control the expansion of bank credit as well as inflation. It is currently almost a quarter of their total funds, which is why 70% of government securities are held by banks. Another 16% is held by the RBI.[7]

Fragmented issues:

The pattern of Government securities issues in India is ‘numerous and small’ as compared to other markets which focus on keeping the issues to a few and thereby increasing their

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5 Yield spread is the difference in yield between two bonds. A bond issued by a large, stable, and financially-healthy corporation will typically trade at a relatively low spread in relation to the government securities.

6 Fabella, R. & Madhur, S. (2003). “Bond market development in East Asia: issues and challenges”, ERD Working paper 35, Asian Development Bank.

7 Ibid. (3)

liquidity. At the time of writing, the government bond market comprises 105 issues totalling Rs 12 trillion.

1.3 Indian Corporate Bonds

The private firms ideally rely on the support of the bond market in order to finance their entry or growth by issuing corporate bonds, but in India this is barely perceptible as compared to other economies. Some of the issues affecting the Indian corporate bond market are:

Arbitrage driven:

Many Indian companies' financial decisions currently are actually based on avoiding regulatory restrictions, tax burden etc as opposed to their strategic needs. *Companies find it more cost-effective to take loan from financial institutions than to issue corporate bonds*. This was confirmed by the RBI in "A study of Corporate bond market in India: Theoretical and Policy Implications".[8]

Structural and regulatory issues:

Most issues in the Indian corporate bond market are not bonds but private placements (93% of issuance in 2011-12).[9] Public issue of corporate bonds is difficult, slow, expensive and inflexible. Documentation, such as prospectuses that need to be approved by SEBI (Securities and Exchange Board of India) for disclosure of the bonds, run several hundred pages, irrespective of the company being already-registered or not. There's no uniform stamp duty across states, and the issue process takes several months. Private placements, on the other hand, are generally easier, quicker and cheaper. They have minimal documentation requirements, and all the formalities can be completed within a day. They allow a maximum of 49 investors, and hence these issues are generally small. Because of the small number of investors, they have the power to renegotiate the terms to their liking; and, in many cases, are

8 ET Bureau, "Govt deficit spending negative for corporate bond market: RBI study", *The Economic Times*, 4 March 2014. Available at: http://articles.economictimes.indiatimes.com/2014-03-04/news/47894810_1_bond-market-stock-market-rbi-study

9 Nidhi Ladha, "RBI takes the wind out of NBFC's sails: Imposes restrictions on private placement of debentures", Moneylife, 10 July, 2013. Available at: http://www.moneylife.in/article/rbi-takes-the-wind-out-of-nbfcs-sails-imposes-restrictions-on-private-placement-of-debentures/33567.html

actively involved in the company. The largest investors in public placements in India are banks - sometimes one bank buys up all the issues placed by a company - and hence these private placements can be considered to be nothing more than syndicated loans.

Lack of demand:

There is a lack of demand for corporate bonds by retail investors. Either they are considered risky, not attractive enough or there is lack of awareness. In the case of private placements, because of their nature, they are made known to the public only once the placement has taken place. But even then, the upper limit of 49 investors, required to raise such high volume of funds, makes small retail investors unfit for such issues.

2. Current Situation

Irrespective of the type of bond (government or corporate) dominant in the primary sector, neither has a good turnover in the secondary market; hence both types are illiquid (See Appendix A).

The corporate bond market needs to be developed in India. The overwhelming presence of the government in the bond market may partly explain why the corporate bond market is under-developed. Some scholars argue that a high level of public debt crowds out corporate borrowing, by reducing the appetite of financial institutions, driving up prices and making the bond market an unviable source of funding.[10] This could be an explanation since 79% of the total amount of outstanding bonds in India is government bonds. Government bonds are also considered safer because they have higher credit rating than their counterparts and hence are more attractive to investors.

