Foreign investment in the Indian Government bond market

Ila Patnaik[*] Sarat Malik Radhika Pandey Prateek

Abstract

A country witnesses currency exposure when locals hold a large amount of unhedged foreign currency denominated debt. However, India's capital controls continue to be guided by concerns about debt and its maturity, rather than its currency denomination. Even though the there is foreign appetite for rupee denominated debt, India has placed many restrictions on foreign investment in rupee denominated bonds. These include caps on the total as well as limits by investor class, maturity and issuer and have been implemented through a complicated mechanism for allocation and reinvestment. This paper presents the logic and rationale for why these restrictions fail to meet the objectives of economic policy today. It recommends removal of quantative restrictions on foreign holding of Indian rupee denominated debt and suggests ways to move to a more efficient framework.

[*]The authors are respectively, as follows: Professor, National Institute of Public Finance and Policy (NIPFP) New Delhi, India; Joint Director, Department of Economic and Policy Analysis (DEPA), Securities and Exchange Board of India (SEBI), Mumbai 400051, India; Consultant, National Institute of Public Finance and Policy (NIPFP)-New Delhi; Officer- Research, DEPA, SEBI, Mumbai 400051, India. The authors are solely responsible for errors, if any. Opinions expressed here are strictly personal and do not reflect the opinions of the organizations the authors are associated with, especially SEBI and NIPFP.

Contents

1 Executive summary

1. India has strong quantitative restrictions against foreign investment in rupee denominated debt.
2. Traditional fears about foreign borrowing are about *foreign currency* borrowing. When a foreign investor buys a *rupee denominated* bond, there is no potential of a debt servicing crisis in the aftermath of a large depreciation for the issuer who can be either an Indian firm or the government.
3. The influence of the domestic policy rate upon the exchange rate requires capital account openness on debt flows. If foreign capital flows are liberalised for rupee-denominated debt, raising or lowering the policy rate will have a bigger impact upon the exchange rate.
4. Currency hedging is an essential tool for foreign investment in rupee denominated debt. If India imposes impediments such as capital controls, transaction taxation or source-based taxation, this activity will take place overseas. It is in India's interest for the bulk of global rupee trading to take place in India. This will give Indian policy makers better information about the state of the market, and slightly increase Indian GDP by fuelling the revenues of financial service producers.
5. Participation by foreign investors in the domestic Bond-Currency-Derivatives Nexus will fuel market development and help achieve a deep and liquid market. This furthers an essential objective of domestic financial development.
6. The deeper challenge is that of overcoming home bias of foreign investors, of having them assign a fair weightage for Indian rupee denominated debt in global fixed income portfolios, and of buying bonds issued by a diverse array of Indian firms, small and big. This requires removing quantitative restrictions on foreign investments in debt markets.
7. This document recommends (a) Removal of quantitative restrictions that impede foreign investment in rupee denominated debt whether government or corporate, (b) Opening up the onshore currency market to foreign investors, (c) Expanding up the credit derivatives market to include more types of underlying debt and wider participation and (d) Making the Government debt market operationally similar to equity markets.

2 Introduction

In 1991, India embarked on integration into the world economy through trade and capital account liberalisation measures. A key idea behind the early decontrol measures was that debt inflows were dangerous and hence strong restrictions need to be placed on debt flows. Restrictions were imposed to shift the composition of capital flows away from debt to non-debt creating inflows and regulate external commercial borrowings, especially short-term debt. As a consequence, while the framework for foreign investment, both for FDI, and for portfolio flows, is relatively liberal, India has a number of restrictions on debt.

Over the past decade, the global thinking on debt flows has changed. The macroeconomic and financial instability in emerging markets following the crises of the late 1990s have led to increased efforts in these countries to develop local currency denominated bond markets as an alternative source of debt financing for the public and corporate sectors.

As the report of the Committee on the Global Financial System (2007) notes:

> Local currency bond markets can help financial stability by reducing currency mismatches and lengthening the duration of debt. Such markets also help economic efficiency by generating market-determined interest rates that reflect the opportunity costs of funds at different maturities. The absence of such markets can lead borrowers to take risky financing decisions that create balance sheet vulnerabilities. Such balance sheet weaknesses played a key role in virtually every major financial crisis affecting the emerging market economies (EMEs) since the early 1980s.

In the 2000s, emerging economies domestic bond markets have grown substantially. The outstanding stock of domestic bonds now exceeds $6 trillion compared with only $1 trillion in the mid-1990s (Peiris, 2010). Along with an increase in the size of the local debt markets, foreign participation has also increased substantially over the last decade. In contrast, the Indian policy framework on debt flows continues to be guided by the position adopted in the early 1990s. The regulatory framework is characterised by quantitative restrictions on foreign participation, resulting in limited investments by foreign investors. This study makes a case for opening up the local currency government and corporate debt market to foreign investors and provides a rationale for removing the restrictions on foreign participation based on sound economic policy objectives.

