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Bond Market in India

Mr. Nilesh Shivratan Dave
Shri G. P. M. Degree College, Vile Parle (E), Mumbai, Maharashtra, India

Abstract*: While India boasts a world-class equity market and increasingly important bank assets, its bond market has not kept up. The Government bond market remains illiquid. The corporate bond market, in addition remains restrictive to participants and largely arbitrage-driven. Securitization, which once had the jump on other Asian markets, has failed to take off.*

To meet the needs of its firms and investors, the bond market must therefore evolve. This will mean creating new market sectors such as exchange-traded interest rate and foreign exchange derivatives contracts. It will mean relaxing exchange restrictions, easing investment mandates on contractual savings institutions, reforming the stamp duty tax, and revamping disclosure requirements for corporate public offers. This paper reviews the development and outlook of the Indian bond market. It looks at the market participants—including life insurance, pension funds, mutual funds and foreign investors—and it discusses the importance to development of learning from the innovations and experiences of others.

Vibrant, deep and robust corporate bond markets are essential to enhance stability of financial system of a country, mitigate financial crises and support the credit needs of corporate sector, which is vital for the growth of an economy. Our review of research and policy papers on the corporate debt markets in India reveals a persistent absence of an efficient, liquid and vibrant corporate debt market in India. Our paper seeks to flag this issue and help to fast track the development of the corporate bond markets in India.

Recent trends reinforce the need for strong policy measures to develop the corporate debt markets in India. A study of corporate bond market experiences across developed and emerging markets such as US, EU, Japan, China, Malaysia, Korea and New Zealand further underscores the importance of strong institutional and regulatory framework, along with support from policymakers for building robust corporate debt markets. A review of literature and an analysis of key trends in corporate debt market help us identify the issues with the three pillars of corporate debt markets – institution and regulators, market participants, and instruments. We find that this lack of depth and efficiency in the corporate debt market is mainly explained by inadequate infrastructure, illiquidity, regulatory gaps, limited investor and issuer base, and absence of benchmark yield curve across maturities. Finally, we apply the insights from literature review, the trend analysis and cross-country study to make recommendations to revive the Indian corporate debt markets

Keywords: Bond Market

I. INTRODUCTION

BOND MARKET IN INDIA

The market for trading debt securities like government bonds, corporate bonds and tax-free bonds is known as a bond market. A bond market is generally less volatile than an equity market and is more suitable for investors with lower risk tolerance. Investing in bond markets is an efficient way to diversify your portfolio.

A bond market is a marketplace for debt securities. This market covers both government-issued and corporate-issued debt securities. It allows capital to be transferred from savers or investors to issuers who want funds for projects or other operations.

You can issue fresh debt in the primary market or exchange debt securities in the secondary market in the bond market. Bonds are the most common type of trading. However, bills and notes can also be used. Institutional investors, traders, governments, and individuals all use the bond market.

Bond markets are divided into three categories: corporate, government, and agency. The most important of the three is government bonds, which are used to compare other bonds and assess credit risk.

Corporates, governments and individuals rely on various sources of funding to meet their capital requirements. Specifically, corporates use either internal accruals or external sources of capital to finance their business. Funds are raised from external sources either in the form of equity or debt or hybrid instruments that combine the features of both debt and equity. The capital raised by companies through debt instruments is broadly referred to as corporate debt.

. The capital raised by companies through debt instruments is broadly referred to as corporate debt. Corporate debt consists of broadly two types – bank borrowings and bond. Corporates borrow from banks and other financial institutions for various business purposes and for varying durations through non-standardized and negotiated bank loans. Bank finance takes the form of project loans, syndicated loans, working capital, trade finance, etc.

Features of Bonds

Bonds come with several features that distinguish them from other forms of investment.

Interest Rate

The interest rate is the coupon the bond issuer pays the bondholder. Typically, it is a fixed percentage of the face value of the bond and is paid out periodically over the bond's life.

Maturity date

The maturity date refers to the redemption date, and the bond issuer must repay the bond's principal amount to the bondholder. It is the date on which the bond "matures."

Face value

The face value is the amount the bond issuer will pay the bondholder at maturity. It is also known as the par value of the bond.

Yield

The yield is the rate of return on a bond. It is a percentage of the bond's current market price. It considers both the coupon rate and the bond's current market price.

Credit rating

Credit rating agencies assign a bond rating based on the issuer's creditworthiness. This rating reflects the likelihood that the issuer will default on its bond payments.

