DBS Focus

India: Assessing prospects of bond index inclusion

Economics/growth/fiscal/monetary/bond

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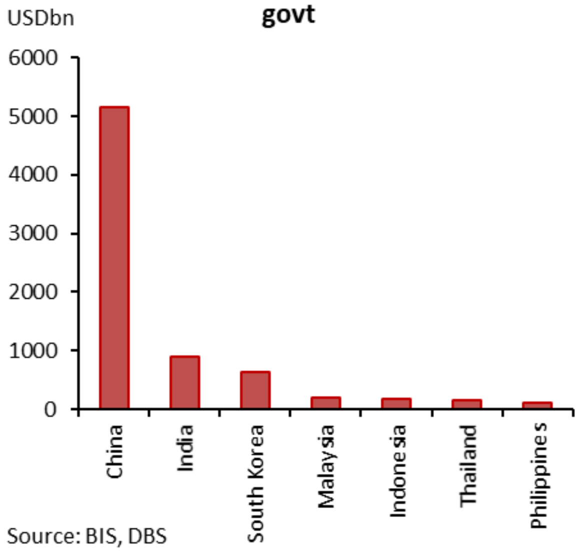
- *Authorities are keen to get Indian securities into global bond benchmarks*
- *Benchmarks like the JPM Global bond index EM and Bloomberg Barclays Global Aggregate Bond index, are likely to be considered for a start*
- *Weightage and strength in inflows will hinge on the scale of securities open to foreign participation*
- *Inclusion typically involves a lead time*
- *Less volatile and long-term focused flows are expected*
- *If opportune, India might widen the scale of such inclusion, and/ or consider an offshore dollar bond*

The Union Budget in early-February officiated the government's plans to facilitate the inclusion of Indian securities to global benchmark bond indices. This idea was last mooted in 2013 to attract offshore investors' interests. Intent is more decisive this time around. We discuss the prospects:

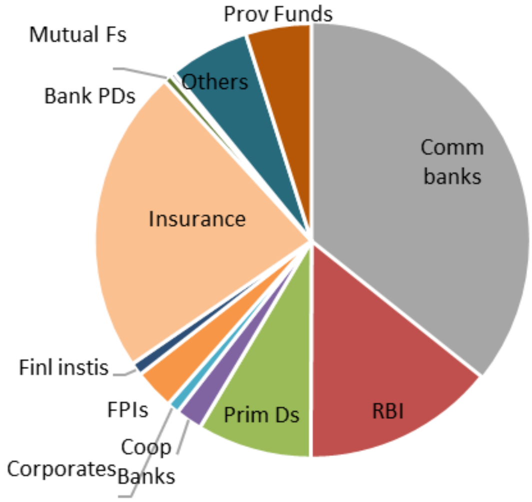
Size of outstanding debt securities - domestic; govt



Source: BIS, DBS

With India not being a part of the global indices, investors are focused on total returns and are classified as off-benchmark investments. The latter tends to be more volatile than flows mirroring global indices.

Ownership of govt bond holdings (FY20)

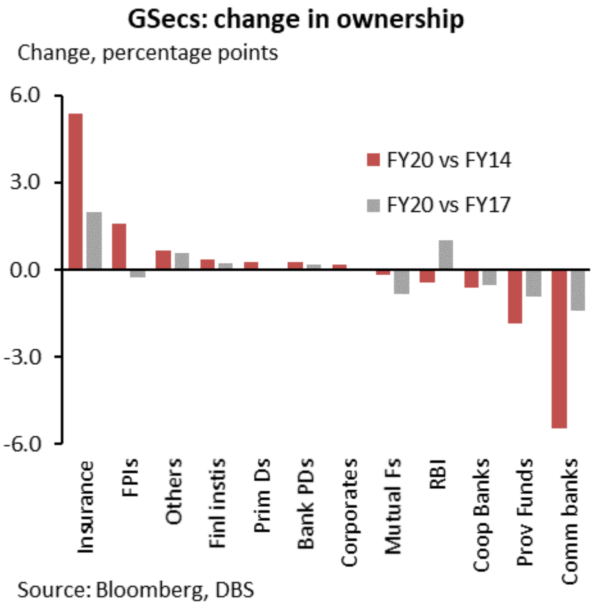


Source: Bloomberg, RBI, DBS

There are push and pull factors behind the interest in index inclusion. A push factor is rising bond issuances in recent years, with FY21 net borrowings budgeted at a record INR5.4trn (gross ~INR7.8trn). Central government's borrowings are primarily raised through domestic sources, led by banks.

The chart below highlights the change in ownership over the past three-five years.