The rest of the study is structured as follows: Section 3 provides an overview of the present regulatory framework governing debt markets in India. Section 4 outlines the legal foundations of the current framework. Section 5 describes the regulatory framework governing Government bond market and documents its evolution. Section 6 provides the rationale for easing the restrictions on foreign participation in local currency debt market. Section 7 discusses the recommendations of the study.

3 Present arrangements

The present arrangement governing foreign borrowing comprises two parts:

Dollar denominated debt India borrows in foreign currency denominated debt through government borrowing (both bilateral and multilateral), external commercial borrowing (ECB) by firms including FCCB and FCEB, and fully repatraiable NRI deposits.

Rupee denominated debt Foreign investment into rupee denominated debt takes the form of foreign investors buying bonds in the Indian debt market, all of which are denominated in rupees. This is curtailed by an array of quantitative restrictions (QRs). There are different limits for foreign investments in Government bonds and corporate bonds. The arrangement is further complicated by having sub-limits across assets and investor classes.

On April 1, 2013, a major attempt was made towards simplification of foreign investment limits in rupee-denominated bonds.[1]

1. The separate sub-limits of investment in Government Debt– Old of USD 10 billion and in Government Debt– Long Term of USD 15 billion was merged into a single limit of USD 25 billion in Government securities.
2. The separate sub-limit of USD 1 billion for QFIs, USD 25 billion for FIIs and USD 25 billion for FIIs in long term infra bonds was merged into a single limit of USD 51 billion for corporate bonds.

Table 1 provides the current position of capital controls on foreign investment in rupee denominated debt. On June 12, 2013, the foreign investment limit

[1] *See* SEBI circular CIR/IMD/FIIC/6/2013

Table 1 Foreign investment in rupee denominated bonds

Instrument	Cap (USD bn)	Eligible investors	Sub-limits
Government debt	25	FIIs and QFIs	USD 3.5 billion in treasury bills within the limit of USD 25 billion
Government debt	5	SWFs, Multilateral Agencies Pension Funds, Insurance Funds	
Corporate debt	51	FIIs and QFIs	USD 3.5 billion in Commercial papers within the limit of USD 51 billion

Table 2 Foreign ownership of Government bonds

	2008	2009	2010	2011	2012	2013
FIIs	0.52	0.24	0.59	0.97	0.88	1.61

in Government debt was enhanced by USD 5 billion. However the enhanced investment limit was available to a specified class of foreign investors.[2]

Table 2 shows the share of the Government bonds outstanding that are owned by foreign investors. While this share has risen through the years, it stands at 1.6% as at end March 2013. In absolute numbers, foreign investors own Rs 700 billion or approximately USD 11 billion of Indian government bonds. At present, the QR for foreign investment in government bonds stands at USD 30 billion. This small scale of ownership implies a substantial upside potential. Even if the ownership of foreign investors went up overnight by ten times (to $110 billion), it would only amount to 16% of the existing stock of bonds.[3]

A comparison against other emerging economies (Table 3) shows that India greatly lags in conditions seen elsewhere in the world. This raises questions on the structure of capital controls in the rupee-denominated bond market that has resulted in scarce foreign ownership of Government bonds.

Table 4 shows the debt utilisation status of Government and corporate debt. The complex nature of quantitative restrictions discourage foreign investors to have deeper engagement in the Indian bond market. As an example, in corporate bond market, though the investment limit is Rs 244,323 crores, the actual investment is only Rs 81089 crores. This amounts to a meagre 33% of the investment limit.

[2] See SEBI Circular: CIR/IMD/FIIC/8/2013

[3] The internal debt of the government stands at Rs.48.7 trillion. Government securities account for 90% of this.

Table 3 Foreign holdings in local currency Government bonds

(Percent of total outstanding)

Country	Sep 2012	Dec 2012	Mar 2013
Indonesia	29.6	32.9	32.5
Malaysia	28.5	29.7	31.2
Thailand	15.0	16.3	17.6
Korea	10.2	9.5	9.4

Table 4 Debt Utilisation Status (as on 26 August, 2013)

Category	Upper Cap (USD billion)	Upper Cap (INR crore)	Total Investment (INR crore)	Percent to GDP (2013; Percent)
Government debt	25	124,432	120,359	1.2
Government debt[1]	5	29,137	1,671	0.017
Government debt - treasury bills	5.5	25,416	15,803	0.16
Corporate debt	51	244,323	81,089	0.81
Corporate debt - commercial paper	3.5	17,462	12,185	0.12

Source: `https://nsdl.co.in/FII/FII.php`

1: Investments by FIIs registered with SEBI under the categories of Sovereign Wealth Funds, Multilateral Agencies, Endowment funds, Insurance funds, pension funds and Foreign Central banks as per SEBI circular ref. no. CIR/IMD/FIIC/8/2013 dated June 12, 2013.

