White paper on Indian Fixed Income Market

Emerging Market - Bonds

Emerging debt's valuations have become quite compelling. In addition to valuations, there are also some macro-economic developments favoring emerging debt. One of them is that yields in developed markets are declining. The Fed has becoming decidedly less hawkish in its recent statements, adjusting its growth forecasts downwards. A Fed rate hike in 2016 has become less likely. Consequently, investors are looking for yield elsewhere, which they find in emerging debt. Apart from these valuation-related and fundamental considerations, the technicals are also improving. Outflows have been declining and have recently even turned into inflows. A case in point is Japan, with its negative rates, where banks have been moving into higher yielding assets, including emerging debt.

Since 2005, most emerging countries' corporate bond markets (including both domestic and international issuances) have grown faster than their overall economies. Notably, Brazil, Russia, India, China and Turkey have all seen their corporate bond markets grow at over a 20% compounded annual growth rate between 2005 and 2014. As emerging corporate bond market values have grown, an increasing proportion of the issuances have been on domestic markets and in local currency. The value of domestic corporate bond markets grew from 18% of emerging countries' GDP in 2005 to 23% in 2014, while internationally issued emerging corporate bond values grew from 4% to 6%, respectively.

India is the third largest economy globally with a Purchasing Power Parity (PPP) GDP of US$ 7.39 trillion as of 2014 (Nominal GDP of $1.99 trillion). Its nominal GDP in 1982 was $202.86 billion. This represents an 9-fold increase (IMF). India has grown (Real GDP growth y-o-y) on a sustained basis at an average of 6.2% for last 33 years with no negative annual y-o-y growth rate. The average GDP growth forecasted is 7-7.5%, highest for larger EM.

Unlike most emerging countries, such as China, India has solid aggregate demand and a consumer-driven economy. At the international level, India has fairly diversified exports including software, iron ore, commodities and non-commodities merchandise like machinery and chemicals; however, the prevalence of a consumer-based economy gives the country a great advantage over many other emerging markets that are overly reliant on exports. India benefits from lower import costs, primarily commodities such as Crude Oil resulting in lower CAD and Fiscal Deficits as well as fuel lower inflation. India's external vulnerability has reduced considerably in the last few years. The foreign exchange reserves of around USD 352 bn would be a good defense during global instability. INR has been stable in the recent EM currency turmoil.

Economies like India, which offers higher growth than the developed economies, have gain favour among investors as attractive investment destinations for foreign institutional investors (FIIs) investing 2322.56 Billion INR in Fixed income and 3564.82 Billion INR in equity markets during last five years. Investors are optimistic on India and sentiments are favourable following government's announcement of a series of reform measures in recent months. Road Ahead India is being viewed as a potential opportunity by investors, with the economy having the capacity to grow tremendously. Buoyed by strong support from the government, FII investments have been strong and are expected to continue to improve going forward. FIIs are flocking towards Indian bonds as the confidence level of central bank and the government is at one of the highest levels and benign commodity prices have added confidence. India rated BBB- (Stable) by S & P & Baa3 (Positive) by Moodys, not downgraded for last 14 years. A higher probability of a rating upgrade is possible in coming years if reforms momentum accelerates

Back-ground of Indian Fixed Income Market

Indian government has a strong role in the domestic banking sector. Most Indian banks were nationalized in 1969 and, today, approximately 75% of loans are from public-sector banks. Forty per cent of loans must be made for priority sectors, primarily agriculture. Government bonds dominate the debt market due to several factors: banks must invest 23% of their deposits in government bonds, limiting capital available to invest in corporate bonds; the Reserve Bank of India manages government-bond yields

In order to finance its fiscal deficit, the government floats fixed income instruments and borrows money by issuing G-Secs that are sovereign securities issued by the Reserve Bank of India (RBI) on behalf of the Government of India. India Fiscal Deficits and Borrowings are largely locally funded – FII Holdings in Sovereign Bonds remain less than 5%. Indian Sovereign and Debt markets are 3rd largest in Asian peers. Markets are opening up further to Foreign investors with reforms.

The debt market in India consists of mainly two categories—the government securities (G-Sec) markets comprising central government and state government securities, and the corporate bond market consists of 1. Public State undertakings bonds (PSU) where central government owns more than 51% in the company. 2. Private corporate bonds which are owned by private entity. Indian Fixed income markets operate in different instruments like G-sec, corporate bonds, Commercial papers (CP), Certificate of Deposits (CD), Treasury bills (Tbills), State Development loans(SDL), interest rate futures, OIS, MIFOR, etc ranging from short-term instruments to longer-term bonds (maximum 40 years in G-sec)

Indian Corporate Bond Market

Domestic credit (i.e. credit disbursed by banks) is the primary source for financing in China (73.9%) and South Korea (73.9%) followed by India which is second with a share of 71.5%. In Emerging markets corporate bonds are not significant with India having a higher share with 18.4% followed by Malaysia with 12.4% and China, S Korea and Singapore with 8% each. Interestingly, relative to other countries, India lends the most through corporate bond issuances at 18.4% standing well above its peer countries in the sample. Hence, despite a smaller contribution of corporate bonds in India (in terms of outstanding issuances) relative to other countries, they play a larger role in satisfying the finance needs compared with other countries in the sample.

