Accessing India’s Financial Markets.
A white paper by Bloomberg
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India’s Prime Minister Modi is not afraid to set bold visions, and one of the latest is perhaps the boldest of all. His government aims to more than double the nation’s GDP to US$5 trillion by 2024, a task it has acknowledged will require fiscal prudence, improved access to and depth of financial markets, empowerment and inclusion. Other necessary catalysts to realising this dream include expanding infrastructure investment, improving ease of doing business and economic governance reforms.

While confidence levels in India’s political and macro-economic stability are high as it rapidly becomes the next emerging market destination for global investors, international investors also highlight pressing needs to remove barriers to foreign participation in the debt capital market, reform the taxation system, overhaul regulations and encourage a greater role for foreign investors in the economy.

Many of these steps are also pre-requisites for India’s eventual inclusion in global indices that could channel its share of the trillions of dollars of passive global investment into the economy.

To understand international investor expectations for easing access, increasing transparency, boosting yields and the signposts they are looking for that will drive international participation, Bloomberg surveyed 65 international asset and fund managers around the world to get their perspectives on what needs to be done to improve India’s relative attractiveness for foreign investment in its debt markets. These included clients in Singapore, Tokyo, Melbourne, Hong Kong, London, New York, Dubai and India.

The results point to optimism that improving ease of access is possible, but also reveal a myriad of potential barriers that need to be addressed for India to achieve its bold ambitions.

This paper offers insights into the global investor view towards India’s financial markets, key challenges to investing in its bond market and how, in their view, access can be improved. As an important global index provider, we also share Bloomberg’s perspective on the road ahead for India’s bond market and considerations for India to be included in global indices.

Bloomberg is far more than a passive observer of the changes required, with the advanced technology, real-time data and deep networks that can help to address some of these challenges. We will continue to convene global investors to India’s financial market, and connect Indian banks to the international financial community, driving greater access and participation.

So the journey towards India’s bold vision begins, and we will be actively supporting and tracking it along the way.

Introduction

Turning India’s bold vision into a reality
Global Investor Survey: Key Findings

Over a period of four months in 2019, a total of 65 buyside and sellside investors across Asia Pacific, the US, the UK and the Middle East provided responses regarding their views on ease of access to India’s financial markets. Of these participants, 19% participated in India’s bond market while 52% participated in India’s equity market. Questions mainly focused on how investors view India’s bond and equity markets and how easily they can access them. Clear trends were identified through tabulation and analysis of the responses. Some of the world’s largest asset managers participated in the survey.

1. Accessing India’s financial markets is more difficult than accessing other key markets

Ease of access to India’s financial markets versus other markets

- Much easier: 2%
- Somewhat easier: 4%
- The same: 18%
- More difficult: 18%
- Much more difficult: 58%

The survey revealed that an overwhelming 76% of respondents who rated ease of access found it either ‘much more difficult’ or ‘more difficult’ to access India’s financial markets compared to other markets that they participate in. While 18% rated ease of access as the same as compared to other markets, just 6% indicated that it was somewhat easier, or much easier. These stark figures underscore the potential that India could unlock if it increases its ease of access.

76%

*Found it more difficult to access India’s financial markets compared to other markets they participate in.*
2. Increasing ease of access is crucial to boost participation

92% said they would increase participation in India if access was easier

The Indian bond and equity markets still clearly remain attractive, with pent-up demand among investors. There is tremendous opportunity for India to increase foreign participation in its financial markets, with a resounding 92% of respondents saying that they would increase participation if access was easier. Only one respondent said that it would not make a difference.

“There needs to be a steady flow of foreign capital every year as it is not sustainable for the Reserve Bank to provide liquidity through their open market operations every year.”

“India is the only large, investment grade relevant economy I can think of which is not in indices. The implication is that if we take a 5 year view, the inclusion of China in the global indices is the biggest market structure shift we are living through, and will take away a lot of global liquidity at the expense of developed and emerging markets. So it’ll come at the expense of US, Japan, Europe, India, Indonesia and Brazil.”
3. Capital controls are the greatest barrier

Capital controls are seen as the greatest barrier to accessing India’s financial markets, with 37% citing it as their main concern. Market liquidity (22%) and lack of electronic access (14%) were also identified as significant roadblocks to accessing India’s financial markets.

Respondents noted the need for licenses to start bond investment, limitations on foreign ownership, lengthy account opening processes and the need to manage frequently changing regulatory guidelines as frustrating aspects of requirements to participate in India’s markets.

