Bond Exchange traded funds (ETFs)

December 13, 2019
Source: *The Hindu*

Manifest pedagogy: The development of a long term capital market for private borrowing and deepening of capital markets has been a key bottleneck in financial sector in India. The steps taken by government hold promise for the development of bond markets and thereby, UPSC may focus on broader aspects of financial sector reforms as a whole in the recent past.

In news: Cabinet okays bond ETFs

Placing it in syllabus: Capital market in India

Static dimensions:

- Capital market in India
- Development of long term bond markets in India

Current dimensions:

- Bharat bond ETF
- Mandatory 25% borrowing from capital markets
- Recapitalisation bonds under Indradhanush

Content:

Capital markets in India:

- The Indian capital market refers to the facilities and institutional arrangements **for borrowing and lending 'term funds', medium and long.**
- It **does not deal in capital goods**, but is concerned with raising money capital or purpose of investment.

- The capital market in India **includes the following institutions:**
- Commercial Banks;
- Insurance Companies (LIC and GIC);
- Specialised financial institutions like IFCI, IDBI, ICICI, SIDCS etc..
- Provident Fund Societies;
- Merchant Banking Agencies;
- Credit Guarantee Corporations
- **Individuals who invest directly on their own in securities** are also suppliers of funds to the capital market.

The Indian capital market is divided into **gilt-edged market and the industrial securities market**.

- The gilt-edged market refers to the **market for government and semi-government securities, backed by the RBI.**
- The industrial securities market **refers to the market for shares and debentures of old and new companies**. This market is further divided into the new issues market and old capital market.
- The **new issue market** refers to the raising of new capital in the form of shares and debentures.
- The **old capital market** deals with securities already issued by companies.
- The capital market is also divided in **primary capital market and secondary capital market.**

Development of long term bond markets in India:

- Honourable Prime Minister has underlined the **importance of bond markets for infrastructure financing** in India.
- Currently all infrastructure financing is done either by the Government or World Bank loans or public sector banks.
- Hence it is opined that bond markets should enable long-

term borrowing.

- Even excluding their borrowings for financing infrastructure, **India's government(s) are the biggest and most influential participants in the domestic bond markets.**
- They have borrowed and continue to borrow the largest amounts for the longest maturities.
- They also have a perennial borrowing presence in the markets.
- **In order to borrow long, there should be some investors willing to lend money for the long term.**
- The investor should be **incentivised monetarily** in yield terms – to lend long term relative to short-term lending, **to compensate for the significant risks** he would be exposed to like credit and inflation risks.
- At present, **there is no specific compensation for the higher level of risks inherent in long-term investing.**
- Hence the investor is better off making short-term investments and rolling them over.

Bharat bond ETF:

- On December 4, 2019 the government approved the launch of the **first corporate bond ETF** – Bharat Bond ETF.
- It is an **exchange-traded mutual fund** that will **invest one's money in bonds issued by public sector companies.**
- **Edelweiss AMC** has received the mandate to launch the ETF.
- The bond ETF will be **open for subscription from December 12-20**, 2019.
- The ETF will have a **base size of Rs 7,000 crore**, with a likely green shoe option of Rs 8,000 crore.
- **ETF will invest only in AAA-rated bonds** issued by public sector companies maturing on or before the maturity of the ETF.
- Any **issuer** that ceases to be a CPSE, CPFI or statutory body or the rating is **downgraded below AAA, shall be**

removed from the index on the next rebalancing date.

- Each ETF will have a **fixed maturity date** and different indices tracking specific maturity years.
- As of now, it **will have 2 maturity series – 3 and 10 years** – NIFTY Bharat Bond Index – April 2023 and NIFTY Bharat Bond Index – April 2030.
- The **unit value** of the Bharat Bond ETF will be **capped at Rs 1,000.**
- As many as 12 central government companies may borrow via the ETF.

Benefits:

1. Bond ETF will **provide safety** as underlying bonds are issued by CPSEs and other government-owned entities.
2. It will have **predictable tax-efficient returns** due to a target maturity structure.
3. It will also **provide access to retail investors** to invest in bonds with smaller amount of as low as Rs 1,000, providing easy and low-cost access to bond markets.
4. Bond ETFs are taxed with the benefit of indexation which significantly **reduces the tax on capital gains for investors.**

Mandatory 25% borrowing from capital markets:

- SEBI has come out with a proposal that will **require large corporates to raise 25% borrowings through corporate bonds** from next fiscal.
- For entities following April-March as their financial year, the framework will come into effect from **April 1, 2019,** and for firms that follow calendar year as their financial year, it will be effective from **January 1, 2020.**
- The large corporates identified as on 31 March 2019 will have to garner at least 25% of their borrowings made in 2019-20 through bond market.

- This is part of an effort **to reduce reliance on banks for financing corporates** and simultaneously developing a liquid and vibrant corporate bond market.
- Sebi has defined " **large corporates**" as such firms who need to have
  - an **outstanding long term borrowing of at least ₹ 100 crore;**
  - a credit rating of **"AA and above";**
  - **target to finance themselves with long-term borrowings (above 1 year).**
- A "comply or explain" approach would be applicable for the initial two years of implementation.
- From 2021-22 the requirement of bond borrowings shall be tested for a **contiguous block of two years 2021- 22 and 2022-23.**
- At the end of block, **if there is any deficiency** in the requisite bond borrowing, a **monetary penalty in the range of 0.2% to 0.3% of the shortfall will be levied.**

Recapitalisation bonds under Indradhanush:

- Government announced Indradhanush plan for revamping Public Sector Banks (PSBs) in August 2015.
- The plan envisaged, infusion of capital in PSBs by the Government to the tune of Rs. 70,000 crore over a period of four financial years.
- Government recently announced its decision **to further recapitalise PSBs to the tune of Rs. 2,11,000 crore, through recapitalisation bonds of Rs. 1,35,000 crore.**
- Though the structure of the bonds has not been worked out, it is expected that the **bonds will be bought by the banks** themselves.
- In effect, the recapitalisation bonds **will be exchanged for equity shares.**
- This is not the first time that the bank recapitalisation bond will be issued in India. **In the year 1994, India had sold about 48 billion rupees of 12-**

year recapitalisation bonds at a coupon rate of 10 %.
- Under standard international accounting practices, **recapitalisation bonds are classified as 'below the line' financing and not included in the fiscal deficit.**

Benefits:

- The massive recapitalisation will strengthen the capital base of the banks.
- It will help banks to write-off its bad loans and subsequently increase its lending capacity.
- According to Goldman Sachs, it could boost credit growth by up to 10 %.