Liquidity

Bonds can be bought and sold in the secondary market so that investors can sell their bonds before maturity. The liquidity of a bond refers to the ease with which it can be bought or sold in the secondary market.

Objectives

The scope of bonds as an asset class is to primarily provide 3 things:

1. Safety:

One of the primary objectives of bond investment is to preserve the principal investment and protect it from potential losses. Bonds are often considered a safer investment option compared to stocks or other high-risk investments, as they offer a fixed rate of return and a low default risk. This makes them an attractive investment option for conservative investors who prioritize safety over potential high returns.

2. Regular Income:

Another important objective of bond investment is to generate a steady stream of income for the investor. Bonds typically pay interest to investors on a regular basis, providing a reliable source of income that can help to balance out the riskier components of an investment portfolio. The amount of interest paid on a bond can vary depending on a number of factors, including the creditworthiness of the issuer, the duration of the bond, and prevailing market interest rates.

3. Steady Growth:

While bonds are primarily considered a conservative investment option, they can also provide opportunities for growth and capital appreciation. As interest rates change and bond prices fluctuate, there can be opportunities for investors to realize gains on their investments. In addition, bonds can help to diversify an investment portfolio, potentially reducing risk and enhancing overall returns.

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Explanations

TYPES OF BOND MARKET

1. Traditional Bonds:

The most generic type of bond, a **traditional bond**, allows bondholders to withdraw the entire principal amount at maturity.

2. Callable Bonds:

A **callable bond** can be called out by the **bond issuer** at their discretion and redeemed before its **maturity date**. The bond issuer may also transform a **high-debt bond** into a **low-debt bond**.Callable bonds are high-yield or junk bonds, which assure high returns but have a higher risk of default due to the poor credit rating of the bond issuer.

3. Fixed-Rate bonds:

These **investment-grade** bonds possess a fixed coupon rate throughout their tenure.

4. Floating Rate Bonds:

Unlike **fixed-rate bonds**, a **floating-rate bond** has its coupon rate varying throughout its maturity period.

5. Putable bonds:

Putable bonds are bonds where bondholders have the option to sell bonds and get their money back before the maturity date.

6. Mortgage Bonds:

These are asset-backed and mortgage-backed securities linked to mortgage-backed loan pools. House and real-estate backed act as primary collateral for a **mortgage bond**.

7. Zero Coupon Bonds:

A zero-coupon bond offers no coupon payments or interest return at maturity. Instead, buyers buy these bonds at a substantial discount on the bond's **par value**. On maturity, bondholders get the full **principal amount** higher than the bond's **face value**.

8. Serial Bonds:

A **serial bond** matures in a step-by-step manner. Issuers pay back the **principal amount** plus **interest rate** at regular time intervals. This helps in reducing the financial obligations of the issuer during the time of maturity.

9. Extendable Bonds:

The maturity period of these bonds can be extended at the investor's discretion.

10. Convertible bonds:

A special type of bond, a convertible bond, can be converted from a debt instrument to an equity instrument.

11. Dynamic Bonds:

Another special type of bond, **dynamic bonds**, are open-ended in nature. These kinds of bonds have a dynamic approach towards bond maturity and do not impose any restrictions concerning maturity periods. Unlike **serial bond**s, dynamic bonds have only a singular maturity date.

12. Inflation-Linked Bonds:

Government bonds are called inflation-linked bonds when they are specifically designed to counter the effect of inflation on **interest rates** & principal payments. **Inflation-linked bonds** are unlike **traditional bonds** in that their principal & interest payments are linked to any nationally-recognized inflation measure index. The **face value** gets adjusted as **inflation risk** changes. However, the interest rate of these bonds is generally lower than other bond types.

Features of Bonds

Bonds come with several features that distinguish them from other forms of investment.

Interest Rate:

The interest rate is the coupon the bond issuer pays the bondholder. Typically, it is a fixed percentage of the face value of the bond and is paid out periodically over the bond's life.

Maturity date:

The maturity date refers to the redemption date, and the bond issuer must repay the bond's principal amount to the bondholder. It is the date on which the bond "matures."

Face value:
The face value is the amount the bond issuer will pay the bondholder at maturity. It is also known as the par value of the bond.
Yield:
The yield is the rate of return on a bond. It is a percentage of the bond's current market price. It considers both the coupon rate and the bond's current market price.
Credit rating:
Credit rating agencies assign a bond rating based on the issuer's creditworthiness. This rating reflects the likelihood that the issuer will default on its bond payments.
Liquidity:
Bonds can be bought and sold in the secondary market so that investors can sell their bonds before maturity. The liquidity of a bond refers to the ease with which it can be bought or sold in the secondary market.

