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Understanding Bonds, the Bond Market: Opportunities for Investments in the Indian Securities Market for Retail Investors

The bond market stands as the world's largest securities market, offering investors an extensive range of investment options. While many investors are familiar with certain market aspects, the increasing number of new products poses a challenge to maintaining their pace. Initially perceived as a means of generating interest while safeguarding capital, bonds have transformed into a $100 trillion global marketplace that can provide numerous potential benefits to investment portfolios, including lucrative returns.

The objective of this article is to cover the legal framework of bonds in India, different types of bonds, advantages and risks associated with bond investments, taxation aspects to be factored, different types of retail investor and their investing strategies, tailwinds and headwinds for retail participation, and the role of Chartered Accountants in this securities market for retail investors.

Understanding Bonds

A bond is a financial instrument that facilitates borrowing between a borrower and a lender.

It comprises three fundamental elements:

1. Borrower/Issuer: The party that seeks to borrow funds.
2. Lender/Investor: The party that provides the funds for borrowing.
3. Financial Document: The formal document that outlines the terms and conditions of the bond.

What is the Bond Market?

A bond market is a place where the borrower/issuer and the lender/investor agree on the terms and conditions of the arrangement, like tenure, rate of interest, security, terms of repayment, etc. This arrangement gets documented in the form of a financial document providing legal acceptance of the terms and conditions. Basis the accepted terms and conditions, the fund flows in the bond market from the lender/investor to the borrower/issuer and vice versa. In a nutshell, the bond market serves as a platform for the movement of funds between the parties involved in the bond process.

The bond market can be further bifurcated into two main segments: the primary bond market and the secondary bond market.

- In the primary bond market, new bonds are issued.
- The secondary bond market provides liquidity by allowing investors to trade existing bonds.

Participants in the bond market include the government, institutions, and retail investors.

The Indian Bond Market, its process, legal framework, and benefits can be encapsulated in the word - **"DREAM".**

Demat and KYC Compulsory: For investment in a bond, a demat account and KYC of the investor is the current setup, is mandatory requirement.

Regulated and Structured Setup: The bonds are regulated by RBI and SEBI, providing legal status to the bond issuance and investment process.

Efficient Risk Management: Bonds enable efficient portfolio diversification and thus assist in portfolio risk mitigation.

Aligned with goals: Different types of bonds are available and can be aligned with short-term / long-term goals of the investors.

Hold till **M**aturity: Bonds provide the best returns when the same are held till maturity.

Regulated and Structured Setup

- Bonds derive its legality from the Securities Contracts (Regulations) Act, 1956. Section 2 of The

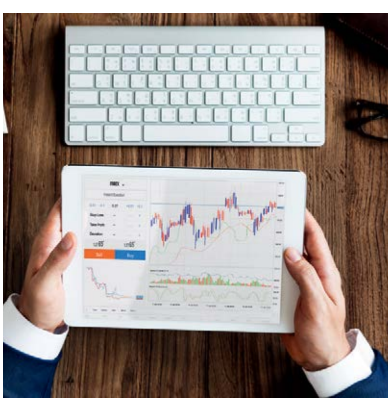
Securities Contracts (Regulations) Act, 1956.

- Reserve Bank of India: RBI regulates and facilitates the government bonds and other securities on behalf of governments. The Government Securities Act, 2006 (G S Act) is an act related to Government securities and is managed by the RBI.
- Securities and Exchange Board of India (SEBI): SEBI regulates bond instruments and processes pertaining to listed corporations, commercial banks, and public sector undertakings.

The above two regulators broadly govern and regulate the Bonds issued in the Indian market.

Bond Market – Need for retail investors

- **Missing bridge between FDs/ Debt MFs/Other savings instruments & Equity investments:** There is a clear market gap for products offering returns between 8-12%.
- **Limited investment options beyond Equity:** Investors can utilize bonds for trading and investment purposes, offering limited downside risk and enhanced returns.
- **Challenges with investment in Bonds via Debt MFs:** Debt MFs offer easy investment and withdrawal, but incur high intermediary costs (3%-4%), reducing returns significantly.



- **Challenges with bond market accessibility and understanding:** Manual processes, limited availability of bonds, and high ticket size.

