Corporate Debt Market in India: Lessons from the South African Experience

Anand, Vaibhav and Sengupta, Rajeswari

IFMR Finance Foundation, Indira Gandhi Institute of Development Research

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Vaibhav Anand and Rajeswari Sengupta[2]

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Abstract

Development of long-term debt markets is critical for the mobilization of the huge magnitude of funding required to finance potential businesses as well as infrastructure expansion. India has been distinctly lagging behind other emerging economies in developing its long-term corporate debt market. Traditionally, bank finance, coupled with equity markets and external borrowings have been the preferred funding sources. The domestic corporate debt market suffers from deficiencies in products, participants and institutional framework. Large fiscal deficit, high interest rates, inadequate market infrastructure, lack of transparency, excessive regulatory restrictions on the investment mandate of financial institutions, and distortionary tax and stamp duty regime are some of the key issues that may potentially hamper the development of a well-functioning corporate debt market in an emerging economy. Several of these issues need the political will to bring about legislative, regulatory and fiscal reforms. In order to gain insight into the required reforms, it may be useful to look at an economy that implemented not only the regulatory but also the policy level reforms in debt markets. South Africa is one such economy where the long term debt market reforms lasted nearly two decades starting from early 1980s. In this paper, we study the development of the South African corporate debt market, which underwent a significant transformation from being moribund into one that is vibrant and large. We also draw lessons for the Indian corporate debt market from the South African experiences.

JEL Classification: G1, G2

Key Words: Corporate bond market, Government Securities, Secondary market, Hedging instruments, Private placement.

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[2] Vaibhav Anand (vaibhav.anand@ifmr.co.in) is at IFMR Capital and Rajeswari Sengupta (rajeswari.sen@gmail.com) is at Indira Gandhi Institute of Development Research (IGIDR), Mumbai.

1. Introduction

At the current time, when India is endeavoring to sustain its high growth rate, it is imperative that financing constraints in any form be removed and alternative financing channels be developed in a systematic manner for supplementing traditional bank credit. In this context, the development of long-term debt markets – corporate debt and municipal debt – is critical in the mobilization of the huge magnitude of funding required to finance potential business expansion and infrastructure development.

A developed corporate debt market serves the needs of an emerging economy in multiple ways:

i. It supplements the existing banking system in providing the required funding to enterprises and while doing so reduces the vulnerability of the financial system to external shocks by ensuring diversification of funding sources in the economy. Previous financial crises have shown that systemic problems in the banking sector can interrupt the flow of funds from savers to investors for a significantly long period of time (Jiang, Tang, & Law, 2002).
ii. It enables better pricing of credit risk, dynamic allocation of capital, realistic pricing of government debt and reduction of currency mismatches in the financial system.
iii. It provides investment options to institutions such as insurance companies and pension funds which seek high quality long term assets to match their long term liabilities.
iv. It fosters the development of credit derivative products thereby allowing efficient credit risk transmission.

In this paper, we try to study the factors behind the development of corporate debt market in South Africa and identify key lessons for the Indian market. The paper is mainly divided in five sections. First two sections provide an introduction to the need and current status of the corporate debt market in India. Section three starts with a comparison of the initial conditions in the two economies: India and South Africa. The section further discusses the key policy and debt market reforms undertaken by South Africa. Section four provides a post-facto comparison of the various economic and market development indicators between the two economies. In the last section we discuss the key lessons for Indian corporate debt market from the South African example.

2. Current Status of Indian Corporate Debt Market

India has been distinctly lagging behind other emerging economies in developing its long-term corporate debt market. While the equity market in India has been quite active, the size of the corporate debt market is very small in comparison to not only developed markets, but also some of the other emerging market economies in Asia such as Malaysia, Thailand and China.

The size of the Indian financial system is not adequate to meet the needs of the real economy. A comparison of the asset size of the top ten corporates and that of the top ten banks reveals that banks in India are unable to meet the scale or sophistication of the needs of large corporate India

[**Figure** 1]. Regulatory limits on single borrower lending and group borrower lending by banks significantly restrict the funding available to the corporate sector. India's largest bank, State Bank of India (SBI), breached the single borrower exposure limit stipulated by the Reserve Bank of India (RBI) on credit to Reliance Industries Limited for three consecutive years from 2008-09 to 2010-11[3]. In such a scenario where large corporates are under-served, small and medium enterprises face even stiffer challenges in raising debt capital. In fact, the share of lending to small scale industry by public sector banks in India declined from 17.5% in 1998 to 8.5% in 2006 (Prasad, 2006).