Domestic Financing Profile (Percentage (%) share of total)

Country	Bank Credit	Corporate Bonds	Equity
China	73.9	8.0	18.1
Hong Kong	17.5	2.5	80.0
Indonesia	41.9	2.4	55.7
South Korea	73.9	8.0	18.1
Malaysia	40.1	12.4	47.5
Singapore	26.2	8.0	65.8
Thailand	51.1	6.3	42.6
India	71.5	18.4	10.1

Source: ASIAN BONDS ONLINE, RBI, ACE Equity

A critical positive is that the turnover in the Indian bond market is second only to Japan. However, this is primarily owing to the active secondary market for government bonds in the country. The secondary corporate bond market while being comparatively passive is still the second most active within Asian countries. Hence, while over all the secondary market trading appears healthy, the same for corporate bonds can be made more vibrant.

Trading volume in the Secondary Market relative to bonds outstanding

Countries	GovernmentBonds	Corporate Bonds	All bonds
China	1.08	1.55	1.24
Indonesia	0.97	0.48	0.89
Japan	4.92	0.31	4.56
South Korea	3.73	0.54	1.76
Singapore	1.77	n.a.	1.10
Thailand	3.09	0.26	2.46
India	4.66	0.66	3.46

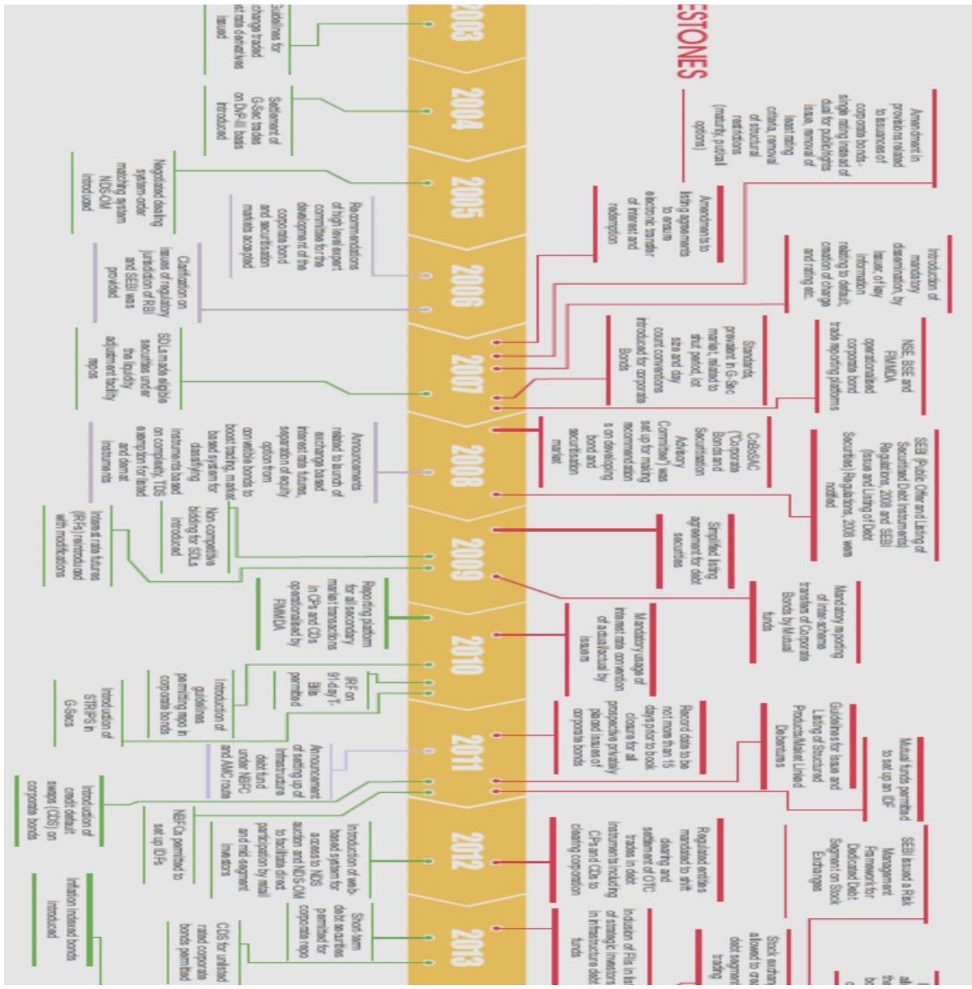
Source: ASIAN BONDS ONLINE, RBI

The above analysis indicates that despite having a large bond market, countries like China and South Korea have a relatively passive secondary market as opposed to India which stands fourth in terms of the size of bond market, but is second with respect the turnover in bond market as a whole and also in the individual government and corporate bond markets.