Advantages of investment in bonds

Four key advantages of investment in bonds for retail investors:

- **Portfolio Diversification:** Bonds are an efficient portfolio diversification instrument and assist investors in overall portfolio risk management.
- **Regular Income Stream:** Bonds provide investors a regular and steady source of income
- **Low market Volatility:** Bonds carry very low volatility as compared to other investment assets like equity or mutual funds.
- **Loan against bonds:** The bonds are securities and considered as assets, which can be pledged, and a loan can be availed by the investor for personal and business purposes.

Types of Bonds

Based on the type of issuers, the bonds are classified into the following segments:

Market Segment and Issuer/ Instruments

A. Government Securities:

- **Central and State Governments:** Zero-Coupon bonds, Coupon-bearing bonds, Treasury bills, STRIPS, State Development Loans

B. Public Sector Bonds:

- **Government Agencies/ Statutory bodies:** Govt. Guaranteed Bonds and debentures, Municipal debt securities
- **Public Sector Units:** Bonds, Commercial Paper

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C. Private Sector Bonds:

- **Banks:** Certificate of Deposits, Bonds, Structured Instruments, Perpetual bonds
- **Financial Institutions:** Certificate of Deposits, Bonds, Structured Instruments, Commercial Paper

I. Government Securities:

These bonds are issued by the Central Government or the State Governments to fund financial requirements. These bonds are considered most safe and practically risk-free, due to the sovereign backing of the issuing government.

Benefits	Key features
High Liquidity in Secondary Markets	**Safety:** Highest (Sovereign)
Wide range of tenors available	**Issuers:** Government of India State Governments (SDL)
G-Secs can be used as collateral for equity derivatives	**Tenure:** 91 Days- 40 years
Buy and Sell anytime in secondary markets	**Fixed Returns:** Yield to Maturity: 6-8% p.a
	Investment: Minimum Investment – INR 100

II. State Guaranteed bonds:

These bonds are issued by state-owned corporations and are guaranteed by the state government. Since the bonds are backed by the creditworthiness of the state, there is an extra layer of security for investors.

Benefits	**Key features**
High safety due to state guarantee	**Safety:** High Safety- AA/A rating
Higher returns than Government Bonds	**Issuers:** State-owned entities such as U.P. Power Corporation, Kerala Infrastructure Investment Fund, etc
Tax benefit in certain jurisdictions	**Tenure:** 5 – 10 years
	Fixed Returns: Yield to Maturity: 8.5 – 10 % p.a
	Investment: Minimum Investment – INR 1 lacs

III. Corporate Bonds:

Companies raise money by taking loans, issuing equity, and also by issuing corporate bonds. These bonds are purchased by investors, who then receive regular interest and principal payments from the issuing corporate entity.

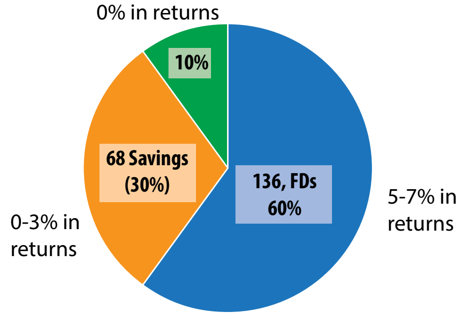
Benefits	**Key features**
Large universe of >10,000 bonds giving a wide selection of issuers, returns, maturity, rating, and payment frequency	**Safety:** Investment grade - Credit rating AAA/AA/A/BBB
Buy and sell anytime in secondary markets	**Issuers:** Over 1000 Corporations
	Tenure: 1- 10 years
	Fixed Returns: Yield to Maturity: 8-14% p.a (Investment Grade)
	Investment: Minimum Investment – INR 1000

With different entities borrowing money for their respective businesses, the interest rates are subject to a great degree of variation by virtue of several issuer-specific and non-specific factors. Generally, corporate bonds have a higher rate of interest than government bonds, and that is the primary reason for considering investment in corporate bonds.