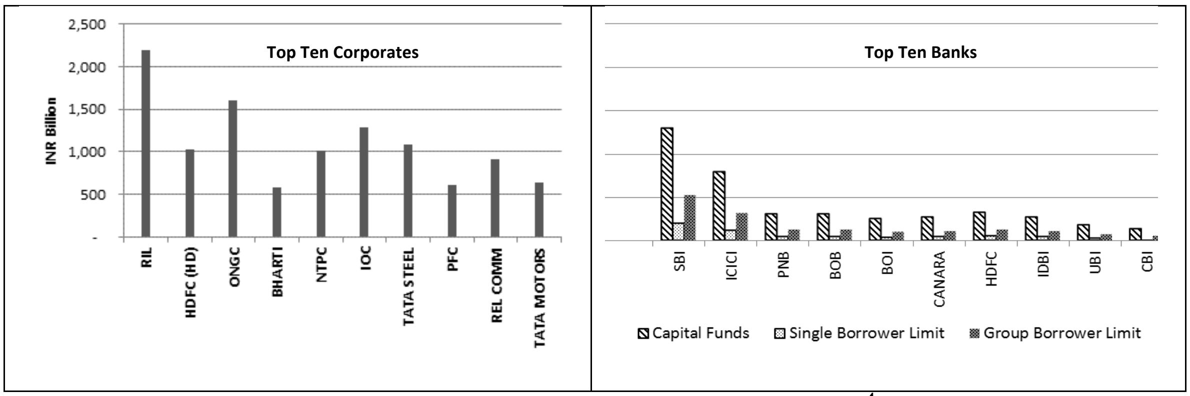

Figure 1: Asset size of top ten corporates and top ten banks of India[4]

In India, as of 2010, the proportion of bank loans to GDP was approximately 37% (Reinhart, C. M. & Rogoff, K. S.), while that of corporate debt to GDP was only 5.4% (BIS, 2012)[5]. According to the Securities and Exchange Board of India (henceforth SEBI) database, outstanding corporate bonds amounted to around INR 9 trillion in 2011 making it nearly 10.5% of GDP (SEBI, 2012). In contrast, corporate bond outstanding was nearly 90% of GDP in USA, 34% in Japan, & close to 60% in South Korea (BIS, 2012). For a sample of eight Indian corporations that featured in Forbes 2000, corporate bonds account for only 21% of total long term financing. In contrast, corporate bonds account for nearly 80% of total long term debt financing by corporations in the four developed economies of USA, Germany, Japan and South Korea.[6] In these countries, the share of corporate bonds in total debt financing is close to 87% for corporates graded above BBB and 66% for the rest. Corresponding figures in major emerging economies such as South Africa, Brazil, China and Singapore, are 57% for corporates rated above BBB and 33% for those rated at BBB or below respectively. All these indicate a tremendous potential for corporate debt market growth in India. Based on the experience of G7 countries since the 1970s, Goldman Sachs has estimated that the total capitalization of the Indian debt market (including public-sector debt) could grow nearly four-fold over the next decade from roughly USD 400 billion in 2006 to USD 1.5 trillion by 2016 (Goldman Sachs, 2007). This growth, if not crowded out by public sector debt, could result in increased access to debt markets for Indian corporates.

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[3] http://articles.economictimes.indiatimes.com/2011-06-10/news/29642992_1_exposure-prudential-limits-credit

[4] *Source*: Respective financial statements of the corporates and pillar-3 disclosures of the banks, 2011

[5] SEBI reports the total corporate debt outstanding as of March 2011 around INR 9 lac crores, which is around 9.5% of GDP at INR 50 per USD (SEBI, 2012).

[6] Based on data collected for a sample of 72 corporates across 9 countries, including India, for FY 2010-11.

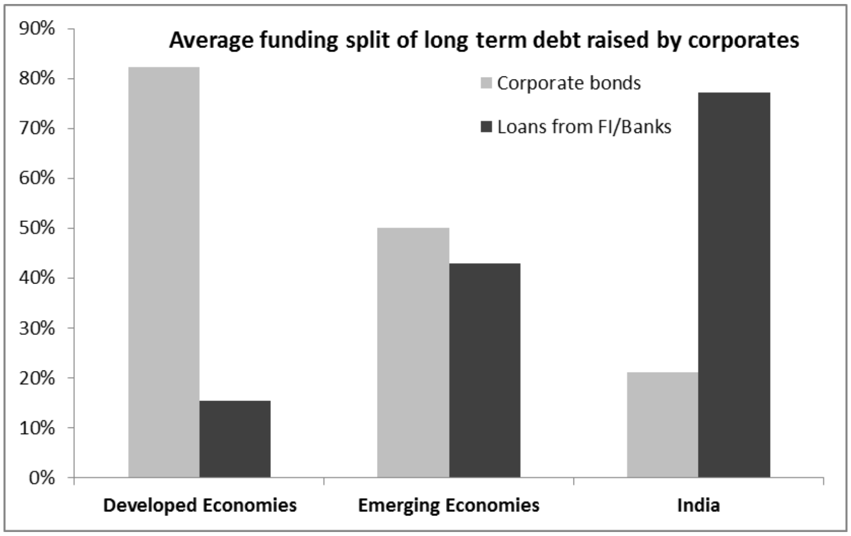

Figure 2: Funding split of long term debt raised by corporations

In India the long-term debt market largely consists of government securities. In 2011, the outstanding issue size of Government securities or Gsecs (Central and State Government) was close to INR 28 lakh crores or USD 622 billion (IndiaStat, 2012) with a secondary market turnover of around INR 53 lakh crores or USD 1.18 trillion (RBI, 2012).[7] In contrast, the outstanding issue size of corporate bonds was only INR 9 lakh crores or USD 200 billion (Khan, 2012) and secondary market turnover roughly INR 6 lakh crores or USD 133 billion (SEBI, 2010) in 2011. Turnover in the Indian equity market was roughly INR 47 lakh crores or USD 1.04 trillion (RBI, 2012) in the same time period.