Credit Watch

Risk of investing in below AAA rated corporate bonds continues to remain high, given the global slowdown which might put pressure on domestic growth also. Highly leveraged companies might face even more stress on their balance sheets, if growth doesn't pick up or takes longer then anticipated. A slowdown in growth can potentially lead to pressure on cash flows in highly leveraged companies. In the current scenario weakness in the credit environment continues to remain is important factor given the risk-reward, it may be prudent to invest in portfolios that predominantly invest in highest rated securities instead of portfolios that take exposure to sub-AAA rated securities to boost the portfolio yield.

As inflation expectations and growth outlook remained stable while financing conditions eased, spreads of corporate bonds, as measured by the difference between 10-year gilt yields and AAA rated corporate bond yields (currently at 60 basis points) would come down further making corporate bonds attractive with comparatively higher yields (against peer’s in EM)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Amendment in provisions related to issuances of corporate bonds - single rating instead of dual for public/rights issue, removal of least rating criteria, removal of structural restrictions (maturity, put/call options)
Amendments to listing agreements to ensure electronic transfer of interest and redemption
Introduction of mandatory dissemination, by issuer, of key information relating to default, creation of charge and rating etc.
NSE, BSE and FIMMDA operationalised corporate bond trade reporting platforms
Standards, prevalent in G-Sec market, related to shut period, lot size and day count conventions introduced for corporate Bonds
SEBI (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008 and SEBI (Issue and Listing of Debt Securities) Regulations, 2008 were notified
CoBoSAC ("Corporate Bonds and Securitisation Advisory Committee") was set up for making recommendations on developing bond and securitisation market
Simplified listing agreement for debt securities
Mandatory reporting of inter-scheme transfers of Corporate Bonds by Mutual funds
Mandatory usage of interest rate convention of actual/actual by issuers
Guidelines for Issue and Listing of Structured Products/Market Linked Debentures
Record date to be not more than 15 days prior to book closure for all prospective privately placed issues of corporate bonds
Mutual funds permitted to set up an IDF
SEBI issued a Risk Management Framework for Dedicated Debt Segment on Stock Exchanges
Regulated entities mandated to shift clearing and settlement of OTC trades in debt instruments including CPs and CDs to clearing corporation
Inclusion of FIIs in list of strategic investors in infrastructure debt funds
Guidelines for exchange traded interest rate derivatives issued
Settlement of G-Sec trades on DvP-III basis introduced
Negotiated dealing system-order matching system NDS-OM introduced
Recommendations of high level expert committee for the development of the corporate bond and securitisation markets accepted
Clarification on issues of regulatory jurisdiction of RBI and SEBI was provided
SDLs made eligible securities under the liquidity adjustment facility repos
Announcements related to launch of exchange based interest rate futures, separation of equity option from convertible bonds to boost trading, market based system for classifying instruments based on complexity, TDS exemption for listed and demat instruments
Non-competitive bidding for SDLs introduced
Interest rate futures (IRFs) reintroduced with modifications
Reporting platform for all secondary market transactions in CPs and CDs operationalised by FIMMDA
IRF on 91-day T-Bills permitted
Introduction of guidelines permitting repo in corporate bonds
Introduction of STRIPS in G-Secs
Announcement of setting up of Infrastructure debt fund under NBFC and AMC route
Introduction of credit default swaps (CDS) on corporate bonds
Introduction of web-based system for access to NDS auction and NDS-OM to facilitate direct participation by retail and mid-segment investors
NBFCs permitted to set up IDFs
Short-term debt securities permitted for corporate repo
CDS for unlisted rated corporate bonds permitted
Inflation indexed bonds introduced

Access to Debt Market for Foreign Portfolio Investor

Foreign Portfolio Investors (FPIs) limits and rationalization

i. Rationalization of investment limits: FPI investment limits have been rationalized, whereby existing limits and subdivisions have been merged in two broad categories – government securities and corporate bonds. The sub-limits for FPIs in Government securities ($10 billion) and dated securities ($15 billion) and other categories have been merged to retain the overall cap of $25 billion. In case of corporate bonds, the ceiling of $1 billion for qualified foreign investors (QFIs), $25 billion for FPIs and $25 billion for FPIs in long-term infra bonds, have been merged – retaining the overall cap for corporate bonds at $51 billion.