The *Working Group on Foreign Investment* chaired by U. K. Sinha analysed these problems and proposed modifications. The Working Group pointed out that the existing regulations create incentives for Indian firms in favour of foreign currency borrowings, instead of issuance in rupees with investments by foreign investors.[4]. Hence, the Working Group recommended that easing the restrictions on rupee-denominated debt is a safer way of managing globalisation. The Committee on Financial Sector Reforms chaired Raghuram Rajan also recommended steady opening of rupee denominated government and corporate bond markets to foreign investors.

4 Legal foundations of the current framework

1. The power to regulate capital account transactions currently vests with the RBI. This power has been conferred on it by the Foreign Exchange Management Act, 1999 ("FEMA"). Specifically, Section 6(3)(b) of the

[4]See *Master Circular on External Commercial Borrowings and Trade Credits* RBI/2013-14/12 Master Circular No. 12/2013-14

FEMA confers this power.

2. Section 47 of the FEMA empowers the RBI to carry out the provisions of this Act. In exercise of its powers under Section 47 and Section 6(3)(b), the RBI came out with the Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000 ("FEMA 20").

3. Regulation 5(4) of FEMA 20 allows FIIs, QFIs and other non-resident investors to invest in rupee-denominated bonds subject to the specified terms and conditions. Regulation 5(4) was amended on October 19th, 2012 to include QFI as an eligible investor class. With this amendment, three broad investor classes were identified–FIIs, QFIs and long-term investors. These investor classes were subjected to different investment restrictions.

4. Schedule 5 to Regulation 5(4) of FEMA 20 specifies the terms and conditions of foreign investment in rupee-denominated bonds. This Schedule was further amended on March 26th, 2013. The intent was to create a unified framework of restrictions for the three investor classes–FIIs, QFIs and long-term investors.

5. The Proviso to Regulation 15(2) of Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 empowers SEBI to impose limits on the maximum amount which can be invested in debt securities by the foreign institutional investor on its own account or through its sub accounts.

6. SEBI issues circulars governing various aspects of foreign investments in rupee denominated debt securities.

5 Regulatory framework of foreign investment in Government bond market

In this section we describe the regulatory framework governing foreign investment in Government bond market and its evolution.

5.1 Changes in quantitative limits

The origin of policy on foreign investment in debt market can be traced back to November 1992, when Ministry of Finance approved the restriction in allocation of total investments by Foreign Institutional Investors (FIIs) between equities and debt instruments in the proportion of 70:30, that is, at the most, only 30 per cent of FII investment were allowed in debt securities. In November 1995, SEBI (FII) Regulations came into existence which notified that FII investments in equity and debt were allowed as part of the 70:30 limits. In 1996, a new category was introduced in the debt segment. Separate route was opened for 100 per cent investment in debt securities. Thus, any FII willing to make 100 per cent investments in debt securities was permitted to do so, subject to specific approval from SEBI as a separate category of FIIs or sub-accounts as 100 per cent debt funds. In such cases, the restriction of 30 per cent debt was not applicable subject to an overall debt cap by FIIs. In 1997, FIIs were permitted to invest in Government securities, first through the 100 per cent debt route and later through the 70:30 route.

From 1996 to March 2004, the overall cap for FIIs to invest in Government debt was USD 1 billion with separate caps for 70:30 route and 100 percent debt route. The cap for the 70:30 route was USD 100 million and for the 100 percent debt route, the cap was USD 900 million. Since then the debt limits have been raised continuously over the years. Table 5 shows the foreign investment limit in Government debt (Old) across the years.

Table 5 Foreign investment in Government debt (Old)

Date of change	Total limit (USD billion)
Nov-1996	1
Nov-04	1.75
Apr-06	2
Jan-07	2.6
Jan-08	3.2
Jun-08	5
Nov-11	10

On November 26, 2010, in addition to the above framework of FII investment in Government securities, FIIs were also allowed to invest USD 5 billion in Government securities with a residual maturity of 5 years. In June 2012, this limit was enhanced to USD 10 billion and the residual maturity at the time of first purchase was reduced to 3 years. In January 2013, this limit was further enhanced to USD 15 billion. Since February 2013, the provision regarding 3 years residual maturity, in the Government debt long term category, at the time of first purchase is no longer applicable. However, within this category, FIIs are not allowed to invest in short term paper like treasury bills. Table 6 shows the foreign investment limit in Government debt (Long) over the years.

Table 6 Foreign investment in Government debt (Long)

Date of change	Total limit (USD billion)
Sept-2010	5
June-2012	10
Feb-2013	15

Till April 2013, foreign investment was permitted in two categories of Government bonds:

1. Government debt-Old
2. Government debt-Long Term

In April 2013, the two categories were merged and the overall limit for FII investment in Government securities became USD 25 billion. This was done by merging the limits of USD 10 billion and USD 15 billion in G-Sec (Old) and G-Sec (Long Term) respectively. A separate sub-limit of USD 5.5 billion is kept for FII investment in treasury bills. In June 2013, a further enhancement has been done in the FII investment limit. The limit has been enhanced by USD 5 billion raising the cumulative cap to USD 30 billion. However this enhanced limit of USD 5 billion is available for investments only to those FIIs that are registered with SEBI under the categories of Sovereign Wealth Funds (SWFs), Multilateral Agencies, Endowment Funds, Insurance Funds, Pension Funds and Foreign Central Banks.

5.2 Allocation methodology

Though the RBI, in consultation with the Government prescribes the cap on the maximum permissible investment by FIIs in debt category, the methodology of allocation of these limits is determined by the capital market regulator, Securities and Exchange Board of India, through its various circulars from time to time .

When the markets opened to FIIs in the early nineties, the limits were very small. At that time the allocation was through the quota system. According to this system, FIIs had to apply for a license to operate in the market. Once the routine checks were done by SEBI, license was issued and the FIIs were allowed to operate in the G-sec market. Revised additional limits were divided amongst the FIIs equally and the players who did not use their limits did not receive any share in the increased limit. This system was clearly anti-competitive.[5] It penalised smarter firms at the expense of the weaker firms. As markets progressed and more and more players started entering the market, quota system could no longer be in use because it was not transparent.

The allocation procedure was changed to first come first served (FCFS) basis since July 2008.[6] The allocation of unutilised/ unallocated limits for investments in Government Securities/ T-Bills came to be on first-come-first-serve basis. The allocation was valid for a period of 15 days from the date of the allocation letter, on the expiry of which the unutilised limits lapsed. Later, in November 2008, the validity period was reduced to 11 days. FCFS had its own share of technical issues with it. Since it was only time-priority method, a delay in seconds could change the allocation. The window opened on a specific date at midnight. On each of those dates, some 5000-10000 mails were received by SEBI once the window was opened. And since technically, the efficiency of the IT servers at the investors' end (including FIIs' foreign locations) and at the regulators' end could not be perfect, there were instances where e-mails were sent at a different time and received at different time and hence allocation could not be efficient. Realising this, due to the uncertainties in allocation of the limits, a number of investors started quoting more than required. Thus, utilisation got low as once the quoted allocation was allocated, they were not able to invest fully.

Considering the limitations of the FCFS methodology, auctions were introduced in the allocation of debt investment limits to FII. Auction mechanism was initially introduced for corporate debt through SEBI circular[7] and subsequently for Government securities through SEBI circular of May 2009.[8] SEBI introduced auctions for a limited amount. For some time the allocation took place through both the FCFS and auction method. These circulars laid down the specifics of the auction i.e. the minimum amount that can be bid by a single entity, the maximum amount that can be allocated to a single

[5]For an analysis of the pitfalls of the quota system *See* "Quota Raj for debt inflows" available at `http://ajayshahblog.blogspot.in/2006/04/quota-raj-for-debt-inflows.html`.

[6]Circular No. IMD/FII & C/ 27 /2008 dated January 31, 2008.

[7]Cir No. IMD/FII & C/ 37/2009

[8]Cir No.IMD/FII & C/ 39/2009.

entity. The time period for utilisation of the acquired limits was 45 days for the auction method and 11 days for the FCFS method. Gradually, FCFS was phased out, first from 'old' category and then from 'long term' category.

The limits that are not utilised are added back to the pool of free limits for auction. The time period for utilisation of limits was subsequently reduced from 45 days to 30 days.[9]

5.3 Reinvestment

An important element of the regulatory framework of FII investment in Government securities is the facility of reinvestment. Due to the mismatch of the waiting period for next FCFS round and the investment opportunity, SEBI introduced a re-investment window of 5-15 days, whereby FIIs could continue to hold on to limits after sale or redemption.

According to SEBI, the reinvestment facility had the following unintended consequences:

1. Allowed FIIs to retain the debt investment limits till perpetuity by rolling over their investment during the re-investment period window. The ability to retain limits till perpetuity made the market anti-competitive.
2. As their average costs were comparatively lower, the existing large allottees continued to bid for debt limits at very high premia through the stock exchange bidding platforms. These costs could be amortised by them over a long period of time, in view of the perpetual nature of limits. This practice gave them an edge over other prospective bidders.
3. The cost of debt seemed uneconomical for the new fund based FIIs entities to participate in the bidding.
4. With the facility of reinvestment, there were no free limits, unless the Government announced fresh limits.