The total corporate bond issuance in India is highly fragmented because bulk of the debt raised is through private placements. The dominance of private placements has been attributed to several factors, including ease of issuance, cost efficiency and primarily institutional demand (Ministry of Finance, 2005). Furthermore, trading is concentrated in a few securities, with the top five to ten traded issues accounting for bulk of the total turnover. The secondary market is also minuscule, accounting for only 0.64% of the total trading as of 2011 [**Error! Reference source not found.**] .[8]

[7] In 2011, 1 USD=45 INR approx.

[8] Source: Authors' own calculation using data from RBI Database, SEBI and IndiaStat

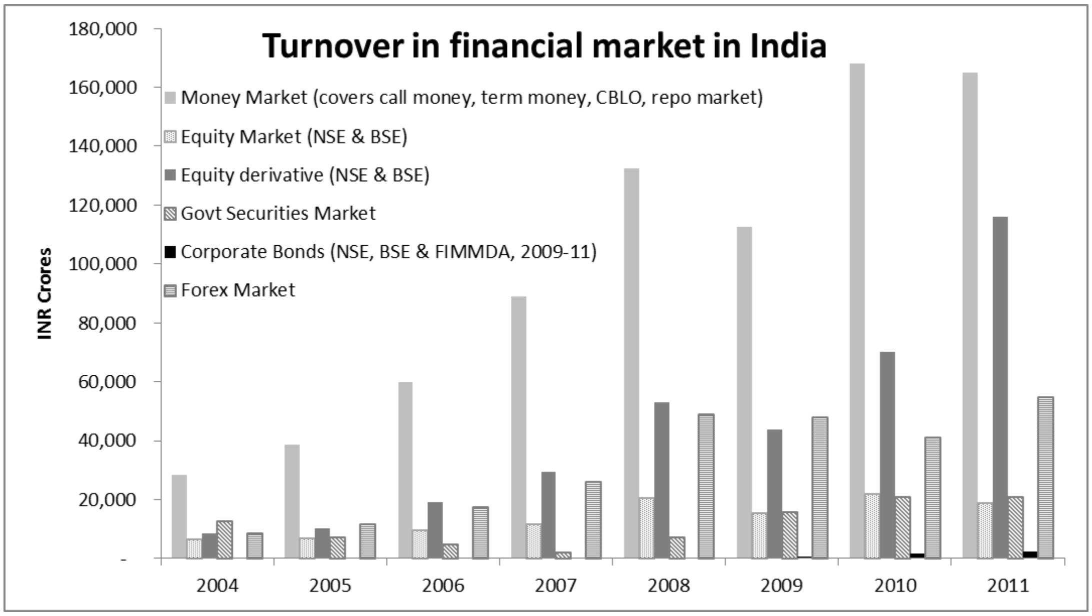

Figure 3: Turnover in Indian financial market
(Sources: RBI Database on Indian Economy, www.indiastat.com, SEBI)

Development of the domestic corporate debt market in India is constrained by a number of factors, the prominent ones being: low issuance leading to illiquidity in the secondary market, narrow investor base and high costs of issuance. The market suffers from deficiencies in products, participants and institutional framework. And this is despite the fact that India appears to be fairly well placed insofar as the pre-requisites for development of the corporate debt market are concerned. There is a reasonably well-developed government securities market, which generally precedes the development of the market for corporate debt securities The major stock exchanges in India have trading platforms for transactions in debt securities. Infrastructure also exists for clearing and settlement in the form of the Clearing Corporation of India Limited (CCIL). Finally, the presence of multiple rating agencies meets the requirement of an assessment framework for bond quality.

In order to put the development of the Indian corporate bond market into context, it will be useful to compare it with the corporate bond markets of other similar developing countries. South Africa is an instructive case study because like India, it is trying to address issues of capital market development in an environment of widespread poverty within a democratic framework. Additionally, South Africa is widely recognised as having created a uniquely innovative policy framework since their break from ‘apartheid’ in 1994.

3. The South African Corporate Debt Market Experience

Large fiscal deficit, high interest rates, inadequate market infrastructure, lack of transparency, excessive regulatory restrictions on the investment mandate of financial institutions, and distortionary tax and stamp duty regime are some of the key macroeconomic issues that may potentially hamper the development of a well-functioning corporate debt market in an emerging economy. Regulators and market participants alone cannot address all of these concerns. Some of these issues also need the political will to bring about legislative and fiscal reforms. In order to gain insight into the required reforms, it may be useful study the development of the South African corporate debt market, which underwent a significant transformation from being moribund into one that is large and vibrant.