ii. Rationalization of allocation of debt limits: Method for allocation of debt limits in corporate bond market through auction has been changed. As per revised scheme, FIIs can now invest in Corporate Debt without purchasing debt limits till the overall investment reaches 90% after which the auction mechanism would be initiated for allocation of the remaining limits. Consequent to the changes, the restrictions on re-investment by FPIs, shall no longer apply in respect of limits held / investments made by FIIs in the Corporate Debt category, till the limits are available on tap.

iii. Withholding tax rate: The rate of withholding tax on interest payments on the borrowings of Infrastructure Debt Funds (IDF), investments made by a non-resident in rupee denominated long-term infrastructure bonds and interest on FIIs' investment made in bonds issued by Indian companies and Government securities have been reduced from 20 per cent to 5 per cent.

iv. The Budget for 2015–16 has proposed to extend the period of applicability of reduced rate of tax at 5% in respect of income of foreign investors (FIIs and QFIs) from corporate bonds and government securities, from 31.5.2015 to 30.06.2017.

v. New Foreign Portfolio Investor (FPI) Regulations: Recently, SEBI has notified new FPI regulations to put in place an easier registration process and operating framework for overseas entities seeking to invest in Indian capital markets. The new regulations replace the existing SEBI regulations for FIIs and the new class of investors, FPIs, would encompass all FIIs, their subaccounts and QFIs.

vi. Currently Indian corporate bonds open FPI limit is 765 INR Billions after utilized limits of 68.67% (1677.73 INR Billion) with a condition of minimum three-year maturity applicable across instruments for FPI while investment of coupons being permitted outside the limits and investments being restricted to securities with a minimum residual maturity of three years, will continue to apply.

vii. RBI announced its quarterly release for FPI in G-sec opening limits as mentioned in the chart, which is announced every half yearly in March and September.

	Existing Limits (INR Billions)	Total Limits as of April4, 2016 (INR billions)	Total Limit as of July5, 2016 (INR billions)
Government debt - all FPIs (auction above 90% utilisation)	1,354	1,400	1,440
Government debt - long -term investors (freely available / on tap)	441	500	560
State development loans (freely available / on tap)	70	105	140

Advantage ETF

ETF trading today offers a vision of the future state of the bond market, exhibiting low cost, transparent, electronic trading in a standardized, diversified product.

1. 1.ETFs can help enhance price discovery, provide investors with low execution costs to establish a diversified portfolio, and increase bond market liquidity and transparency.
2. ETF liquidity is incremental to the underlying bond market liquidity because buyers and sellers can offset each other's transactions without necessarily having to trade in the underlying market.
3. Even during periods of market stress, ETF shares are at least as liquid as the underlying portfolio securities

While some electronic bond trading is available to retail investors, the entire bond market remains an over-the-counter market (OTC). Unlike stock trading - for which automation has leveled the playing field for retail and institutional investors - the bond market lacks liquidity and price transparency except for the most liquid of bonds. For the self-directed bond investor, for whom it may make little sense to invest in expensive actively managed bond funds, exchange-traded funds (ETFs) which track bond indices may offer a good alternative.

While similar to other ETFs, bond ETFs are unique in the world of fixed income because, as they are traded on stock exchanges, the current and historical prices of bond ETFs are available to all investors. Historically, this kind of price transparency for bonds has been available only to institutional investors. The challenge for the architect of a bond ETF is to ensure that it closely tracks its respective index in a cost-effective manner, despite the lack of liquidity in the bond market. An active secondary market is typically not available all the time. Hence to ensure liquidity bond ETF encompasses enough liquid bonds to track an index. This is more advantage in case of corporate bonds which are termed less liquid than the government bonds. The liquidity and transparency of a Bond ETF offers advantages over a passively held bond ladder. A bond ladder, which requires buying individual bonds, does not offer this luxury. Bond ETFs offer instant diversification and a constant duration, which means an investor needs to make only one trade to get a fixed-income portfolio up and running.

Bond ETFs and index bond funds cover similar indices, use similar optimization strategies and have similar performance. Bond ETFs, however, are the better alternative for those looking for more flexible trading and better transparency. The make-up of the underlying portfolio for a bond ETF is available daily online, but this type of information for index bond funds is available only on a semi-annual basis. Furthermore, on top of being able to trade bond ETFs throughout the day, active traders can enjoy the ability to use margin, sell short and trade options on these securities

Kindly refer to our Monthly and other publication for market review and outlook on Indian Fixed Income Markets