Bond market – Potential

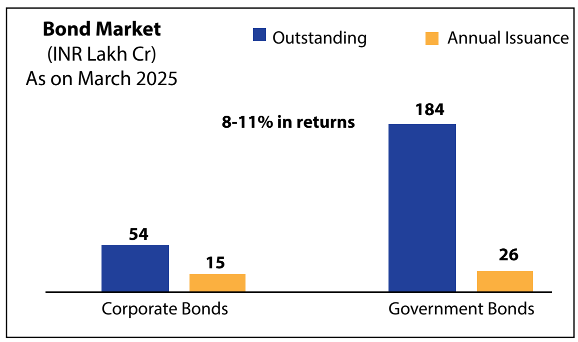
Bank Deposits

(INR Lakh Cr)
As on March 2025



- Outstanding Bank Deposits – INR 227 Lakh Cr

Source : *RBI*



- Bonds Outstanding – INR 238 Lakh Cr (~ $ 2.78 trillion)
- Growing at a CAGR of 20%, expected to double every 3.5 years.
- The Bond Market is almost 2/3rd of GDP & Equity Market and is expected to become larger than the equity market.
- Retail Investment in Bonds is still negligible – a market of – 70 cr PAN holders.

As compared to global peers, India's bond market stands at 0.65X of equity market capitalization, compared to 1.2-2.0x in developed countries.

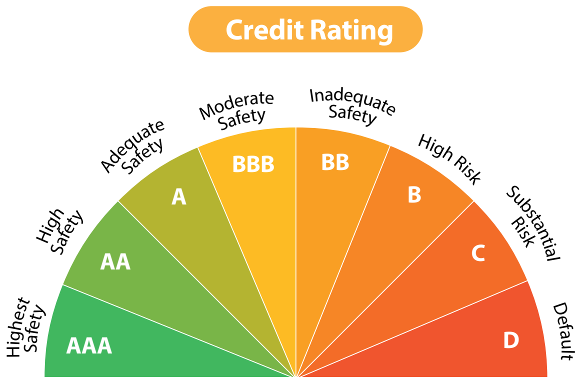
Bond Ratings by Credit Agencies

Bond ratings determine the creditworthiness of a bond issuer. These ratings provide insight into whether the issuer can meet the terms of the bond agreement, including timely repayment of the principal and interest.

SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 makes it mandatory for the issuer to obtain at least one credit rating from the registered credit rating agencies and disclose the same in the offer document.

As per the regulations, if the credit ratings for an issue are obtained from multiple credit rating agencies, all ratings, including unaccepted ones, must be disclosed in the offer document.

Bond ratings range from AAA to D, with AAA representing the highest level of creditworthiness and D signalling a default by the issuer. The following pictorial illustrates the credit rating across different grades.



In India, popular bond rating agencies are CRISIL, ICRA, CareEdge, and India Rating and Research. Globally, some of the famous rating agencies in the world are S&P, Moody's and Fitch. The rating criteria of these agencies are a mix of several internal and external attributes. The hollowing table depicts the ratings that are considered as Investment Grade and Non-Investment Grade category:

Grade	Rating	Description
Investment Grade	AAA	Lowest level of credit risk
	AA+, AA, AA-	Very low credit risk
	A+, A, A-	Low credit risk
	BBB+, BBB, BBB-	Moderate credit risk
Non - Investment Grade	BB+, BB, BB-	Substantial credit risk
	B+, B, B-	High credit risk
	CCC+, CCC, CCC-	Very high credit risk
	CC	Highly speculative
	C	Highest level of credit risk
	D	Currently in default

The above ratings can help the investors to determine the issuer ability to fulfil the terms of the contract. They are an efficient tool to gauge the risk profile of an investment. Before making an investment, investors should understand the bond rating scales and categories, analyse their risk appetite and make the investment decision.

> "Companies raise money by taking loans, issuing equity, and also by issuing corporate bonds. These bonds are purchased by investors, who then receive regular interest and principal payments from the issuing corporate entity."

Risk Associated with Bond Investments

I. Credit Risk or Default Risk

Credit risk is the risk of losing money because someone doesn't keep their promises. For instance, if you invest in a bond with an AAA credit rating, it means the bond has a very strong credit rating, and the chances of it defaulting are extremely zero. But if you invest in a bond with a credit rating of C or lower, you're much more likely to lose money if it defaults.

II. Interest Rate Risk

Bond prices and interest rates are like two peas in a pod. When interest rates go up, bond prices tend to take a nosedive. But when interest rates drop, bond prices tend to soar!