3.1 India and South Africa- A Comparison of Initial Conditions

The long-term debt market (LTDM) reforms in South Africa lasted nearly two decades starting in the early 1980s. For the 1980s and leading up to the mid-1990s, the economic indicators convey that India fared better than South Africa. In this period, South Africa witnessed low economic growth (averaged less than 2%) and high fiscal deficit (averaged around 5%). India, on the other hand, had reasonable economic growth (averaged around 5%) and a moderate fiscal deficit (averaged around 3%) during the same period (World Bank Databank, 2012)

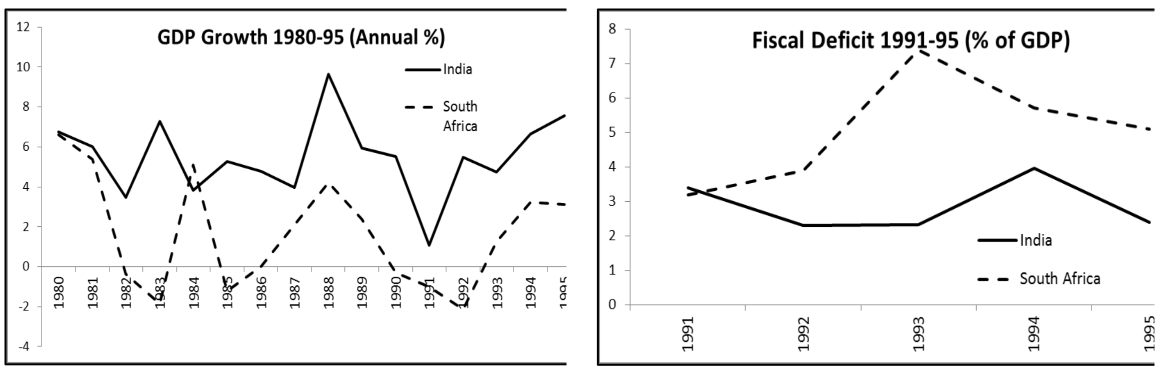

Figure 4: GDP growth and fiscal deficit during 1980-95 for SA and India

Both countries faced significantly high consumer inflation and lending rates during 1980-1995. The average inflation during this period in South Africa was 13.6%, while it was at 9.4% for India. The average lending interest rates were around 17% in both the economies during the period, though the lending rates in South Africa displayed much higher volatility than India (World Bank Databank, 2012).

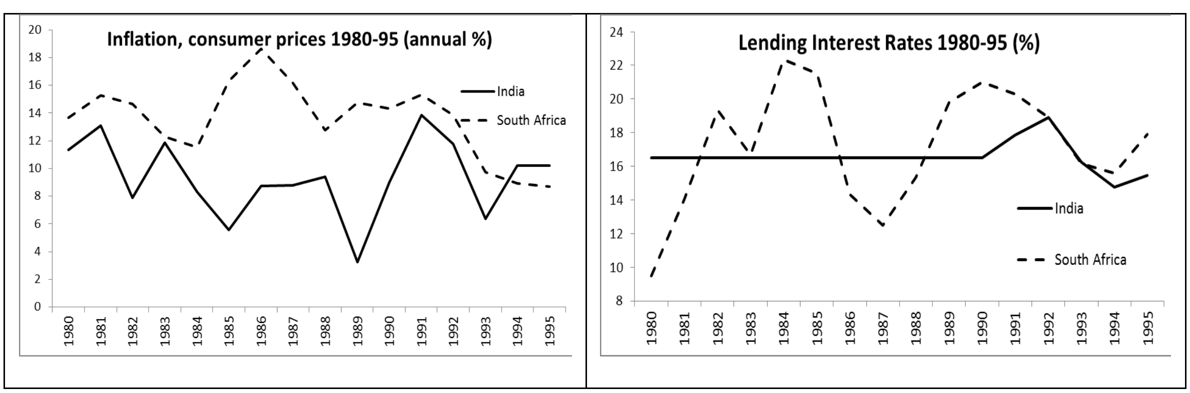

Figure 5: Inflation and lending rates during 1980-95 for SA and India

During early 1990s, both economies had a long term debt market dominated by government securities, with government debt-to-GDP ratio of around 30-35% until 1990, but diverging significantly in the 1990s. In 1995, the government debt-to-GDP ratio stood close to 45% in South Africa and 30% in India (Reinhart, C. M. & Rogoff, K. S.)