“If India issues USD bonds, different types of investors can invest.”

“Our conversations with fund managers is about how they will remain true to their investment philosophy. The largest equity funds in India would not be able to manage a small allocation from one of our larger institutions without a significant compromise. Getting in is hard - imagine getting out.”
4. The path to greater participation

Ease of access to India’s financial markets versus other markets

- Better corporate governance 2.5%
- Better research 2.5%
- Ease of FX compatibility 11%
- Electronic trading access 4%
- New account processes 20%
- Internationalization of bond market 17%
- Clearer regulatory guidelines 43%

A majority of respondents (43%) said clearer regulatory guidelines would increase ease of access and lead to deeper foreign investor participation. Measures they highlighted included:

• A tax structure more attractive to foreign investors; abolishing capital gains tax
• No limitations on foreign investor ownership
• Easier process to set up new accounts
• Liberalization of RBI regulations
• Not changing regulations so frequently

Internationalization of bond markets was called out by 17% of respondents as a positive move to consider, while 20% also wanted new account processes.

Better quality research and clearer corporate governance were other advancements that respondents said could help increase access to India’s financial markets.

A few respondents also said that India needs a dollar denominated market.

“Every time the stars align another market rolls out the red carpet – India on the other hand creates roadblocks. Seize the opportunity – open doors, simplify requirements and assure no changes for the next 5 years.”

“Frequent change in regulations / taxation make it very difficult to invest with long term horizon.”
5. Greater depth and activity needed in corporate bond market

Respondents indicated that more depth in corporate markets and a more active yield curve is required in India. While India has an active bond trading market, respondents have noted that most of the trading is concentrated on just two or three bonds.

There is also a need for the inclusion of foreign bond issuances so that India has a steady flow of money from passive investors e.g. India is not a member of JPM GBI-EM Global Index, but would be included if access was easier.

Banks currently run the risk of no guaranteed settlement for corporate bonds, especially those that are illiquid, and respondents have called for an easier and clearer settlement process.

Red tape such as requiring foreign portfolio investor (FPI) licenses to start bond investments is restricting bond trades, and investors are advocating for regulations to be eased to increase participation significantly.

“India is going to be the 5th largest economy within a year, and there is a lot of interest in all asset classes in India, specially debt. Participation can increase significantly if regulations are eased.”
Accessing India’s Financial Market

There is considerable optimism that improving ease of access to India’s debt markets is possible, but there are barriers that need to be addressed for India to achieve its ambitions:

• A significant majority of investors (76%) admit it is more difficult to access India’s financial markets compared to other markets they participate in.
• 92% of respondents say that they would increase participation in Indian financial markets if access was easier.
• Capital controls (37%) are cited as the greatest barrier to accessing India’s financial markets. Low market liquidity (22%) and lack of electronic access (14%) are also identified as significant roadblocks to accessing India’s financial markets.
• A majority of respondents said clearer regulatory guidelines would increase ease of access and lead to deeper foreign investor participation.
• Greater depth and a more active yield curve is needed in the Indian corporate bond market to drive global investor participation.

In the months ahead, overcoming and addressing these barriers will be critical for global investors to further participate in India’s bond market. This will require a review of capital controls, greater clarity of regulatory requirements for participation and an investment in advanced trading technology. Based on Bloomberg’s experience in global fixed income markets, there are four key main criteria in creating an investible bond market - regulatory guidelines, market access, investor demand and improved benchmarks. Having these factors in place will enable India to capitalize on a robust bond market that will ultimately unlock new financing opportunities, enhance capital allocation and drive economic growth.

Conclusion

“Frequent change in regulations / taxation make it very difficult to invest with long term horizon.”
The current low-to-negative interest rate environment around the world is making Indian bonds an even more attractive option for certain investors.

India has an active and open financial market. The country’s stock market is among the top ten largest in the world, and its fixed income market is the fourth largest among emerging economies.

However, cultivating a stronger bond market to help underwrite the burgeoning economy is necessary if India is to reach its bold ambitions of becoming a $5 trillion economy by 2024, and, according to Bloomberg base-case estimates, $8.4 trillion by 2030. If it can do so, India’s economy could be the third largest by 2026, behind China and the U.S.

India’s future inclusion in benchmark indices could significantly deepen the India bond market and attract global investors, which are playing an increasingly important role in shaping foreign portfolio allocation flows into growing economies.