Considering these consequences, SEBI withdrew the facility of reinvestment through a circular[10] dated January 3, 2012. Henceforth, for all new allocations of debt limits to FIIs/sub-accounts, no re-investment period was allowed and the limits came back to the pool once the investment was sold or redeemed. Those FIIs who held limits at the time of this circular were allowed reinvestment facility under certain conditions.

[9] Sebi circular: CIR/IMD/FIIC/ 22/2012

[10] CIR/IMD/FIIC/1/2012

Prior to this circular, an FII which had acquired or obtained investment limits from SEBI, had the flexibility to reinvest into debt securities after the initial investment had been sold off or had matured, provided the subsequent investment was made within 15 business days of such sale or maturity of the earlier investment. Such changes in the regulatory framework adversely affected the interests of the foreign investors in the debt market. FIIs that were planning to use their existing debt limits over a relatively longer horizon by re-investing were not be able to do so after the restriction on reinvestment was introduced. This reduced the attractiveness of debt securities and reduced the purchase of debt by foreign investors.

Since the prohibition on the reinvestment facility, SEBI received many proposals to consider changes in rules on reinvestment. Consequently on November 7, 2012, SEBI partially eased the restrictions on reinvestment.[11] With effect from January 1, 2014 it was decided that FIIs/ Sub-Accounts could reinvest during each calendar year to the extent of 50% of their debt holdings at the end of the previous calendar year.

In January, 2013, in response to the representations received, and to provide greater operational flexibility to FIIs/ sub-accounts, the following changes were made[12]:

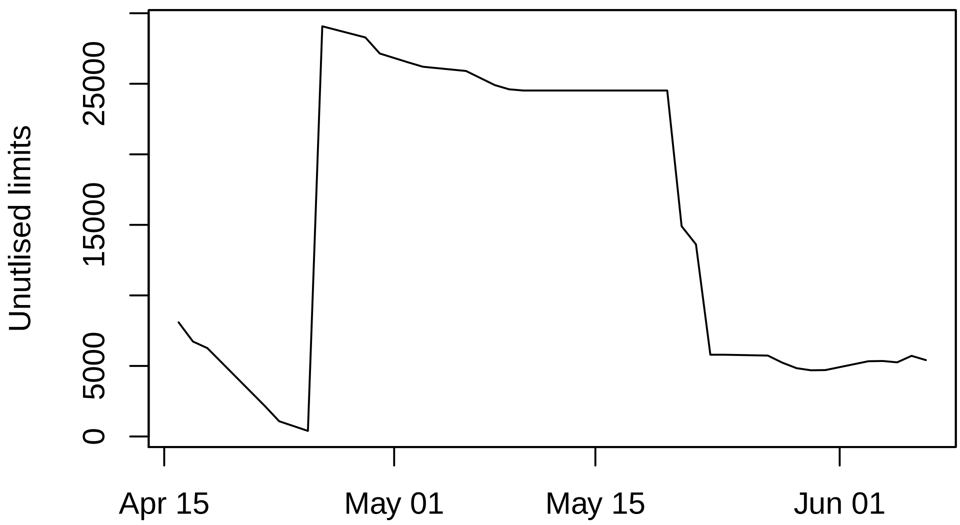
- For those FIIs that did not hold any debt investment limits as on January 03, 2012 and purchased debt investment limits thereafter, it was decided that they would be allowed a cumulative re-investment facility to the extent of 50% of their maximum debt holding at any point of time during the calendar year 2013.
- From January 01, 2014, the re-investment facility as indicated in the SEBI circular dated November 07, 2012 became available during each calendar year to those FIIs which held debt investments as on December 31 of the previous calendar year.

[11] CIR/IMD/FIIC/ 22/2012.

[12] CIR/IMD/FIIC/1/2013 January 01, 2013

5.4 Unutilised limits

Figure 1 Unutilised limits



With the present system of auctions and partial prohibition on reinvestment, acquiring of limits and actual investments does not go hand in hand. Figure 1 shows the limits that are acquired but not invested by the foreign investors. Given the current system of monthly auctions and partial reinvestment, the investors bid for higher limits in anticipation of better investment opportunities and in the absence of such an opportunity, the limits remain unutilised.

As seen above, the regulatory framework is characterised by a number of frictions that adversely affect investors' interest in rupee denominated bond market.