Commercial banks are still the key captive audience (~39% of outstanding) for domestic bonds, but they have scaled back on their exposure in recent years. Banks' SLR (Statutory Liquidity Ratio) has been gradually lowered to 18% of their net demand and term liabilities (NDTL) vs 25% a decade ago. While banks still maintain SLRs at ~5-10% more than mandated levels, they now have more discretion on level and scale to buy/ hold. As banks' fall back, provident funds, foreign portfolio investors and the central bank have stepped in to fill the gap in the past two-three years. We also note that the recent Budget sought to eliminate tax exemptions for investments in insurance, which at the margin could hurt demand for bonds particularly the longer-tenors (15Y+).

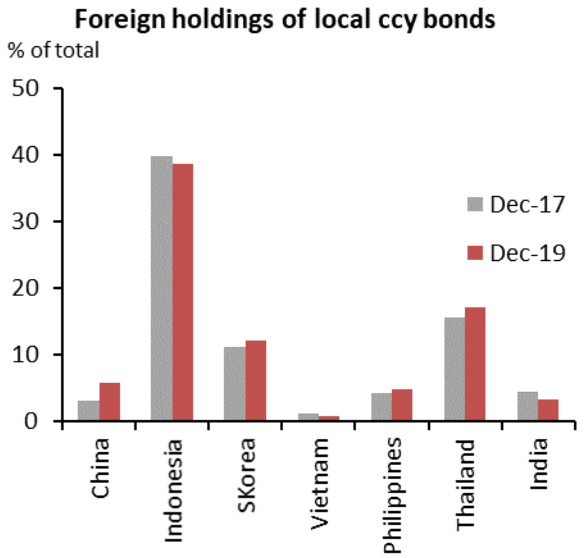


Source: Bloomberg, DBS

As structural demand from banks moderate and domestic financial savings ease (demand), vs rising public sector borrowings (supply) i.e. centre plus state and public enterprises (~8-9% of GDP), there is need to bridge this demand-supply mismatch. Hence, the interest in attracting a new source of demand and financing avenue from a diversified pool of investors, particularly from passive investors and EM-focused fund houses.

Important pull factors are flush global liquidity and an avenue to attract index-focused investors. Global central banks have cut rates to low or are near zero-bound, while also deploying asset purchases as a tool to lift growth and spur inflation. This has eroded returns in developed market treasuries, pushing investors into higher-yield and more attractive emerging market debt, including India. Investors have routinely been drawn to a) a potential FX play i.e. a firm INR environment due to steady flows, b) if yields are perceived as cheap enough after being oversold due to domestic catalysts, and c) tap attractive yields vs low returns in much of the developed part of the world.

Notwithstanding fiscal concerns, foreign portfolio investors bought ~USD4bn of INR securities in 2019. To open up the bond market further to foreign ownership, the authorities prefer an incremental and gradual approach, with current investment quota for government bonds pegged at 6% and corporate bonds at 15% of outstanding issues. With foreigners likely 'under-invested' in Indian securities at this junction, expectations are that an inclusion into any of the global indices would help attract more investor groups, hitherto limited only to benchmark funds.



Source: ADB, RBI, Bloomberg, DBS

Secondly, certain category of investors/ funds prefer to tap into benchmark indices, for reasons like: a) utilise as portfolio performance targets; b) informational measures of security-level and asset class risk and return characteristics, and c) references for index-linked products [1].

Warming up to global indices

Two bond indices are likely under consideration, as a start: JPM Global Bond Index – Emerging Markets (JPM GBI) and Bloomberg Barclays Global Aggregate Bond index. Few prerequisites (differs between benchmarks) include a sovereign debt rating of investment grade, sufficient liquidity, transparent pricing, a developed forwards/ NDF market so that foreign participants can hedge their exposures into core currencies etc,. amongst others. Add to this and more important is the requirement of no capital controls and free access to investors. There are minimum token size requirements in some cases, for instance, the JPM government bond EM series attract issues with a current face amount outstanding of USD1bn for onshore local currency bonds [2]. Sufficient secondary market liquidity will also be important to ensure easy entry and exit for the investor community; thus securities more liquid benchmarks in the INR GSec universe will have to be part of the basket.

With respect to assets under management (AUM), about USD200-250bn worth funds are benchmarked under the JPM GBI-EM, while ~USD2.1trn tracks the Bloomberg Barclays GABI.

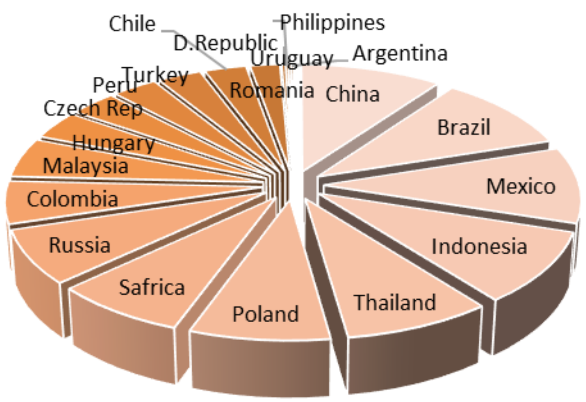
Potential weightage and scope for flows

Indian authorities are not considering a complete opening up of the local debt markets. **Recent remarks point to a preference for a gradualist and incremental approach.**

To tread lightly, a special 'carve-out' from the FY21 fresh annual borrowings is likely, free of investment restrictions. There is also a possibility that few of the pre-issued securities are re-opened for this inclusion. Press reports [3] suggest that related announcements might come as early as this month, along with the issuance calendar for 1HFY21 i.e. April to September period.