Continued reform in its financial market will be critical in the road ahead. The easing of controls on foreign investments into the bond market would open new avenues for capital flows as India increases issuance of government debt to fuel its growing economy. The government is looking to increase public investment to 100 trillion rupees over the next five years from 35 trillion rupees over the last five.

In addition, the issuance of foreign currency debt and removal of restrictions on bond investments—including caps and capital controls that are roadblocks for global investors—would help to address concerns over the ease of access to India’s financial markets.

For global investors, a more internationalized debt capital market would deliver greater pricing transparency, stronger governance in assessment of opportunities and more efficient capital allocation. Index inclusion would also be a strong signal that India’s bond markets are open for business.

The India index inclusion journey and what needs to happen

In order for Indian bonds to be included in some of the most important global indices – many of which are tracked by trillions of dollars of benchmark driven assets under management – India’s local currency debt market must be classified as investment grade. The currency must be freely tradable, convertible, hedgeable and free of capital controls.

China’s recent inclusion in the Bloomberg Barclays Global Aggregate Index could hold guidepoints for India in achieving similar index inclusion.

China’s bond market accessibility was first discussed at Bloomberg’s Index Advisory Council meetings in 2016. The following year we updated inclusion rules for the Bloomberg Barclays China Aggregate Index and launched two global indices that included China as a forerunner to future full inclusion.
As of April 2019, Chinese bonds are being phased in to the Bloomberg Barclays Global Aggregate Index over a period of 20 months. So far, with the inclusion of only Chinese government and policy bank securities in the Index, the amount of Chinese bonds held by overseas institutions reached a historic high of RMB 2.02 trillion as of July. Goldman Sachs predicts that China’s inclusion into global benchmark indices will attract more than $1 trillion of capital inflows to the China bond market over the next decade.

Once fully phased in, Chinese bonds in the index are expected to make up approximately 6% of the index overall. That would make the Chinese bonds the fourth largest currency component of the index after the USD, Euro and Japanese Yen.

Some of the core initial conditions to support index inclusion are already in place in India. These include a rules-based monetary and fiscal policy framework, manageable levels of external debt, a flexible exchange rate and adequate levels of forex reserves.

Three key lessons - broad engagement, financial reform, operational requirements

Implementing the further required elements may take time and political will, but it’s worth remembering that China’s journey to index inclusion took three years. China also holds some relevant insights for India’s own moves forward, notwithstanding the differences in the financial, political and regulatory dynamics in these two huge markets.

Firstly, regular communication between international investors and India’s regulators, government and economic architects is crucial. Engagement on the accessibility and ease of access to India’s bonds markets will be a core part of the governance process for index providers and investors alike. Index providers such as Bloomberg can play a proactive role in facilitating that engagement.

Secondly, concrete steps to reform India’s financial markets will need to be undertaken systematically and over time to meet index inclusion rules. For example, quotas, caps and other restrictions on bond investments will need to be removed or eased in a planned and transparent way.

Thirdly, resolving the operational requirements of investors is critical. Successful index inclusion requires the coordination of many market players and regulators. Taxation laws need to be clear, global custodians must be able to support market participants, and rating agencies need to establish their presence to support the eventual inclusion of corporate bonds.

A well-functioning, internationally accessible bond market thrives on transparency. Attracting global investors through a clear, time-bound and stepped series of reforms and easing of restrictions can be a key lever in India achieving its bold economic vision and targets. It’s time to turn the dream into a near-time reality and unlock new financing opportunities for India’s bond market.
Making India a USD 5 trillion economy - Role of corporate bond markets

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The target of making India a USD 5 trillion economy calls for significant investment by the corporate sector, including by companies involved in infrastructure activities. Access to capital for all productive sectors of the economy is a critical prerequisite in this regard. Traditional bank financing, on its own, may fall short in fulfilling this requirement. In this regard, the role of bond markets in facilitating long-tenor, fixed-rate, debt financing from non-bank credit channels becomes all the more significant.

The role of 4 I’s - Issuers, Investors, Innovation and Infrastructure - in the corporate bond eco-system needs to be examined critically in this regard.

Firstly, let us consider the supply side, i.e. Issuers. In order to boost investor confidence and enhance transparency in markets, issuers need to uphold the highest standards of corporate governance and must provide adequate disclosures to investors at the time of initial appraisal (i.e. filing of offer documents), as well as on an ongoing basis, in a timely manner. It is often said that bond market vigilantism incorporate credit discipline in borrowers through transparent credit pricing and impact on bond spreads through signaling of credit deterioration. Market participants expect borrowing discipline and clear, consistent articulation of issuance strategy from issuers. The role of auditors, credit rating agencies and debenture trustees are extremely critical in this regard.