6 The objectives of economic policy reform

Five ideas guide our policy thinking about capital controls against foreign investment in rupee-denominated bonds:

1. Indebtedness through rupee-denominated bonds is qualitatively different from foreign currency borrowing, which can involve 'original sin'.
2. The effectiveness of monetary policy is enhanced when foreign investors have access to debt investment in India.
3. Foreign investment in financial markets in India fosters financial development in India, as opposed to investments by foreigners into Indian issuers at overseas locations such as London.
4. When foreign investors carry the currency risk of rupee fluctuations, they are likely to require hedging against exchange rate fluctuations. While this can be done overseas on the NDF market, giving foreign investors access to currency trading in India is in India's interest.
5. The major challenge that India faces is that of overcoming home bias on the part of foreign investors. In order to overcome home bias, policies must be conducive to the development of knowledge and organisational capital in foreign financial firms. This requires removing quantitative restrictions (QRs), and solving the tax impediments against foreign investors establishing operations in India.

6.1 Avoiding original sin

Borrowing in foreign currency denominated bonds can induce the problem of "original sin" and "financial dollarisation". The empirical literature has placed a high importance on these concerns (Yeyati, 2005; Eichengreen *et al.*, 2007). A key finding of this literature is that the composition of external debt – the extent to which the debt is foreign currency denominated – is a key determinant of the stability of output, volatility of capital flows and management of exchange rates.

When a government or a company borrows in foreign currency it can suffer from currency mismatch – earning in local currency but repaying the debt in foreign currency. A sharp depreciation of the local currency can then sharply increase the costs of debt servicing and thus induce credit distress.

When currency mismatches are present, they create political economy pressures to manage the exchange rate, which leads to large-scale distortions of macroeconomic policy.

A safer option is to encourage local currency borrowings. In such a case, the foreign investor bears all the currency risk. There is no “original sin” when a foreign investor buys a local currency bond.

In India, at present, we do the reverse of what is considered as appropriate for sound macroeconomic policy. Foreign investment into rupee denominated bonds - which is not original sin - has been tightly restricted through quantitative restrictions. The policy framework incentivises firms to borrow abroad through the external commercial borrowings route,[13] which creates dollar liabilities on firms' balance-sheets.

Borrowing in foreign currency denominated debt is particularly likely to induce currency mismatch when the issuer is an infrastructure developer, who has cashflows almost entirely in rupees. In recent years, the difficulties of the Indian bond market have led to an emphasis on foreign borrowing for infrastructure financing. This is a particularly incorrect approach and needs to be replaced by a strategy where foreign investors come into India and buy rupee-denominated bonds issued by infrastructure developers.

6.2 Improving the effectiveness of monetary policy

When the policy rate is raised, there are two impacts. Borrowing becomes costlier within India, which reduces demand and thus cools the economy. In addition, when the interest rate in India is higher, more capital comes into India, and the rupee appreciates, which cools the economy.

These two effects also work in reverse. When the policy rate is lowered, there is one channel working within India, where demand is increased. In addition, at a lower interest rate, less capital comes into India, and the rupee depreciates, which is expansionary.

The second channel has been largely ineffective till date, owing to the capital controls that affect debt flows into India. Changes in the policy rate have a feeble impact on the rupee, as the channels through which foreign investment comes into Indian debt are clogged. While foreign investment into equity is

[13] A permissible end-use of ECB is that the borrowed funds can be used for investing in outbound direct investment.

open, equity investment has a low sensitivity to the policy rate. The main impact of monetary policy will come about through debt flows.

Liberalisation of capital inflows into the rupee-denominated debt market would increase the sensitivity of debt inflows to the policy rate. Through this, monetary policy in India would become more effective. When RBI raised rates, along with other effects, the rupee would tend to appreciate, which is contractionary. Conversely, when RBI cut rates, along with other effects, the rupee would tend to depreciate, which is expansionary.

6.3 Fostering domestic financial development

Foreign participation in the Indian bond market will help accelerate modernisation of the debt market. For an analogy, the development of the equity market from 1992 to 2001 was, to a certain extent, influenced by the need to match the market arrangements that are found in other emerging markets. In similar fashion, if foreign investors are strongly present in the Indian Bond-Currency-Derivatives Nexus, there will be greater pressure to match the market arrangements that are found in other emerging markets.

Of particular importance is the choice of onshore versus offshore issuance. As an analogy, in the early 1990s, there was a surge of GDR and ADR issuance by Indian companies. Indian issuers and foreign investors preferred to meet each other in London or New York, instead of intermediation through the Indian equity market. However, after the equity market reforms took shape with the onset of equities trading at NSE in November 1994, overseas issuance by Indian firms dropped sharply.

With bonds, there are two possibilities: Indian firms borrowing overseas in dollars or borrowing overseas in rupees. Both cases involve reduced market activity and liquidity in India. The former involves original sin. Bond issuance in London, denominated in rupees, is relatively difficult when compared with issuance in rupees. For these reasons, there is strong reason to favour a framework where foreign investors bring money to Indian issuers by purchasing rupee-denominated bonds in India.