Currently, financing options for the private sector are few and hence it relies heavily on banks as the major source of funding. Funds are available at higher price as loans or private placements, and only high credit-rating companies dominate the bond market.[11] There is

[10] Senay Agca and Oya Celasun (2009), "How does public external debt affect corporate borrowing costs in emerging markets?", IMF working paper, WP/09/266. Available at: https://www.imf.org/external/pubs/ft/wp/2009/wp09266.pdf

[11] The RBI study, mentioned above, confirms the fact that banks prefer the option of giving loans to the corporate units rather than invest in their bonds because they already have so much cash tied up in long-term government investment bonds.

some evidence that government crowds out corporate growth. For e.g., in February 2012, Indian companies were paying the highest borrowing costs in 11 months as the government's record debt sales drained cash from the banking sector.[12] This scenario manages to keep a good proportion of small and medium-sized enterprises (SMEs) out of the market because they cannot afford these funds. They mainly borrow funds, not from the commercial banks, but from development banks. It is important to note that buying bonds issued by SMEs may be risky. However, in later stages of bringing about reforms in the corporate bond market, there is a need to introduce an institutional mechanism that would augment credit to enable SMEs to access the bond market, since their credit ratings will be much lower.

However, other scholars have argued that, in the case of India, the development of the government bond market has in fact had a positive effect on the corporate bond market. The argument is that the development of government bonds has a positive effect on the economy as a whole, indirectly adding to the development of the corporate bond market.[13]

Irrespective of whether the government bonds crowd out corporate bonds or not, the lack of political will to bring about reforms to change the current situation of the corporate bond market was mentioned in the R H Patil report (2005). The government does understand the need for a long-term healthy corporate bond market and has consistently taken steps to improve the condition. For e.g., the Union budget (2008) removed TDS (Tax Deduction at Source) on interest from corporate bonds and simplified the disclosure requirements for listed entities in 2009. Still, there are many regulations that continue to affect the growth of the corporate bond market. Other than the ones mentioned in the earlier section, pension funds and insurance companies which are typically among the biggest buyers of corporate debt in other countries, are restricted by how much they can invest in bonds.[14] The removal of many regulatory barriers to the issue of corporate bonds, including review of the stamp duty, is still at the stage of just proposals; and hence their implementation is uncertain, which is affecting the supply and awareness of corporate bonds in the market.

India can learn a lot from Japan's success story. Heavily regulated until 1985, Japan's corporate bond market was underdeveloped and dominated by banks. In the late-1980s,

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[12] V. Ramakrishnan, "Singh crowding out companies pushes rates to 11-month high: India credit", Bloomberg, Feb 27, 2012. Available at: http://www.bloomberg.com/news/2012-02-27/singh-crowding-out-companies-pushes-rates-to-11-month-high-india-credit.html

[13] Sunder Raghavan and Daniel Sarwono, "Development of the corporate bond market in India: an empirical and policy analysis", 2012, International Conference on Economics and Finance Research.

[14] Andrew MacAskill, "India's bond market needs to bulk up", Bloomberg businessweek, Feb 10, 2011. Available at: http://www.businessweek.com/stories/2011-02-09/indias-bond-market-needs-to-bulk-up

simplification of issuance procedures, deregulation of private placement, incorporation of three credit rating agencies, issuance of dual currency bonds and reduction of underwriting fees and trust fees helped the development of the primary market for corporate bonds. This led to a drastic decline in the influence of banks in corporate bond issuance - from 40 per cent in 1985 to zero by the end of 1989.[15]

Figure 2 sums up the various factors that make corporate bonds so unattractive both for the buyer as well as the seller.

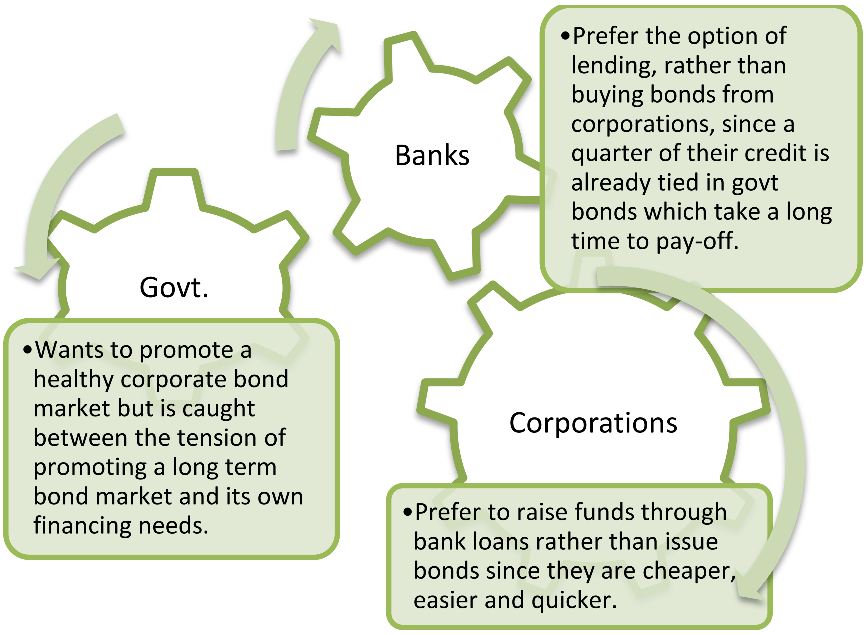

Figure 2: Why is corporate bond market dismal!

3. The Case of the Negative Yields

Until around 2007, savings option in Indian banks usually revealed positive yield, and people were content in leaving their money in savings account. However, due to the inflation rate being very high and with hardly any change in the banks' interest rate on savings, the negative yield on simply leaving one's money idle in the bank is becoming quite apparent. Even after deregulation of interest rate by the RBI, most banks maintain their interest rate on

15 RBI, "A Study of Corporate Bond Market in India: Theoretical and Policy Implications, 4 March, 2014. Available at: http://rbi.org.in/scripts/PublicationsView.aspx?id=15725

savings at 4% per annum. Some banks do offer slightly higher rates ranging from 5.5% to 7% depending on the amount of deposit.[16] However, it is still inadequate to convince people to secure their money in savings accounts with banks rather than by buying gold.

Year	Inflation rate*	SBI savings rate (in %) **
2005	4.41	4
2006	6.7	4
2009	12.37	4
2010	10.45	4
2012	10.44	4
2013	10.88	4

Table 1: Comparison between inflation rate and bank's savings rate

**Source: Indian Express **SBI website*

According to Nomura, the savings rate of India fell to a 10-year low at 27% in 2013.[17] Hence, people are looking for investments with greater returns than evincing interest in bank accounts.

This is where the opportunity arose for the Indian government to introduce inflation-indexed bonds (IIBs) to attract retail investors who want to safeguard their savings from the impact of inflation. For the government, apart from financing its deficit, these measures would hopefully dissuade people from buying gold. India's insatiable thirst for gold, as a safe hedge against inflation, is partly responsible for the huge current account deficit and a tumble in the Rupee.[18]

Although such bonds have been used for a long time world over to attract retail investors, India has only now introduced it in the local market. Countries have usually issued such

[16] "All about savings bank interest rates!" *The Economic Times*, Aug 12, 2013. Available at: http://articles.economictimes.indiatimes.com/2013-08-12/news/41332914_1_interest-rate-savings-bank-3-lakhs

[17] "India's saving rate to plunge to 1-year low this fiscal", *The Economic Times*, Feb 3, 2013. Available at: http://articles.economictimes.indiatimes.com/2013-02-03/news/36721288_1_savings-rate-sonal-varma-nomura-india

[18] Anant Vijay Kala, "Is New RBI Bond as good as gold?", *Wall Street Journal*, Oct 31, 2013. Available at: http://blogs.wsj.com/indiarealtime/2013/10/31/is-new-rbi-bond-as-good-as-gold/

bonds when faced with double- or triple-digit inflation rates. Israel issued such bonds in 1955 in response to double-digit inflation rate. The British government first issued them in 1981. United States (1997), Australia (1985), Canada (1991), France (1998), New Zealand (1995), Japan and many others have issued such bonds in the past. In 2008 alone, government-issued bonds constituted US$ 1.5 trillion in the international debt market.[19]

Hence, the introduction of the WPI- ad CPI-linked bonds, though late, is timely for the Indian government to attract more investors and diversify the bond market.

3.1 Introduction of IIBs

The first attempt by the Indian Government at issuing IIBs was in 1997; the capital-indexed bonds. There was a lukewarm response for these bonds in 1997, both in primary and secondary markets, and the reasons mentioned were the complexities involved in pricing the instrument and the perception that these bonds provided protection against inflation only for the principal and not the interest as well.[20]

On 4 June 2013, RBI launched bonds which were linked to the Wholesale Price Index (WPI)[21] and would earn interest on the adjusted principal. The WPI with a lag of four months is used to adjust the principal, and then a fixed coupon rate of 1.44% is applied on this adjusted principal for the interest, which is compounded half-yearly. The WPI-linked bonds, however, also failed to excite much enthusiasm, and the rationale quoted was that retail investors would be more interested if the bonds were actually linked to the Consumer Price Index (CPI) instead.[22]

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[19] Prerna Katiyar, "Remember inflation-indexed bonds?" *The Economic Times*, June 30, 2008. Available at: http://epaper.timesofindia.com/Repository/ml.asp?Ref=RVRELzIwMDgvMDYvMzAjQXIwMTIwMA==&Mode=HTML&Locale=english-skin-custom

[20] RBI Publication, "Capital-indexed bonds". Available at: http://rbido cs.rbi.org.in/rdocs/PublicationReport/Pdfs/53629.pdf

[21] In India, the wholesale price index (WPI) is based on the wholesale price of a few relevant commodities out of over 676 commodities available. The indicator tracks the price movement of each commodity individually. Based on this individual movement, the WPI is determined through the averaging principle.

[22] "Inflation indexed bonds: How they work" *NDTV Profit*, June 7, 2013. Available at: http://profit.ndtv.com/news/your-money/article-inflation-indexed-bonds-how-they-work-323080

3.2 CPI vs. WPI

The RBI has always placed more emphasis on WPI than CPI for calibrating its monetary policies. This has been in contrast to other countries' central banks and governments relying on CPI to measure inflation. As is shown in the table below, the RBI site officially uses WPI to compare India's inflation with the CPI indicator for other countries.

Inflation* in BRICS Countries		
Country	2010 (Average)	2011 (Latest)@
Brazil	5.0	6.9
Russia	6.9	9.0
India	9.6	9.4
China	3.3	6.5
South Africa	4.3	5.0
***WPI for India and CPI for other countries** **@ June/July (year-on-year)**		

Table 2: Disparity in inflation comparison tools between India and other countries

Source: Reserve Bank of India website

On average, the CPI has always been higher than the WPI in India.[23] Figure 3 shows the monthly WPI and CPI in 2013. Now consider June 2013, the WPI was 5.16% while the CPI was 11.06%. A WPI-linked bond would have fetched a pre-tax return of 8.96% while a CPI-linked bond would have fetched 12.74%.

[23] While WPI measures variation in producer prices, the Consumer Price Index (CPI) gives a more accurate measure of inflation because it takes into account increase in costs of education, food, transportation, housing and medical care.

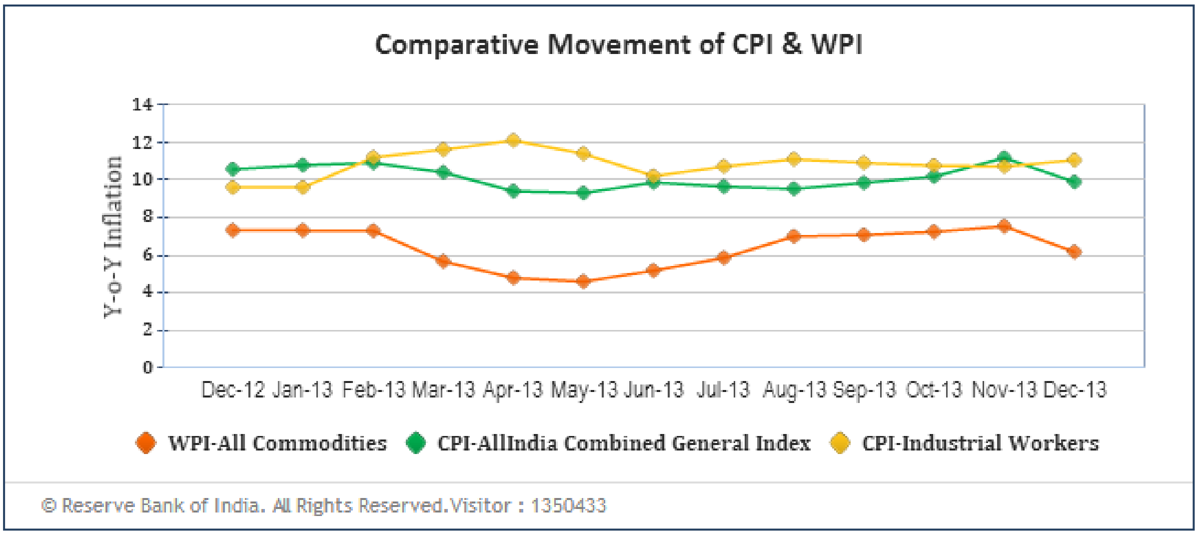

Figure 3: Monthly comparison of CPI and WPI rates

3.3 Introduction of CPI Bonds

Following this dismal response to IIBs, on 23 December 2013, the RBI introduced the Inflation Indexed National Savings Securities-Cumulative (IINSS-C), or CPI-indexed bonds. It also quietly buried the official anchor of Indian monetary policies, the WPI, and accepted CPI as the new tool on 28 January 2014 (as recommended by the Urjit Patel committee).

These CPI bonds could be availed of at any State Bank of India (SBI) branch, associate banks, nationalised banks, three private banks (HDFC, ICICI, and AXIS) and Stock Holding Corporation of India Ltd. (SHCIL) and the initial deadline to buy these bonds was 31 December 2013 (later extended to 31 March 2014). The range for investment is between Rs 5,000 and Rs 500,000. The interest rate on these bonds is linked to the combined-CPI (Base 2010 = 100) and comprises two parts: the fixed rate (1.5%) and the CPI inflation rate, based on 3-month lag CPI, which will be compounded with the principal on a half-yearly basis.[24] The tenure is fixed at 10 years and the full amount will be paid only at the time of maturity. They can also be used as collateral for loans from banks and non-banking financial companies (NBFCs). In case of deflation, the principal does not go below the issue amount. Anyway, looking at India's current economic situation, though inflation is off-peak, it is still quite high and stubborn, so investors don't need to worry about it.

[24] The principal amount will be adjusted with the CPI inflation rate and then interest is calculated on this adjusted principal using the coupon rate of 1.5%.

Hence, indexing the bonds to CPI instead of WPI, RBI made a move in the right direction. These are the first type of bonds that provides protection against inflation not only for the principal but also for the interest. They can also be pledged against a loan. So how do these bonds compare with other investment options in the market that are not inflation-proof?

3.4 Other Existing Investment Options

The Public Provident Fund (PPF), which is issued by the Government of India, offers an assured return of 8.7% which is tax-free for both the interest and the principal amount. There is also the option of making the investment in instalments. However, upon premature withdrawal, these bonds get taxed and lose their advantage over other options.

Other tax-free bonds (like NTPC, IIFL, Hudco) also offer similar returns. Returns on debt mutual funds range from around 8-10%, depending on the institution, but are taxable. Fixed deposits of banks are also taxable and give returns similar to debt mutual funds.

4. Are the CPI-Linked Bonds Working?

There have been several improvements in the IIBs since they were first issued in 1997 by the Indian Government. However, they do not hold the kind of appeal required for people to buy or enquire about them. They lack a few basic and attractive characteristics essential to a retail investors' portfolio.

1. **Lack of awareness:**

   Apart from lack of awareness, currently, investors have a poor understanding of how these bonds work; constant readjustment of the principal amount leads to complication in its calculation, and it would take a while for them to gain confidence in this new product. Hence people rather opt for the usual bank deposits or PPF. This author's enquiry at some branches of SBI, ICICI and Axis Bank in Mumbai, Chennai and Kolkata also showed that banks themselves are not marketing these bonds aggressively and some employees are not even aware of this product.[25] This is because banks are paid a nominal commission which is lower than the 1-5% paid to them by insurance companies, hence the greater incentive lies in offering the other products.

2. **Long tenure of the bond:**

The full amount will be paid only at maturity; there is no provision for regular interest payout. Logically, senior citizens would not want to go for an option that delivers returns after 10 years. Early redemption is allowed, but only after three years for younger citizens and one year for senior citizens; however, the investor will be paid only 50% of the previous year's interest.