Weightage hinges on market capitalization, implying that securities represented in the index are weighted according to the market size of each bond type.

Clearly, larger the size of securities available for inclusion, higher the weightage on the index. By virtue of investments under consideration, the weight of Indian securities will be higher under JPM GBI-EM and smaller with the Bloomberg Barclays index.



Source: JPM, Reuters, DBS

Assuming, Indian authorities earmark a third i.e. ~USD30-35bn of the FY21 gross issuance. As a percentage of the market capitalisation of securities tracked by JPM-GEBI, this will lend a weight of about ~3% in the index and less than 1% under the Bloomberg Barclays index. **Every 1% weightage in either of the two indices can potentially draw in inflows worth USD2-3bn and USD18-20bn respectively.**

Typically such inclusion will also involve a lead time. The process includes convincing an advisory committee of global investors on attractiveness of the new securities. The Bloomberg Barclays Global Aggregate Index will add Chinese government and policy bank bonds over a span of 20 months since April 2019. Onboarding the selected Chinese local currency bonds onto the JPM GB Index will likely be a 10 month process, from February 2020.

In a nutshell, weights on the index need to be meaningfully large to attract sufficient funds. And the process carries a lead time and is a lengthy process, even after approval from the respective indices.

International experience

Emerging markets are under-financed and have sizeable investment requirements, which suggest that the region-focused funds will continue to expand. Multiple countries have received representation on such indices, as the weightage chart highlights.

In 2015, Chile recognised the need to be included in the key EM local currency debt index. Efforts began by addressing one of the key constraints in its debt market i.e. its bonds are small and numerous, making a challenge for investors to replicate a benchmark index based on these securities. Subsequently, the economy issued longer-duration and big-ticket papers, which was expected to replace the illiquid papers over time. Subsequently, to increase liquidity in the domestic market and pushing for broader inclusion of Chilean bonds in the GBI index, all government and central bank securities became Euroclearable, moving away from the past practise of global depositary notes which was used to sell peso securities to offshore investors. These measures increased Chile's share in the JPM GBI from 0.1% to 3% last year. Holdings of local debt by non-residents also rose from 3.4% in 2016 to ~16% in mid-2019.

China was added to the indices most recently. Amongst many of the measures taken to ease higher foreign participation included, doubling the QFIIs quota, removing the cap on repatriations for QFIIs and lock-in period for both QFIIs and RQFIIs. Investors under this jurisdiction were also allowed to engage in FX derivative transactions with their custodian onshore as well as other onshore financial institutions for hedging FX risk. September 2019, the securities and FX agency also scrapped the quota system for QFIIs and RQFIIs.

Estimates of additional flows into China range from USD20bn under the JPM GBI-EM umbrella to USD 150bn under the Bloomberg Barclays index.

Paves the way for greater participation

Higher offshore representation in local bond markets will increase scrutiny of fiscal and growth developments. This will be, more so, in comparison to other EM economies in the basket. This, we believe, will enable better pricing discovery and adequate factoring of underlying risks.

A step into global benchmarks will result in stronger incremental flows, particularly passive funds that benchmark against such global indices. Benchmarked funds also tend to be less volatile and includes ones with a long-term investment horizon.

We also add that existing debt investment routes also have enough room for investors to participate in the local debt markets – the central government bond ceiling at USD52bn, states' at USD10bn and corporate bonds at USD45bn. As on date, utilisation rate is the highest for the centre's bonds at ~75%. There is still ~USD20-25bn worth limits for investors to partake in the local currency debt market. Investors will also be keen to gauge the ease in participation and smoothening of operational challenges to participate more actively in the INR debt space.

Limits on FPI debt investments

Categories	USDbn	% of outstandg
Government bonds	52	6%
State govt bonds	10	2%
Corporate bonds	45	9%*
Total	106.6	

* FY21 Budget raised ceiling to 15%

Source: CCIL, DBS

Index inclusion expectations are likely to drive a kneejerk strengthening in the INR bonds (yields to slip by 10-15bps) and bounce in the Indian rupee. The latter thereafter will remain subject to the central bank's presence which has demonstrated its preference to accumulate the FX reserves buffer and thereby reining in rupee bulls.

Beyond this experience, if opportune, India might widen the scale of such inclusion, and/ or consider an offshore dollar bond.

Notes:

[1] Bloomberg Barclays Index Methodology, 2017

[2] Government Bond Index-Emerging Markets Family of Indices; 2015

[3] Cogencis, February 2020

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations)