

Qoncept

From Storage to Circulation: Can Total Return Swaps Transform India's Corporate Bond Market?

India's corporate bond market has grown steadily in size and importance, becoming an essential pillar of the broader fixed-income ecosystem. Yet, despite this growth, liquidity remains shallow compared with developed global credit markets.

Trading activity is largely concentrated in government-backed issuances — particularly PSU bonds — or highly rated corporate paper. Lower-rated credits often remain locked in portfolios under a buy-and-hold framework, limiting secondary market depth.

The result is a structural imbalance:

- Q Active trading exists only at the top end of the credit spectrum
- Q Risk transfer is limited
- Q Price discovery weakens, especially during periods of stress

When market shocks emerge, AA- and lower-rated bonds are typically the first to feel the pressure. Buyers disappear, spreads widen sharply versus government securities, and prices begin reflecting fear rather than fundamentals.

The core issue is clear:

India's corporate credit market lacks mechanisms that allow risk to move without forcing ownership to change.

What's Missing in the Ecosystem?

Government securities benefit from a mature support structure:

- Q Repo markets
- Q Active market makers
- Q Deep derivatives participation

Corporate credit, however, lacks development of a comparable ecosystem.

Without efficient tools for risk mitigation or transferring credit exposure, investors are often forced into a binary choice:

Hold to maturity – or exit entirely.

This structural rigidity limits liquidity and discourages broader participation.

Enter Total Return Swaps (TRS)

A Total Return Swap is a financial derivative contract where one party transfers the total economic return of an asset to another party without transferring ownership of the asset.

It allows investors to gain economic exposure to a bond – or a basket of bonds – without physically owning the securities.

In a TRS, two parties enter into a contract:

- Q Total Return Receiver:** receives the full economic return of the underlying asset
 - coupon income
 - capital gains or losses
- Q Total Return Payer:** receives a funding leg
 - typically linked to a benchmark such as MIBOR plus a spread

The key innovation:

No bond changes hands. Only economic returns are exchanged.

TRS creates exposure without ownership – performance without paperwork.

Applying TRS to Corporate Bond Indices

The FY 2026–27 Budget’s proposal to introduce TRS on corporate bond indices represents a meaningful structural step forward.

Instead of locking capital into individual bonds for long durations, investors could:

- Q** Take exposure to diversified corporate bond indices
- Q** Transfer credit risk dynamically
- Q** Manage portfolio risk more efficiently
- Q** Improve effective liquidity without disturbing underlying holdings

Institutions better equipped to manage or offset credit risk can warehouse it, creating a more fluid risk-transfer ecosystem.

Why This Matters

India's corporate bond market remains structurally shallow — particularly below AA ratings.

Key challenges include:

- Q Thin secondary market liquidity
- Q Sharp spread widening during periods of stress
- Q Inefficient and delayed price discovery

In practice, the bond market often behaves more like a fixed-deposit book than an active capital market.

The introduction of TRS signals a philosophical shift:

From → Buy and hold

To → Trade, manage risk, and transfer risk

This is not merely a product innovation — it is an architectural change.

The Policy Context

The move aligns with broader policy goals aimed at strengthening India's fixed-income ecosystem:

- Q Improving liquidity
- Q Enhancing price discovery
- Q Enabling efficient risk transfer
- Q Increasing tradability of corporate bonds
- Q Diversifying market participation

TRS can act as a bridge between investors seeking credit exposure and institutions capable of managing or offsetting that risk.

What Could Change If It Works

If supported by strong regulatory coordination, market-making frameworks, and robust risk management standards, several structural improvements could follow:

1. **Corporate bond indices may evolve into active risk benchmarks**
2. **Market makers could manage exposure exposures more efficiently**
3. **Credit spreads may adjust faster to fundamentals**
4. **Participation in lower-rated segments could gradually improve**

The proposal of introducing TRS is not merely about adding another derivative.

It is about unlocking balance sheets.

Instead of forcing investors to hold bonds until maturity, TRS allows economic exposure to circulate without disturbing ownership structures.

The Bigger Picture

India's equity markets transformed once derivatives added a second layer of liquidity and price discovery.

Corporate bonds haven't received that second layer.

TRS may be the missing link.

If implemented carefully, it could mark the transition toward a more dynamic, tradeable, and resilient corporate credit market.

A shift: **From storage mode to circulation mode.**

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