3. **No special tax advantages:**

When adjusted for tax, there might be better options in the market than CPI-linked bonds. For example, say CPI is at 9%, an investor investing Rs 100 will get Rs 10.5 as interest and have to pay a tax of Rs 3.15 (assuming one is in the highest tax bracket). Then the tax-free interest return actually comes to Rs 7.35 or 7.35%. For someone in the 20% tax bracket, Rs 2.10 tax gives him a final return of 8.4%. The PPF, in comparison, proves to be a better option. It might benefit people in the low tax bracket, but they are mostly unaware of these bonds.

4. **Understated CPI:**

There is a general notion that CPI is understated by the RBI. CPI has been on the decline for many months (and WPI on the rise) even though food inflation is on the rise.[26] This calls into question the RBI's credibility in announcing a CPI which does not reflect the actual inflation in the economy. A true (maybe higher) CPI would cost the government more which would probably hurt its long-term public debt.

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[25] Saikat Das, "Most banks like SBI, ICICI and Axis Bank, fail to push RBI's CPI-linked bonds", *The Economic Times, Dec 30, 2013.* Available at: http://articles.economictimes.indiatimes.com/2013-12-30/news/45711282_1_branches-inflation-indexed-national-savings-securities-cumulative-axis-bank

[26] Indivjal Dhasmana, "Is WPI Inflation overstated and CPI understated?" *Business Standard*, September 24, 2013. Available at: http://www.business-standard.com/article/economy-policy/is-wpi-inflation-overstated-and-cpi-understated-113092400919_1.html

5. **Non-tradability of the bonds:**

These bonds are not allowed to be traded in the secondary market. Hence, only the highly risk-averse people may invest in these bonds. Even if they were tradable, India lacks an active secondary market in which these IIB can be easily bought and sold; because unlike the stock market, bond market is not well developed in India, and institutions are not yet confident about trading in these bonds.

6. **Floating interest rate:**

Retail investors want certainty. Though in real terms, these bonds provide a steady interest throughout, people are discouraged when the interest rate is not stable. Looking at the recent trend of a decrease in CPI rate and at the RBI’s announcement to reduce it further, the attraction of these bonds will be lesser still. It would take a lot of effort by the RBI to reduce the allure of gold from the mindset of the common people.

5. Conclusion

The response to the CPI-linked bonds has been dismal as these bonds do not offer anything significantly different or better, especially since the interest rate is not stable; sometimes the return may even be worse than what the other existing options offer. Status quo bias would prevent people from switching to IIBs from their existing options unless these bonds provide a significantly better return over the same period. These bonds may be a better option than some FDs but not PPF or tax-free bonds (especially for people belonging to higher tax brackets who probably already have existing options which give better return). Hence, the target market for these particular bonds has, for the various reasons, narrowed down to the lowest tax bracket retail investors. However, they do not have the required awareness or access. But here as well, non-tradability, no regular income and falling CPI will discourage these investors.

The Urjit Patel Committee Report states that inflation based on the CPI should fall below 8% by January 2015 and below 6% by January 2016.[27] With RBI focusing primarily on reducing inflation rate in the economy, there will be monetary policies in the near future that will reflect in the reduction of the CPI index. Though a reduction in inflation will be a great relief for the people, it will further decrease the shine of the CPI-Bonds and hence affect their demand. After the extension of the deadline to 31 March, 2014 and with no significant improvement in the response to the CPI bonds, there have been no further extensions or announcement regarding this.

The latest announcements on the CPI bonds have stirred the same questions and doubts about the bond market scene in India. For long, the main partakers in the Indian bond market have been banks, mutual funds and the RBI. Retail investors probably stayed out because they were content with their bank deposits, or due to regulatory complications or even a lack of awareness. The issuance of IIBs, though an indication by the government that it would manage inflation in the long run, would only attract retail investors who grab the opportunity to get higher yields when inflation is high and stubborn. The current phase of high inflation may have awakened many to look at additional investment options, and this could be very well-tapped by the government for long-term investment funding and to increase its investor base. The government should be more pro-active in the advertisement of these bonds so as to reach the target market better. Removal of non-tradability and some tax characteristics may make the IIBs much more attractive.