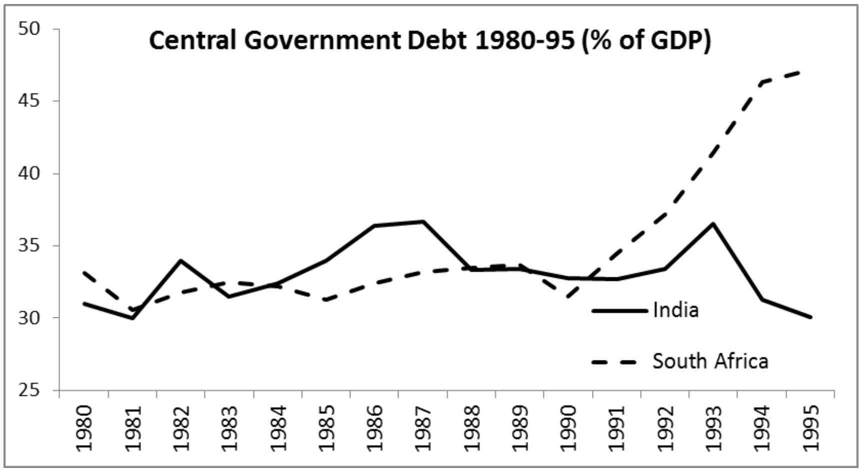

Figure 6: Central government Debt to GDP ratios during 1980-95 for SA and India

The corporate debt market was insignificant in both countries during the 1980s. The first corporate debt issue in South Africa was by South African Breweries in 1992. However, South Africa has traditionally had more depth in its capital market. The market capitalization of listed companies (as percentage of GDP) in South Africa was nearly 150% even during the early 1990s as compared to less than 50% in India. In 1996, the corporate debt issuance in India was only 0.56% of GDP (Kataria, 2010). Also, the domestic credit provided by banking sector was close to 150% of GDP in South Africa as compared to 50% in India during this period (World Bank Databank, 2012).

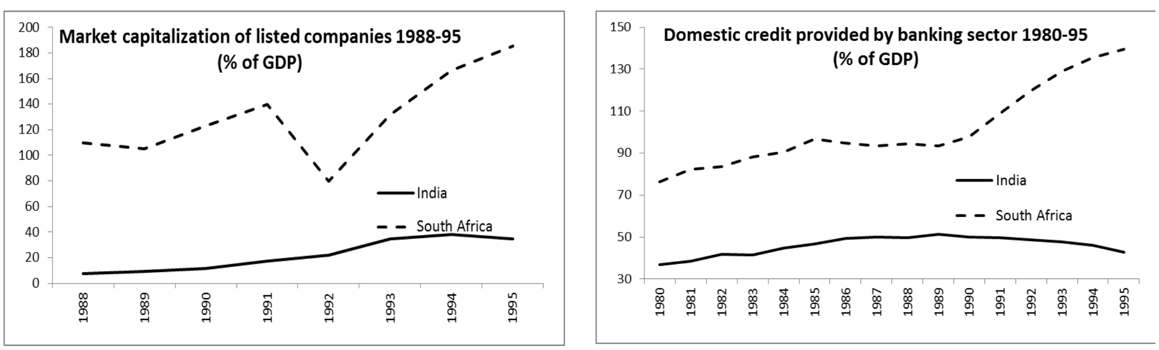

Figure 7: Market Capitalization of Listed Companies and Credit provided by banks during 1980-95 for SA and India.

The early 1990s' liberalization and privatization reforms in India coincided with a major economic transformation in South Africa. The policy reforms that began in early 1980s in South Africa and continued till late 1990s resulted in a remarkable improvement in the overall macroeconomic environment thereby providing a strong fillip to the emergence of a well-developed corporate debt market.

3.2 South Africa: Debt market reforms

The evolution of the South African debt market can be divided in four phases:

Phase 1: Repealing of the Prescribed Assets Act and consolidation of smaller issues to create benchmark rates

This phase started at the end of 1970s and continued till 1989. The South Africa government started issuing bonds at a discount on an open-ended tap basis after the Electricity and Supply Commission's (ESKOM) first discounted bond issue in 1981 (IMF & The World Bank, 2003). South African Reserve Bank (SARB) acted as the principal underwriter and the major issuers were the National Treasury, the Landbank, and public utilities (Guma, 2007). However, the market had negligible liquidity and the bond maturities were highly fragmented and limited to only 15 years (National Treasury, Republic of South Africa, 2008).

During 1980s the government also appointed various committees and commissions (the De Kock Commission, the Stals committee, and the Jacobs committee) to provide recommendations for South Africa's capital market reforms. The Jacobs Committee in 1988 suggested that the requirement for holding prescribed assets should be abolished and highlighted the need for market makers in government bonds (Davey, 1992). As per the Prescribed Assets Act, created in 1958 to generate funds for semi-government organizations and the development of South African homelands, the pension funds and the insurance companies were obliged to keep part of their assets as 'prescribed assets' in public sector debts (IMF & The World Bank, 2003). Until 1989, pension funds had to invest 53% of their assets and long term insurers had to invest 33% of their liabilities in government debt. The act provided encouragement for hold-till-maturity investor behaviour and proved to be a significant hindrance in the creation of a liquid debt market. By late 1980s, the Prescribed Asset act was repealed. Further, the South African government took the initiative to consolidate smaller issues to create benchmark in different maturities up to 20 years (Hove, 2008). As a result a nascent secondary market in government bond started developing.

Phase 2: Beginning of bond trading on the stock exchange and the creation of an electronic settlement system

This phase roughly covered the period from 1989 to 1996. The formation of Bond Market Association or BMA (with no exchange license) comprising bond issuers, intermediaries, banks, brokers, and investors marked the beginning of this phase. The aim of BMA was to formalize the market structure, achieve greater depth and increase transparency. The BMA started paper-script based trading through open outcry on Johannesburg Stock Exchange (JSE). Around the same time, SARB started acting as a market maker for government securities and public utilities started quoting bid and ask prices in their bonds.

In 1989, the major clearing and bond settlement banks, along with SARB, created Universal Exchange Corporation Ltd (UNEXCor) in order to develop an electronic settlement system using a central securities depository. In 1994, UNEXCor was appointed as the clearing house for the South African bond market. The secondary market in government and state owned entities was also developed during this period. The first corporate bond was issued in 1992 by South African Breweries (Standard Bank & BESA, 2007).

Phase 3: Establishment of the Bond Exchange and reforms in primary issues of government securities and public debt management

This phase began in 1996 when Bond Market Association (BMA) received the exchange license. BMA was soon transformed to Bond Exchange of South Africa (BESA), a self-regulated organization (SRO), that would operate within the rules and directives set by Financial Services Board (FSB) (Oxford Business Group, 2008). The establishment of a formal bond exchange was one of the recommendations of the Jacobs committee. BESA adopted the G-30 recommendations on clearing and settlement and established UNEXCor as a recognized clearing house (IMF & The World Bank, 2003). During the same period, South Africa decided to follow the widely accepted regular auctions practice as a method of selling primary issues of the government securities. In 1998, South African Reserve Bank (SARB) was made responsible for conducting auctions of benchmark bonds on behalf of the National Treasury. A formal system of market making was put in place and primary dealers were appointed to quote bid-ask prices and to provide liquidity in the secondary market for government bonds.

During the early 1990s, the South African economy was grappling with high fiscal deficit of around 4-7% of GDP, soaring government debt at 45% of GDP and high interest rates of nearly 16-18% (World Bank Databank, 2012). In 1996, the government decided to review its entire debt management policy and instituted important components of reform.

A framework for managing government debt, cash and risk was put in place. The framework identified certain gaps in the debt management and monetary policy of the government such as the incoherent funding activities among state owned enterprises and the lack of coordination between the national treasury's liability management and SARB's monetary operations. In order to address the latter, a detailed work plan was developed for the public debt management committee (National Treasury, SA).

The reform initiatives resulted in the Public Finance Management Act (PFMA) of 1999 and the Municipal Finance Management Act (MFMA) of 2003.

Phase 4: Implementation of Basel-II guidelines and improvement in various economic indicators

This phase began in 2001 and witnessed a remarkable increase in the issuance of corporate bonds. The period was characterized by four factors: (i) lower interest rates; (ii) underleveraged corporates; (iii) reduction in fiscal deficit resulting in low supply of new government debt; and (iv) implementation of BASEL-II norms leading to migration of corporate loans from bank balance sheets to capital markets (Rand Merchant Bank, 2001) as a result of pressure on banks to correctly price corporate loans.

In 2000, the outstanding nominal corporate debt was less than Rand 25 billion. By 2007, there were more than 800 outstanding corporate debt issues resulting in a nominal outstanding amount of Rand 265 billion, which accounted for 34% of the total outstanding listed debt in South Africa

(Standard Bank & BESA, 2007). By 2010, the outstanding size of the corporate bonds in South Africa was nearly 20% of the GDP and accounted for nearly 40% of the total South African bond market (Mu, Phelps, & Stotsky, 2013).

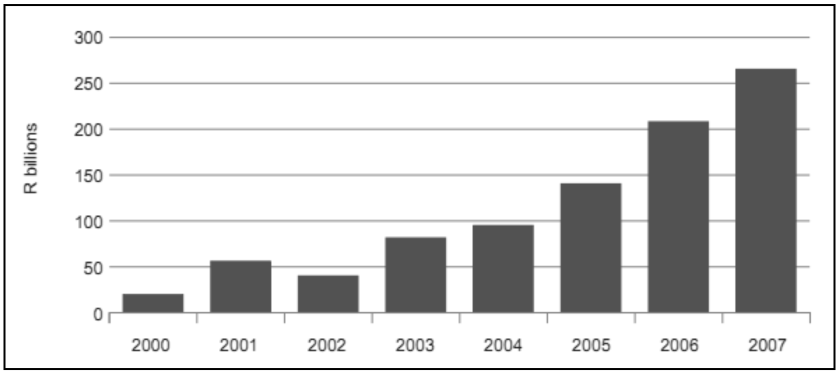

Figure 8: SA Corporate Bonds Nominal Outstanding 2000-07

4. India & South Africa: Current Status

The economic and debt market reforms in South Africa, which were initiated in 1996, resulted in significant improvements in various economic and market indicators. In particular, the diverging trends of fiscal deficit-to-GDP and government debt-to-GDP ratios over the years in South Africa and India provide strong evidence of the efficacy of reform measures adopted by South Africa.

