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Development of Debt markets

What is the issue?

As debt markets evolve, equity investors need to understand the perspective of debt markets on companies.

What are the differences between debt and equity markets?

- The basic differences between the debt and equity markets include the type of financial interest they represent, the way in which they generate profits for investors, how they are traded and their respective risk levels.
- Equity investments involve the buying and selling of stock and are conducted on trading exchanges.
- On the other hand, Bonds are the leading form of debt investments.
- Overall, equity investments represent an ownership interest in a company, while debt investments only represent a financial interest.
- Both debt securities and equity investments have the potential to deliver significant returns.
- However, investments in debt securities typically involve less risk than equity investments.

What is the growth trend of Indian debt markets?

- Till recently, most equity market investors hardly paid any attention to local debt markets.
- Indian debt markets were quite undeveloped, with limited issuance and trading beyond government securities.
- Most corporate borrowings were either through banks or raised overseas.
- Retail participation in corporate bond issues was almost non-existent.
- All the above has gradually changed over the last five to seven years.
- With the increasing financialisation of savings, flows into debt markers, both directly and indirectly through mutual funds and insurance companies, have raised.
- With the gradual liberalisation of foreign investment limits, even Foreign Portfolio Investments (FPIs) have become significant players in our debt

markets.
- Companies, mostly the NBFCs, have been able to issue bonds directly to retail investors, of varying tenure, with issue sizes in the thousands of crores being quite common.
- Thus, there is a great change in our debt markets, in terms of size, liquidity and sophistication.
- These markets will only get deeper and bigger, as domestic investors continue to shun real estate and gold, in favour of equities and debt for their own asset allocation.

What are the interlinkages between debt and equity markets?

- There are interlinkages existing between the debt and equity markets, and one has influence on the other.
- This was witnessed in the case of IL&FS default.
- IL&FS group of companies (NBFC) has a total consolidated debt of close to Rs 1 lakh crore, and it started to miss deadlines on its debt obligations beginning last week of August 2018.

- Fears grew among the investors that the default problem will spread to other NBFCs, leading to a sharp fall in the stocks of housing finance companies (HFCs) and NBFCs (which operate on borrowed funds).
- Hence institutional debt investors sold their stocks in housing finance firms, leading to stock market plunge.
- Consequently, NBFCs that were able to access debt funds at lower rates before had to pay higher rates post IL&FS default case.
- This has reduced the growth and profitability outlook for most of these NBFCs, which has subsequently affected the profitability of corresponding equity market investor who owned the specific NBFC stock.
- Thus, if debt markets are worried about default and reduced their exposure to these companies, it will have repercussions on the profitability of equity investors on those companies.
- This shows that the equity market is being driven by the debt market in recent times.

What are the advantages?

- The development of the debt markets and their increasing scale and sophistication are good things and need to be encouraged.
- The fragmentation of credit risk between equity and debt markets will make our financial system stronger.
- The decentralisation of credit decisions also reduces the scope for directed lending only to specific larger companies.

- It will also serve as an alternate to bank credit, which are witnessing higher number of non-performing assets in their balance sheets.
- Thus, an equity investor need to spend some time understanding the debt markets' perspective on the companies that they invest.

What are the challenges to the development of debt markets?

- **Monopoly of large companies** - At least 10 to 15 large corporate treasuries have disproportionate power over debt funds, especially those run by mid-sized Asset Management Companies.
- If these large corporate treasuries decide that they do not want exposure to a certain issuer, most funds will have to fall into line, and exit that debt paper.
- This can have macro-economic consequences, as just observed in the NBFC funding crisis.
- In that case, many funds were forced to reduce their NBFC exposure upon default.
- Thus, this monopoly has resulted in reduced access of debt funds and increased cost of funding for most NBFCs.

- **Rating agencies** - Rating agencies are perceived to be slow and behind the market in adjusting ratings to the current reality.
- The rating agencies seem to take no account of equity market views.
- This disconnect between the equity market and ratings agency view on a specific issuer can create market dislocations.
- Once ratings lose relevance, markets will narrow and nobody will want to take any risk.

Source: Business Standard

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