6.4 Currency hedging alongside rupee denominated bonds

When a foreign investor buys a rupee-denominated bond, the currency risk is placed on him. All foreign investors will choose to hedge this risk some of the time. While many foreign investors may not be hedged at all times, all foreign investors who envisage buying rupee-denominated debt require to first have a clear mechanism for currency hedging as and when desired.

Given the substantial size of rupee derivatives that are trading overseas, foreign investors who buy rupee-denominated debt always have the ability to hedge these purchases overseas. Using the NDF market is free of taxation of transactions and the attempts by Indian tax authorities to impose source-based taxation.

At the same time, India is the natural venue for global trading in the rupee. It is advantageous to Indian authorities if the bulk of global trading in the rupee takes place in India. When this activity takes place in India, it fosters a deep and liquid market with the comprehensive development of the Bond-Currency-Derivatives Nexus. This will help improve the monetary policy transmission.

To the extent that foreign investors engage with Indian issuers on Indian soil, and to the extent that their currency trading activities take place in India, the revenue stream for financial services associated with these transactions will accrue to Indian financial firms. This will increase Indian GDP.

For these reasons, opening up access to currency trading in India – on terms and conditions which are as unencumbered as the NDF market – should be seen as an integral part of opening up the rupee denominated bond market.

6.5 Credit risk management for rupee denominated bonds

When an investor buys a rupee-denominated bond, the credit risk is also placed on him. All investors will choose to hedge this risk some of the time. At present, due to the under-development in the credit derivatives market, the avenues for credit risk management for investors are very restricted. Liberalisation of this market will help give the investors the opportunity to hedge their credit risks. The key changes required here are: expansion of the list of market participants, and the list of debt instruments on which the credit defaults swaps can be written.

6.6 Overcoming home bias

In the field of international portfolio management, the major problem that is faced is that of 'home bias', where investors tend to keep too much of their money invested at home. As a consequence, the share of the global portfolio that is invested in India is below what it should be for global investors to achieve efficient diversification.

Home bias by foreign investors is closely related to a lack of knowledge about India. This is also associated with unstable responses to global and local events, such as capital flow reversals, sudden stops, etc. From a strategic perspective, India's engagement with financial globalisation requires sound knowledge in the hands of foreign investors, so as to alleviate home bias.

At present, the market value of emerging market debt is roughly $2 trillion. When India opens up, an additional $1 trillion will be added into this and India will make up roughly one-third of EM debt. For a while, however, global investors are unlikely to place a third of their overall EM debt investments into India, owing to home bias.

Home bias is particularly strong against smaller securities and bonds issued by smaller companies. When India opens up, it is likely that global fixed income investors will relatively readily take to bonds issued by the top 10 firms. It will, however, be atleast five years of sound policies before global investors buy over 10% of the bonds issued by the 1000th biggest firm of India. Alleviating home bias is required in order to avoid a non-level playing field where small firms in India lack access to foreign debt capital while large companies do.

In order to alleviate the home bias of foreign investors, the Indian strategy towards financial globalisation needs to be modified in several directions.

The key insight into home bias lies in the organisational capital of foreign financial firms. In the equity market, where India's engagement with financial globalisation is now 20 years old, a sophisticated 'ecosystem' of foreign investment into Indian equities has come about. All large global financial firms have a group that works on Indian equities. Databases and analysis of firms and portfolios are available. This has given a gradual process of alleviating home bias. At first, foreign investors purchased shares of the biggest companies with small weights. Over the years, as the teams inside foreign financial firms have impounded knowledge about India within their organisations, they have become more confident and foreign investment has now percolated into the top 500 companies. However, even today, foreign equity investment has not percolated beyond the top 500 firms, which reflects the presence of home bias.

The problem of home bias is greatly amplified with debt investment. In the field of rupee denominated bonds, quantitative restrictions have repeatedly disrupted the development of these organisations. For investments into bonds from Indian issuers to take place, global financial firms have to develop teams which specialise in this field. Over the years, these teams would gain confidence, and be willing to accept bonds issued by smaller companies. However, the formation of these teams has repeatedly hit a barrier in terms of quantitative restrictions and the auction system. When a foreign financial firm is blocked from accessing rupee denominated debt, the team working on rupee denominated debt is disbanded, and this organisational capital is disrupted. A few months later, the Indian rules about quantitative restrictions and the auction system may be modified to make investment opportunities possible, but the organisational capital has to then be rebuilt from scratch.