During 2000-2008, South African economy grew at an average rate of 4 to 5% (World Bank), fiscal deficit as a percentage of GDP declined from 5% in 1997 to a fiscal surplus of 0.9% in 2008 (Trading Economics), consumer price inflation remained less than 9% and interest rates declined from 22% in 1998 to 12% in 2005 (World Bank). During the same period, Indian economy displayed significant growth (6 to 8%), inflation remained low (and varied in the range of 4 to 6%), and interest rates declined from 14% in 1997 to less than 12% in 2006 (World Bank). However, fiscal deficit in Indian economy remained high in the range of 3 to 5% of GDP throughout the period (Trading Economics). Though a lot of public infrastructure projects were undertaken by the Indian government during this period (such as the Golden Quadrilateral highway project connecting the four metros in India) resulting in huge public spending, the opposite movement of fiscal deficit in the two economies nevertheless signifies the importance of the public debt management reforms undertaken by South Africa during mid and late-1990s. While India adopted the economic reforms in early 1990s, no substantial initiatives were taken to reform the management of public finances.

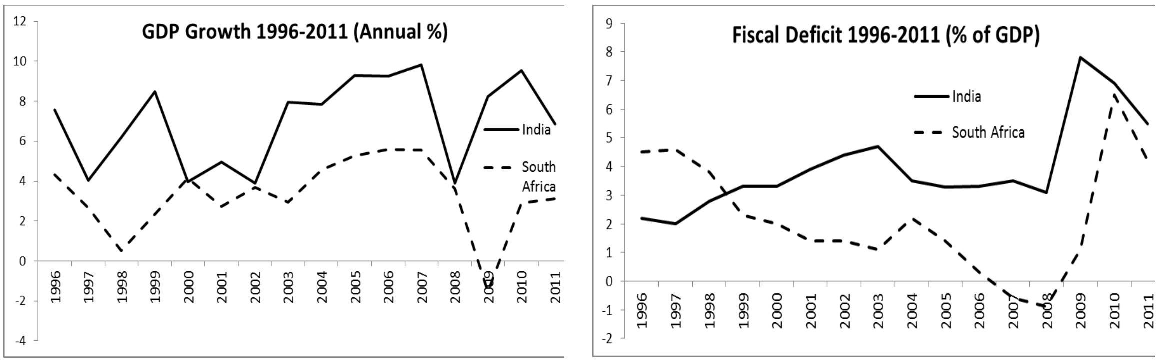

Figure 9: GDP Growth rate and Fiscal Deficit during 1996-2010 for SA and India

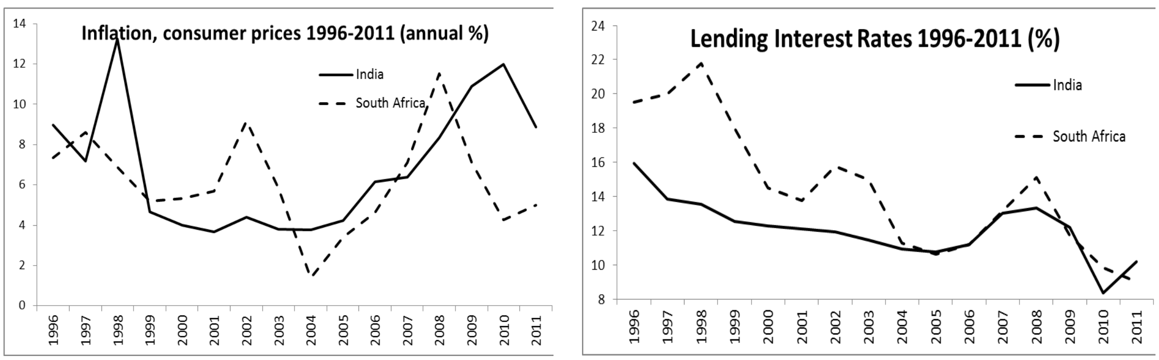

Figure 10: Inflation and Lending Interest rates during 1996-2010 for SA and India

As a result of prudent public debt management, South Africa witnessed a decline in government debt-to-GDP ratio from close to 50% in late 1998 to less than 30% in 2008. In India however, the debt-to-GDP ratio has risen sharply in this period, from less than 30% in 1998 to around 40% during 2000-08 (World Bank). This has resulted in the bond market in India significantly dominated by the government securities, with outstanding corporate bond issues at less than a third of the outstanding government bond issues in 2011.