Imagine you're buying a bond that pays a 5% yield. If interest rates suddenly jump to 6%, you'd be tempted to sell your bond and buy one that offers a higher yield. And guess what? Thousands of other investors would feel the same way, leading to a flood of bonds with a 5% yield in the market. But since there aren't many buyers, the bond price will naturally go down.

Now, let's say interest rates take a dip to 3%. In this case, investors will be more likely to hold onto their bonds. But here's the catch: there's still a huge demand for bonds with a higher yield. So, the bond offering a 5% yield will see its price skyrocket.

That's what interest rate risk is all about! It's the fear that your investment value will take a hit when interest rates rise. It's a balancing act between the potential for higher returns and the risk of losing money.

III. Reinvestment Risk

Reinvestment risk is like the risk of not getting the same return on your investment when you reinvest the money you earn. In simpler terms, it's the chance that the money you make from an investment won't grow as much if you put it back in the same place.

Let's say you invest in a bond that pays 10% interest every year. You earn 50,000 rupees at the end of the year, and you decide to put it back in the bond. But then, the interest rate goes down to 8%. So, instead of earning 10% interest, you'll only earn 8% interest on your reinvestment. That's reinvestment risk in action.

“Bond ratings determine the creditworthiness of a bond issuer. These ratings provide insight into whether the issuer can meet the terms of the bond agreement, including timely repayment of the principal and interest.”

IV. Liquidity Risk

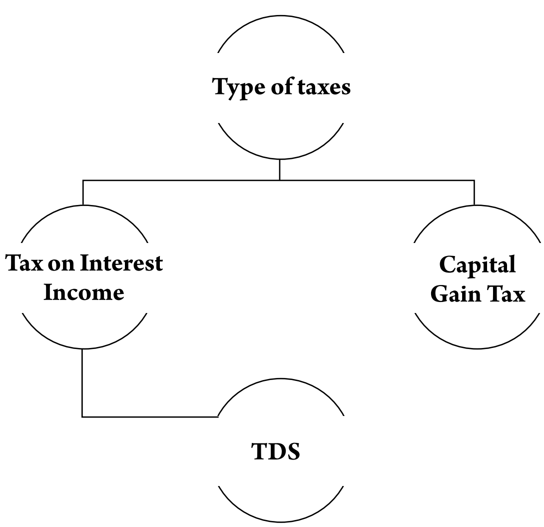
When there aren't many buyers and sellers in the market, it's called liquidity risk. Bonds are usually less liquid than stocks. This can happen if the investors who bought a bond are mostly holding it for the long term, so there aren't many buyers and sellers. It can make it harder to buy or sell the bonds. Even if the bonds are listed on an exchange, there's no guarantee that a liquid secondary market will form. Unlike the huge demand for government bonds, the market for corporate bonds is still pretty small. This means investors could face liquidity risk, where they might not be able to sell their bonds if they want to.

V. Call Risk

Some bonds have a special feature called callability. It means the issuer can choose to buy back the bond before it's supposed to end. But here's the catch: if interest rates are lower than when we bought the bond, we might face some reinvestment risks.

Let's say we invest in a bond with a 8% yield and a 10-year maturity. The bond has a call protection period of four years. After that, the issuer decides to call the bond because interest rates have dropped below 8%. Even though we get a bit more money for the principal, the drop in interest rates makes it tough to reinvest the amount.

Taxation aspects



Taxes on Interest Income:

- Tax payable on receipt of interest income vis-a-vis accrual of interest as in FDs
- Tax Slab: Slab rate applicable to the person
- Individual: Maximum tax rate is 42.74% (From FY 2024-25)
- Corporate: Now ~ 29%

TDS:

- As per Section 193 of the Income Tax Act, 1961, 10% TDS for all listed bonds.
- For NRI, as per section 195 of the Income Tax Act, 1961, 20% TDS for all listed bonds.
- For Cumulative interest bonds, cumulative TDS will be deducted at maturity

Capital Gains - Long term / Short term:

The capital gains imposed on taxable bonds depend on the holding period.