Fundamentally, government needs to focus on fiscal discipline; not a single budget since Independence has shown a surplus. The Fiscal Responsibility Act (2003) did little to curb the central government's debt addiction and put the burden on the Indian banking system. According to the International Monetary Fund, the gross government debt as percentage of GDP of India was 66.8% in 2012.

There is need for better tax/revenue collection, reduction of subsidies that have long served their economic purpose and for bringing down the revenue expenditure-to-GDP ratio. These are more sustainable ways to deficit financing and would lead to reduction in the issuance of G-Secs in large quantity. It is essential for the government to issue bonds to finance long-

[27] Bodhisatva Ganguli, "With RBI Governor Raghuram Rajan's hawk eye on inflation, rates may keep rising through 2014", *Economic Times*, dated Feb 10, 2014. Available at: http://economictimes.indiatimes.com/news/economy/indicators/with-rbi-governor-raghuram-rajans-hawk-eye-on-inflation-rates-may-keep-rising-through-2014/articleshow/30124977.cms

term infrastructure and urbanisation projects; however, it can be done in a more competitive manner that doesn't crowd out corporate bonds or hamper the growth of any industry. The government should also focus on lowering the inflation rate and avoiding the occurrence of negative yield. This will safeguard the savings of senior citizens who may not be in a position to opt for long-term investments.

5.1 Further Recommendations:

1. In order to support credit growth of the country, the SLR needs to be eventually removed. In the report by the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households, the RBI, too, had stated that the SLR had outlived its utility for banks and NBFCs (which have an SLR requirement of 15%).[28]

2. Foreign investor participation should be increased by increasing the limits to broaden investor base; a broader investor base would not only have a multiplier effect in deepening the market but will, in the long run, help the private sector grow and generate more employment. The government should also introduce more attractive bonds that would draw domestic retail investors in at this opportune time. These measures would lessen the crowding out, by freeing up bank credit, since government has a better credit rating than domestic companies.

3. Develop a smooth yield curve for the government securities, and this can be used as benchmark to price the corporate bonds. Currently, there exists mainly the 10-year, 5-year and 2-year government bonds benchmark.

4. Reform the stamp duty and make it uniform across all states: It appears to be one of the biggest hurdles, being a tax burden and a costly affair in the issuance of corporate bonds.

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[28] "RBI panel says abolish statutory liquidity ratio norm gradually", *Economic Times*, 7 Jan, 2014. Available at: http://articles.economictimes.indiatimes.com/2014-01-07/news/45955254_1_rbi-panel-slr-nbfcs

Reform the disclosure requirements: The prospectus need not run several hundred pages which cause delays and waste resources, especially for corporations which are already well-known in the market community.

These steps, however, have to be in sync with a reduction in several regulations related to public issue of corporate bonds. This way, corporations will find it easier to issue bonds, and banks can choose to invest in corporate or government bonds, or give loans at cheaper rates.

Appendix

Why is a liquid market important?

Liquidity of a market is assessed by the ease with which an asset can be sold in it. A liquid asset can be sold off quickly without causing much change in its price. An illiquid market is one of price volatility; and investors cannot exit it without affecting the price greatly. Hence, investors are either reluctant to buy illiquid assets or they expect a higher return for it. In a liquid market, the returns on an asset are, hence, lower. A liquid market is beneficial for both buyers and sellers and helps increase the investor base. A market with high liquidity would eventually reduce cost of capital for the issuer, and investors would typically invest in deep markets since they can easily recalibrate their portfolio by pulling out.

There are several reasons for the secondary market to be illiquid in India. Apart from a small investor base, there is fragmentation of issuance - most of the issues, being very small, limit the liquidity. About 4/5th of government securities are of 'hold to maturity' (HTM) nature, and hence banks and other investors are restricted in trading them. This is because the sellers have to mark up these bonds to market price while trading in the secondary market, which in the present situation of rising interest rates in India would lead to a loss. For the remaining 'hold-for-trading' (HFT) bonds, the seller is required to trade the bond at the cut-off of the 90th day. Due to a lack of demand and supply of bonds and an extremely small investor base, there's hardly any action in the secondary market, leading to the Indian bond market accommodating only the lowest-risk borrowers, most of whom want to buy and hold.

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