If the quantitative restrictions on rupee denominated debt are comprehensively and permanently removed in 2013, in the medium term, this will result in the development of organisational capital within global financial firms, through which sustained investments into this new asset class will come about. At first, investment will be concentrated in liquid government bonds and in bonds issued by the top 50 companies. The magnitude of investment will be small. As the teams in foreign financial firms gain confidence and credibility, the weights will go up, and investment will percolate into the full range of government bonds and into bonds issued by smaller companies. This process will result in a reduction of home bias.

This process will be accelerated if foreign financial firms *establish operations in India*. As an example, the knowledge with foreign financial firms about the 500th largest firm in India will always be greater if the investment team is located in Bombay and not in Singapore. For this to come about, a critical impediment which needs to be solved is the tax treatment of offices of investment managers that are located in India.

When foreign money managers locate offices in India, this will diminish home bias against both equity and debt investment. In the case of the equity market, there is significant foreign ownership of the top 50 stocks, and small ownership of the next 450 firms. Reduction of home bias would involve larger foreign shareholding for these 500 firms, where foreign investment has already begun, and a percolation of foreign ownership beyond these 500 firms into the next 2000 firms. In the case of the bond market, foreign ownership of rupee denominated bonds is primarily in the top 20 liquid government bond issues and in bonds issued by the top 20 companies. Reduction of home bias would involve percolation of foreign investment to all bonds issued by the government, and to bonds issued by the top 500 companies.

One element of the global fixed income investment landscape is fixed income index funds including ETFs. The most widely tracked debt market index is the 'J. P. Morgan GBI - EM Global Diversified' index. At present, it has a negligible country allocation for India, given the presence of quantitative restrictions that make it impossible to implement index funds.

If India removes quantitative restrictions on foreign investment into rupee denominated debt, it is expected that roughly 10% of the weightage in EM index funds will be allocated to India. As roughly $100 billion is at present invested in EM debt index funds, this should generate a $10 billion inflow into India within roughly a year.

Over and above this, there are substantial assets with actively managed EM debt funds, all of which would start building an India-related business once India opens up.

7 Recommendations

Drawing on this analysis, the next steps in policy reform consist of:

1. Removal of all existing quantitative restrictions: The existing framework of quantitative restrictions on foreign investment in Government bond market should be dismantled. This will encourage greater engagement of foreigners in the government debt market. Since this is rupee denominated debt, the concerns associated with "original sin" and liability dollarisation of financial firms do not arise.

2. Percentage limits on foreign investment: If at some stage, restrictions need to be imposed, the existing quantitative restrictions could be replaced by percentage limits on foreign ownership. This will enable greater foreign participation as the size of the Government bond market increases. Foreign ownership should be capped at a certain percentage of the outstanding government debt, such as at 10 or 15 percent of the total government debt. Under this framework, the Government debt market should be made operationally similar to the equity market. The regulator should allow free investments till the prescribed limit at any time. For this, the regulator should provide for daily dissemination of

utilised levels to indicate to the market, the availability of spare investment. This would address the issue of bidding for higher limits and the presence of large unutilised limits in the market. Once the limit is reached, the investors can acquire Government bonds in the secondary market. This will help in easing the frictions associated with current auction system.

3. No distinction on asset class: Recently there has been an attempt towards merging the two categories of Government debt-Old and long. The consolidated limit for foreign investment in government bond is USD 25 billion. However within this limit, the investment in treasury-bills is restricted to USD 5.5 billion. This limit should be eased in order to provide investors with flexible options to switch from long- term to short-term debt instruments. In general, there should not be any distinction between the asset classes within the prescribed umbrella limit.

4. No distinction on investor classes: The framework should not create artificial distinctions between investor classes i.e FII, QFI, Sovereign Wealth Funds etc. Recently, the increase in foreign investment limit in Government securities to USD 30 billion dollars is only applicable to certain specifies classes of foreign investors.

5. KYC regime should be simplified: The current practice of submitting documents to multiple agencies should be done away with.

6. Sudden changes in market micro-structure should be avoided: This should involve the following steps: a) The regulator must state the long-run objective. b) Formal interactions should be done with market participants to identify problems in the market. c) A draft document should be released in the public domain incorporating the regulators response and what steps it proposes to take to mitigate the problems. d) The market participants should be allowed to give their feedback and comments within a specified time-frame. e) The regulator should then come up with a single amendment regulation incorporating the proposed changes.

7. Strengthen the liquidity and market efficiency of futures and options on currency underlyings in India: Give access to foreign investors (as envisaged in the Budget Speech of February 2013) and increase the range of products available. This will allow them to hedge their exposure in the rupee denominated bond markets.

8. Expand the scope of the currency derivatives market by including un-

listed corporates and alternative investment funds as users of credit default swaps, and allow credit default swaps on unrated bonds and loans.

9. Clarify the tax treatment of foreign asset managers who build offices ("permanent establishments") in India.

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