	Listed	
Holding Period	< = 12 months	> = 12 months
Type of Capital Gain	Short term	Long Term
Tax Rate	Income Tax Slab Rate	12.5% without Indexation

- **Tax-free bonds**: Issued by PSUs – Interest Income is exempt from income tax. However, any capital gains on the sale of such bonds would be taxable.
- **54 EC Bonds:** Used to save tax on long-term capital gains arising from the sale of a property. The interest is usually paid annually or compounded and paid at maturity.
- **Sovereign gold bonds:** Investor receives 2.5% interest on the face value, and maturity value of the bond is equal to the price of gold on the maturity date. Interest income taxable, add slab rate, no TDS on interest income. Capital gains are taxable only if sold in the market before maturity, but are exempt on maturity.

Retail Market Participants and Investing Strategies

Retail investors can be categorised into three distinct segments:

Mass Market Investors: These investors generally possess lower levels of financial education, have limited financial resources, value liquidity, and easy access to cash. Their investment strategies are typically self-directed or facilitated through employer plans, relying on peer recommendations.

Affluent Investors: Historically, affluent investors have demonstrated a higher level of financial knowledge. They

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often seek professional guidance to make informed investment decisions and have access to substantial investment budgets and a greater capacity for valuing liquidity.

High-Net-Worth Investors: High-net-worth investors generally demonstrate higher financial literacy levels. They frequently seek guidance from financial advisors for portfolio allocation. Their substantial investment budgets and intricate investment strategies often lead to a greater propensity to consider illiquid assets.

The investing strategy varies across the different types of investors:

Investor Type	Struggling to find products matching risk preferences	Find Products matching risk preferences through a Financial Adviser	Uncomfortable with Loss in the Short or Long Term
Mass market	15%	30%	34%
Affluent	9%	39%	17%
HNI	2%	47%	10%

Tailwinds for retail participation

- **Reduction in Face Value:** Lowering the face value from 10 lakhs to 10,000 for private placements.
- **Debt IPO limit adjustment:** Reducing the limit for Debt IPOs to INR 10 crores (Face value INR 1000).
- **Retail access via cash segment of Exchange & RFQ platform:** Empowering retail investors to trade bonds through the cash segment of Exchange as well as RFQ platforms.
- **Guidelines for Online Bond Platform Providers (OBPP):** Regulatory Framework and Working Group set up by SEBI to enhance retail participation in the bond market.

Headwinds for retail participation

- The bonds purchased are credited to the investor's demat account. The demat account is governed and regulated by SEBI through the Depositories Act, 1996. The demat account has stringent rules, regulations, and monitoring frameworks for conducting Know Your Customer (KYC) of the investor. Therefore, for onboarding the investor for bond purchase, instead of the requirement of full KYC, the entire KYC process should be minimised, and a simple declaration should suffice. This will also facilitate an increase in participation from Non-Resident Indian (NRI) retail investors.
- For lower tax deductions or no deductions at all, an automated validation process should be implemented. This validation can be built by the issuer directly with the Income Tax portal, thereby minimising the burden of tax compliance, particularly for senior citizens.
- Education and Awareness Program: A comprehensive education and awareness program to be conducted on a regular basis to raise awareness about the benefits and risks associated with bond investments, particularly those issued by Non-Banking Financial Institutions (NBFCs), which are regulated entities within the banking system.

Role of Chartered Accountants

While the equity market receives substantial attention in public discourse, the corporate bond market in India has experienced steady growth and holds substantial potential for raising long-term capital. Despite its growth, India's corporate bond market remains relatively underdeveloped compared to global standards. This is primarily attributed to factors such as low liquidity in corporate bonds, complex regulations, credit risk, and limited awareness among retail investors. However, there are significant opportunities available. As Chartered Accountants, we can assist in bridging these gaps by educating both businesses and investors about the advantages and risks associated with the corporate bond market, as well as its significance in the overall growth of the economic and investment portfolios.

Conclusion

The bond market presents a stable investment avenue, with government bonds offering the utmost security. The growing institutional and retail participation is bolstering market liquidity and resilience. Furthermore, bonds serve as a diversification tool, extending beyond the traditional stock portfolio. The increasing institutional demand for bonds is positively impacting liquidity. Technological advancements have democratised bond investments, enhancing their accessibility and transparency. If the analysis holds true, this will empower investors to achieve consistent returns.

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