Limitations of Bonds
Despite their many advantages, bonds also have some limitations.
Interest rate risk:
Generally, bond prices tend to fall when the interest rate increases. It means that if an investor needs to sell their bond before maturity, they may have to sell at a loss. This risk is particularly relevant in a rising interest rate environment.
Inflation risk:
While bonds provide a steady income stream, inflation can erode the value of that income over time. It means that investors may end up with less purchasing power.
Credit risk:
Bonds are only as good as the issuer's creditworthiness. If the issuer defaults, bondholders may not receive their entire principal and interest payments. One can mitigate the risk by investing in bonds with higher credit ratings, but this generally comes at the cost of lower yields.
Liquidity risk:
Some bonds may be difficult to sell quickly, especially if they do not trade frequently. It can be a problem for investors who must sell their bonds before maturity.
Limited potential for capital appreciation:
While some bonds may experience capital appreciation, the potential for price gains is generally limited. Investors looking for significant capital appreciation may need to consider other investments.

Advantages of Bonds
The main advantage of investing in bonds is that they provide a steady stream of income through interest payments. Investors seeking predictable returns often turn to bonds because of this consistent income stream. Other advantages of bonds include:
Safety:
Bonds, especially government and municipal ones, are considered safer than stocks as they provide a fixed return and the principal amount is repaid at maturity.
Predictable Income:
Bonds pay a fixed interest rate (also known as a coupon rate) at regular intervals, providing a steady income.
Diversification:
Including bonds in an investment portfolio can help diversify risk, as bonds usually have an inverse relationship with stocks.
Tax Benefits:
Certain bonds like tax-saving bonds and infrastructure bonds offer tax benefits under the Indian Income Tax Act.
Inflation Protection:
Some bonds like inflation-indexed bonds offer protection against inflation.

Issuer flexibility:

They can be issued in various forms and terms, allowing issuers flexibility in raising capital. Bonds are customisable and meet the specific needs of the issuer, such as funding long-term projects or managing short-term cash needs.

Disadvantages of Bonds

1. Market volatility:

The market is responsible for increasing and decreasing the bond market value, which is affected by two factors, i.e., market volatility and macroeconomics. Bond prices are also influenced by the rating allocated by credit agencies which can either upgrade or downgrade a bond issuer based on its financial health. But these external factors do not impact the bond's interest or coupon interest payment but only affect the market price of bonds.

2. Fluctuation of interest rate:

Increment and decrement in the bond's interest rate depend on the bond price, as the bond's price is inversely proportional to the interest rate. Interest rate decreases when the bond price increases and vice versa. Due to this, the total value of a bond may suffer from rising interest. This fluctuation or change in bond price impacts the institutional and mutual funds investors with exposure to bonds. This affects professional investors like insurance companies, banks, and pension funds.

3. Lower returns:

Mainly two types of returns are available on two types of bonds in the bond market, i.e., fixed-rate bonds and floating-rate bonds. In fixed-rate bonds, the returns are fixed (pay a predetermined interest rate at regular intervals); in floating-rate bonds, returns fluctuate. The customer price index and London interbank offer rate are considered benchmark rates. In India, the long-term investment return for a bond can be less than for equities. For example, the average return on a bond is 7% per annum. Still, equity investments yield about 12%, and the bond tax is more than equity, indicating that the overall return from a bond is significantly lower than equity.

4. Not best for short-term investment:

Bonds are not meant for a 1-year investment because, in the year, the issuer should not receive the maturity amount instead, the investor has to pay the penalty (equal to three months of interest). This condition arises when the issuer cashes out at any time over five years of buying the bond.

5. Limited liquidity:

Bonds are tradable as shares in terms of liquidity. In most cases, bonds are long-term investments with withdrawal restrictions on the invested amount. If creditors want to withdraw their debt before maturity, their bonds are liable to several fees and penalties.

6. Interest rate risk:

Generally, bond prices tend to fall when the interest rate increases. It means that if an investor needs to sell their bond before maturity, they may have to sell at a loss. This risk is particularly relevant in a rising interest rate environment.

7. Inflation risk:

While bonds provide a steady income stream, inflation can erode the value of that income over time. It means that investors may end up with less purchasing power.