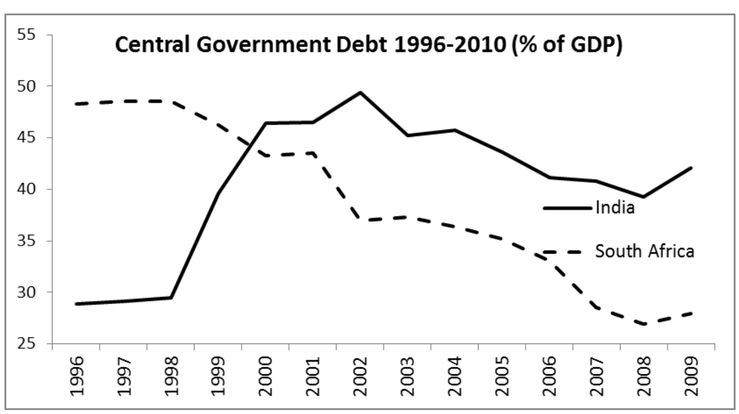

Figure 11: Central Government Debt to GDP ratio during 1996-2010 for SA and India

Role of Insolvency Mechanism

One of the required components of a corporate bond market is a reliable and efficient insolvency framework to ensure that bond holder's interest is protected in the event of financial distress for the bond issuer. Traditionally both India and South Africa have had comprehensive legal frameworks governing corporate insolvency but there are multiple governing authorities and statutes which make the mechanism complex and time consuming. Though insolvency framework reforms began in South Africa, for example the New Compaies Act 71 of 2008 implemented in 2011 which introduced the compromise and business rescue mechanism to expedite the debt recovery and curtail the asset value erosion, we have not been able to conclude if the reforms had played significant role in the South African bond market development. In India, the role of the New Companies Bill, approved recently in 2013, is yet to be seen in reforming the corporate insolvency mechanism.

5. Conclusion and Key lessons for India

It follows from the above discussion that during 1980-90s South African debt market was facing issues, which were not much different from what the Indian debt market is facing today. These include large fiscal deficit, a debt market dominated by government bonds, high interest rates and restrictive investment mandates imposed on financial institutions. The market and policy level reforms adopted by South Africa addressed these issues and resulted in the emergence of an efficient debt market. Against this background, the following are a few potential reforms relevant in the Indian context:

Investment Mandates for financial institutions: Rationalization of investment norms for financial institutions and funds will help to remove various investment bottlenecks that may have prevented the development of a well-functioning corporate debt market in India. According to the eligible Statutory Liquidity Ratio (SLR) investments, banks are required to hold 24% of their liabilities in cash, gold, central and state government investments, thereby leaving non-government bond market instruments completely out of the picture. Similarly, as per the norms for insurance company investments, which cover the following businesses: life insurance, pension and general annuities, unit linked life insurance, general insurance and re-insurance, funds are permitted to invest in corporate bonds, but the category of "approved investments" only includes bonds rated AA or above. Bonds below AA, can be held in unapproved assets. However, total unapproved assets cannot exceed 15% of the portfolio. In practice, insurance companies hold less than 7% in unapproved assets. For instance, as of 2011 and 2012 the proportion of unapproved assets in the total investments by life insurance companies were 4.85% and 4.42% respectively (IRDA, 2012). Restrictive investment mandates tend to limit participation of financial institutions in primary as well as secondary debt market. Further, such norms may result in long term holding of government debt in skewed proportions, illiquidity as well as lack of pricing information. When financial institutions do not have a large pool of qualifying assets to choose from, it may result in an excess demand for government debt, in turn resulting in mis-priced government debt markets. Relevance of such investment mandates may need to be revisited from time to time.

Consolidation of issues to create benchmarks: Pricing and liquidity is a classic ‘who follows whom’ conundrum. The consolidation of existing bond issues reduces the maturity fragmentation and provides benchmark rates for certain maturity tenures which result in enhanced pricing transparency and, in turn, promotes liquidity. Further, it is essential that benchmarks should be made for an appropriate range of maturity tenures covering differing needs of the bond investors.

Pricing of corporate loans on bank balance sheets: One of the major factors responsible for the development of corporate bond market in developed economies has been the movement of corporate loans from banks’ balance sheets to capital market. When the capital requirement for holding the corporate debts on the balance sheet becomes too high and results in lower return on equity, the bank may be forced to trade the debts actively. Effective pricing of on-balance sheet corporate debt and risk based capital allocation by the banks will encourage active trading of debt and better price discovery.

Controlling fiscal deficit in a sustained manner and public debt management: High fiscal deficit and high interest rates may keep corporate borrowers away from debt markets. Better coordination of public debt management and monetary operations is essential to deal with these issues. Further, an effective legal framework ought to be in place to ensure proper public debt and cash management. The RBI Act of 1934 provides the essential framework for the management of the public debt of the central and state governments. The Public Debt Act of 1944 was replaced by the Government Securities Act of 2006 which provides RBI the powers to issue and manage the government debt securities.

Regulatory and policy level reforms may prove to be more effective when designed and implemented in coordination with market participants. Further, self-regulation by market players may be more effective than any enforced control. Issues such as crowding of debt markets by government securities cannot be addressed by market participants and regulators alone; better management of public debt and cash could result in a reduction in the debt requirements of the government, which in turn would provide more market space and create greater demand for corporate debt securities. Clearly, the market development for corporate bonds in India is likely to be a gradual process as experienced in other countries. Regulators as well as market participants need to play a proactive role. It is important to understand whether the regulators have sufficient willingness to shift away from a loan-driven economy and also whether the corporations themselves have strong incentives to help develop a deep bond market. Only a conjunction of the two can pave the way for the systematic development of a well-functioning corporate bond market.

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