India needs to develop a debt market

The banking system is being asked to fulfill the roles of debt markets while ensuring the government's financial inclusion agenda, which is a tall order

ADITYA PURI

At the heart of the debt market's woes lies the government's large fiscal deficit. The household sector's savings in financial assets is about 11% of GDP and the corporate sector saves 8% of GDP. The Centre and states combined run a deficit of close to 8% of GDP and finance it largely through bonds and some other fixed income instruments

The structure of the financial system in the country is required to reflect the development of the real economy. India has developed as a rich-poor country and our financial system is required to have the sophistication of developed markets coupled with base banking to meet the needs of small businesses, farmers, individuals, etc. Pending the development of debt markets, the banking system is being asked to fulfill the job of debt markets and the government's financial inclusion agenda, which is a tall order. In addition, we have developments in regulations, which would compound the issue further.

India will need huge amounts of funds for its development. As the government grapples with the imperatives of bringing public finances under control and of improving execution efficiency, the role of the private sector in this domain is likely to keep growing. The Twelfth Five Year Plan put in place by the government envisages $1 trillion worth of infrastructure investments over the period 2012-2017. Of this, $500 billion or 50% is expected to come from the private sector—a significant jump from the average private sector participation rate of 25-30% during the Eleventh Five Year Plan period. Of the $500 billion worth of private sector investment towards infrastructure, $350 billion is projected to be funded through debt.

Where does the private sector raise this debt from? Infrastructure projects are long-gestation projects that require long-term funding. This would typically be the domain of the capital markets. Will the domestic private bond market be able to deliver these funds? That seems unlikely. At a mere 5% of GDP, the market for non-government bonds in India remains underdeveloped despite more than a decade of effort. This compares with a corporate bond market size of 16% of GDP for China and 19% for Brazil.

Could this change? Given the experience of the past decade, it would be optimistic to expect a dramatic turnaround in the debt market's fortunes going forward. The reasons for the stagnation in the bond market are known. Here's a quick recap of what has held back the development of a debt market.

At the heart of the debt market's woes lies the government's large fiscal deficit. The household sector's savings in financial assets is about 11% of GDP and the corporate sector saves 8% of GDP. The Centre and states combined run a deficit of close to 8% of GDP and finance it largely through bonds and some other fixed income instruments, leaving only a small share of effective domestic savings for private borrowers. In short, the government is a disproportionately large player in the domestic bond market. The average share of government issuance in the domestic bond market works out to about 48% for the world as a whole; for India the proportion is 90%.

The government's dominance of the bond market is not confined to the quantum of sovereign bond supply, but regulations and practices that hamper efficient price discovery and the development of a meaningful yield curve spanning the maturity spectrum. The statutory liquidity ratio (SLR) mandate creates a captive market for government bonds that depresses prices. The compulsion to abide by SLR requirements also promotes a "buy and hold" strategy for banks driven by the need to reduce adjustments from mark-to-market valuations. This curbs secondary market trading and liquidity.

Given the captive market for its bonds, the government restricts the bulk of its bond issuance to the longer tenors in order to push redemption pressures resulting in the shorter segments of the yield curve remaining illiquid. Roughly 75% of the settlement volumes in central government dated securities are concentrated in the 10-year and 12-year segments. 15 securities (concentrated in the maturity range of 5-20 years) account for over 90% of the volume. Except for about 8-10 securities at a time for which two way quotes are available in the market, other parts of the yield curve represent securities that are not actively traded. In the absence of a representative sovereign yield curve, markets for instruments like credit and interest rate derivatives, which would complement the growth of a robust bond market, have also not developed.

Regulations specific to the domestic corporate bond market are also hampering growth. Restrictive investment norms for institutions such as insurance companies and pension funds whose liability structures enable them to invest in long-term bonds restrict their participation. For instance, at least 75% of investments in debt instruments by insurance companies need to be in AAA-rated paper and investments can only be made in instruments with a minimum maturity of ten years. Regulations like these push several attractive infrastructure investment options outside the ambit of insurance companies and pension funds.

These problems are unlikely to go away in the near term. In the absence of a sharp decline in the sovereign and states' demand for funds, the compulsion to overhaul regulations like the SLR will remain muted. Thus, we can assume that at least over the next three years, the bond market is unlikely to become an active conduit of delivery of long-term funds.