8. Credit risk:

Bonds are only as good as the issuer's creditworthiness. If the issuer defaults, bondholders may not receive their entire principal and interest payments. One can mitigate the risk by investing in bonds with higher credit ratings, but this generally comes at the cost of lower yields.

How to Invest in Bond Market in India?

Investing in the bond market in India can be done through primary markets (new issue market) and secondary markets (where previously issued securities are traded). Here's a step-by-step guide to investing in the bond market in India: A Demat Account is necessary to hold the bonds in electronic form.

Open Demat Account:

A Demat Account is necessary to hold the bonds in electronic form. Bonds are a type of fixed-income investment that represents a loan made by an investor to a government or a corporation. When you invest in bonds, you're essentially

lending your money to these entities in exchange for interest payments and the return of your principal when the bond matures.

Determine your investment goals:

Before investing in bonds, it's important to determine your investment goals. Are you looking for a regular income, tax-saving or retirement funds? This will help you determine the types of bonds you should invest in.

Choose the type of bond:

There are different types of bonds available, including government bonds, corporate bonds, municipal bonds, and green bonds. Each type of bond has different risks and potential returns. For example, government bonds are generally considered safer than corporate bonds, but they may offer lower returns.

Evaluate bond ratings:

Bond ratings are issued by rating agencies and they indicate the creditworthiness of the issuer. Higher-rated bonds are generally considered less risky than lower-rated bonds, but they may also offer lower returns.

Consider the yield:

The yield on a bond is the return you can expect to receive on your investment. Higher-yielding bonds may offer greater potential returns, but they also come with higher risks.

Diversify your portfolio:

It's important to diversify your bond portfolio by investing in different types of bonds from different issuers. This can help reduce the risk of losing money if one issuer defaults. One can also explore duration play and invest based on various interest rate frequencies.

Monitor your investments:

Once you've invested in bonds, it's important to monitor your investments regularly. Keep an eye on the bond ratings, interest rates, and other market trends that could impact your investments.

Start your investment journey with India Bonds:

Invest in Bonds with India Bonds for a hassle-free and seamless online investment experience all in less than 6 minutes. Simply signup, complete your paperless KYC and invest with ease all from the comfort of your home.

How Bond Market Works?

Here's a simplified step-by-step process of how it works:

Issuance:

A corporation or government entity that needs to raise funds will issue bonds in the bond market. This issuance includes details such as the maturity date, coupon rate (interest rate), and face value.

Purchase:

Investors buy these bonds, effectively lending their money to the issuer.

Interest Payments:

Over the life of the bond, the issuer pays the bondholder periodic interest payments, usually semi-annually.

Maturity:

At the bond's maturity date, the issuer returns the principal amount to the bondholder, and the bond is retired.

II. CONCLUSION

Bonds are fixed-income instruments that signify a loan forwarded by an investor to a borrower. The issuer promises to pay a specific interest for the life of the bond and the principal amount or the face value at maturity. Bonds are generally issued by governments, corporations, municipalities and other sovereign bodies. Bonds can be traded, just like securities.

Learning about the advantages and disadvantages of bonds concluded that rather than disadvantages, bonds are a profitable method of investment and a source of fixed income. Bonds involve low risk in investment, but it is mandatory to understand the terms and conditions of bonds, their profitable income, how to calculate the returns, and how much time it is profitable. Bonds are one of the best sources for channelizing your savings and getting low-risk returns.

In conclusion, bonds are a crucial part of the global financial system, providing a means for governments, corporations, and other entities to raise capital. There are various types of bonds, from government and municipal bonds to corporate

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and high-yield bonds. Each bond type has its advantages and risks, and investors and issuers should carefully consider these factors when deciding which bonds to invest in or issue.

Despite the risks, bonds remain a popular investment choice for those seeking steady income, diversification, and lower risk, making them an important asset class in any well-diversified portfolio.

One big reason for growth in India's bond market is the need for infrastructure development. The government is taking on huge projects in transportation, energy, and urban development. To fund these projects, governments and infrastructure companies raise funds through bonds.

India's bond markets have a promising future. They're driven by infrastructure development, more regular people participating, digitalization, sustainable finance, regulatory changes, and global integration. As India's economy grows and its financial markets mature, bonds will play a bigger role in financing different sectors and providing investment options to a broader group of people. With strong regulation and growing interest in bonds, India's bond markets are set for a bright future.

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