Secondly, let us consider the demand side, i.e. Investors. While there are enough regulatory efforts to nudge large corporate borrowers to raise debt finance through bond markets, these need to be matched by commensurate demand side measures. Existing regulations for insurance companies and retirement funds skew the investor demand towards debt instruments rated “AA” and above. The investor appetite for issuers across the credit curve, including the ability to price and trade different structures, would be a key determinant in achieving the desired objective. Existence of a deep and diverse investor base is an essential prerequisite for development of corporate bond markets.

Traditionally, household savings are channelized into financial assets through mutual funds, insurance companies and retirement funds. The steady growth in AUM of these entities indicate growing demand for fixed income securities. However, the surge in gross borrowings of central and state governments, including supply of GoI-serviced bonds, tend to have a crowding out effect on market borrowings by private corporates, a trend that becomes more pronounced in the event of “flight to safety”, thereby further shrinking the available pool of debt capital for private sector corporates.

One of the efficient ways to increase liquidity is to increase the breadth of the market by bringing new investors into the market. This may be done by diversifying away from the traditional pools of institutional liquidity by encouraging new investor segments including retail investors and corporate treasuries to invest in corporate bond markets directly. Further, large institutional investors like LIC and EPFO may be encouraged to participate in the secondary markets, thereby enhancing market liquidity.
In order to achieve the target of making India a USD 5 trillion economy, access to domestic pools of debt capital alone may not necessarily be adequate. The measures for attracting foreign pools of capital, especially real money investors and sovereign wealth funds, assume equal significance. The Voluntary Retention Route (VRR) is a key initiative in this regard, as it offers great flexibility to foreign portfolio investors (FPIs) looking to commit long-term money to local INR debt markets. The authorities may also evaluate relaxing the withholding tax provisions for foreign investors, who are willing to commit long-term capital through VRR mechanism. The FPI route should be made easier to access by easing guidelines on concentration norms, residual maturity restrictions and by simplifying the overall compliance structure. Eligibility of domestic security holdings under Euroclear/Clearstream shall further enhance the operational convenience for FPIs.

Thirdly, let us consider the product side, i.e. Innovation. Product innovation now encourages creativity in terms of exploring different structures, payout profiles and currencies, replicating most features of bank finance. Given the preference for high rated bonds among end investors, a wider segment of issuers may access the bond markets through credit enhancement mechanism, including partial guarantee mechanism and securitization. There should be adequate funding options for a range of inter-bank as well as non-interbank participants, including corporate bond repo markets, CBLO-equivalent products and term money. RBI may also consider accepting high rated corporate bonds as collateral under LAF window.

The ability to hedge underlying risk through interest rate derivatives, including interest rate futures, swap markets and interest rate options, is a key determinant of establishing investor confidence further. Credit Default Swaps (CDS) may be encouraged to allow market participants to hedge their credit risk by permitting netting of counterparty risk arising out of CDS contracts and by allowing more entities to act as market makers. Asymmetric accounting treatment of derivative and bond, wherein the profit and loss on derivative is recognized through P&L, whereas loss on bond is recognized through P&L while the profit on bonds is only recognized on sale, needs to be evaluated in order to incentivize the use of derivatives.

Last, but not the least, we need to consider strengthening the market infrastructure further, which forms the backbone of well-functioning markets. Unlike the screen-based government securities market, corporate bonds are traded in the OTC/voice market. Introduction of anonymous, electronic trading platform with DvP-3 settlement can improve secondary market liquidity significantly and can help investors buy or sell large positions anonymously without impacting secondary market levels significantly. The implementation of Insolvency and Bankruptcy Code is a significant development for credit investors and progress on this front needs to be watched to provide assurance of creditor rights and build confidence about resolution and recovery. This would increase investor interest and liquidity in the distressed debt segment.
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Today, Bloomberg’s customers in India include leading corporations, financial institutions, government agencies and business schools. As India moves into the next chapter of growth to become a $5 trillion economy, Bloomberg will leverage its innovative technology, data and analytics to advance its financial market development. With our deep global network, we convene global investors to India’s financial market, and connect Indian banks to the international financial community, driving greater access and participation.

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