So, in the near future, money will have to come from banks. This is not an easy task as they will simultaneously have to provide long-term funds, service the working capital needs of the economy, enable households to leverage and purchase their dream homes/ cars and finally take the financial agenda forward. In short, banks have to make available a humongous amount of credit to the economy. Going by some estimates, the working capital demand alone over the next five years could total close to $3 trillion.

Add to this the fact that Indian banks, despite not having toxic business models/products, are looking at capital adequacy regulations that are tougher than the West. The advent of Basel III norms across global economies by themselves will not only raise the capital requirements of banks but will also put pressure on them to improve their capital mix. Basel III keeps the minimum total capital requirement unchanged at 8.0% of risk weighted assets (RWA) but introduces a capital conservation buffer of 2.5% of RWA, raising total capital requirement to 10.5%. Further, the internal norms require a minimum Tier-I capital of 6.0% against 4.0% previously, of which at least 4.5% must come from common equity.

RBI, however, has imposed tighter capital requirements than Basel III. Banks in India are required to operate at a higher minimum capitalisation level of 9% (excluding capital conservation buffers) as compared to 8% according to international standards. Going by RBI guidelines, banks are required to maintain minimum Tier-1 capital of 7.0% (that is a percentage point above the Basel stipulation) of which 5.5% (and not the 4.5% that Basel stipulates) must come from common equity only. Based on these norms, the additional common equity requirements for the banking system over the next few years will likely total ₹1.6-1.7 trillion. Further, with regard to the overall leverage ratio of a bank, RBI mandates a minimum 4.5% as against the 3% ratio that will be monitored by BIS.

In addition, risk weights prescribed by RBI across asset classes are far more stringent than international guidelines. Take the case of mortgage loans secured by residential property. The risk weight for this category in India is between 50% to 75% depending on the quantum of the loan. Basel norms for this category are 35%. In some countries, the risk weight at to mortgages is as low as 10%. Further, while under international norms lending to public sector enterprises can attract a weight as low as 0% and be treated as a claim on the sovereign according to international standards, RBI requires domestic banks to maintain risk weights of 20% to 150% based on the external credit rating of the PSU and so on. Also, SLR as its nomenclature implies should be taken in its entirety as near-term assets, otherwise bank's lending capacity will be impacted.

Indian banks seem to be maintaining high net interest margins and are advised to reduce them and compensate for this by reducing costs. Let us be clear, the margins shown globally are net of credit provisioning. If we compare our margins on the same accounting basis, they are lower. Superimpose the costs likely to be incurred on financial inclusion and margins will be further squeezed.

From a risk perspective, provisioning requirements could rise as domestic banks take on the mantle of inclusive growth and greater credit outreach. It is possible to get a tentative idea of the additional provisioning required as the priority sector as it exists today could work as a proxy for the likely pattern of impairment for loans related to financial inclusion. Based on RBI statistics, the gross NPA ratio for priority sector loans of public sector banks as a group works out to 4.97%. This is more than twice the gross NPA ratio in non priority sector advances.

While the NPA ratios reflect the intrinsically higher risk in priority sector lending, the risk weightage for capital adequacy and the provisioning rate currently required to be maintained for this segment of lending by RBI are disproportionately low. With banks having to step up priority sector lending in unbanked areas, the risk levels as well as the risk related capital gap could increase. Further, pricing on these exposures are expected to be economical for the borrower in this segment and therefore might not be able absorb the actual risk premium that such lending warrants. This could result in banks having to forego returns on the capital deployed for these exposures, which is tough in a scenario in which they have to increase their capital requirements.

What are the implications of all this? Profitability will reduce and banks will have to dilute their equity base to comply with capital requirements. The casualty will be the return on equity for banks (ROE)—this could go down as low as 12-14%. Given global competition for capital and risk premium attached to India, it is unlikely banks will be able to raise capital on favourable terms.

In conclusion, given that our banking system did not participate in the crisis and nor does it have the toxic products—is it desirable to burden banks with regulations that are more restrictive than those for the world that caused the crisis and has the problem? If we follow Basel III guidelines, Indian banks will be the stars of the world with ROE's of 17%-plus.

The author is MD and CEO, HDFC Bank