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Robust, Liquid & Deep Financial Markets will Lead to $5T Goal

The govt has announced a slew of reformist measures such as netting and other initiatives for deepening bond markets

Opinion

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Much has been spoken about the target of $5 trillion for the Indian economy. We see the current economic slowdown and the evolving global growth scare as temporary and a short-term hurdle in the achievement of this target. The potential and scope for India with its demographic dividend, high working age population ratio and strong institutional reforms have not gone unnoticed by global investors. What has not been spoken about much is the requirement of robust, liquid and deep capital/financial markets to effectively fund this growth and channel resources efficiently. The government has realized this necessity and is taking a number of steps to further strengthen our capital markets. This year too, the government has announced a slew of reformist measures such as netting and initiatives for deepening bond markets. These measures will also increase financing opportunities and reduce cost of capital for borrowers. Let us discuss the implications of a few of these steps.

This year's budget speech referred to the introduction of an exclusive bill for bilateral netting of financial contracts in the context of expanding the scope of Credit Default Swap (CDS) contracts. However, the implications of this are far more than just CDS contracts. Currently, for all derivative contracts, the capital adequacy guidelines of the Reserve Bank of India (RBI) require that capital be provided on a gross positive basis. This means that our current regulatory framework does not net off exposure which two counterparties have against each other and rather capital needs to be provided on the basis of gross exposure. This increased capital requirement for banks to deal in derivative contracts results in higher costs for the banks, affecting market liquidity and thereby affecting the hedging prices for end users in the economy and thereby the real economy itself. Additionally, this high cost puts onshore transactions at a disadvantage to offshore transactions where typically netting is the norm. It is envisaged that with netting, capital will be used more efficiently and transaction costs for derivatives will come down, positively impacting end users as well as attracting transactions of non-residents. The impact of netting on the CDS market (which is what the speech referred to in the first place) is only one amongst the many benefits that this legislation will provide. Today's investors in corporate bonds are effectively packaging both interest rate and credit views. An active CDS and IRD market will have the capability to delink the two.

The announcement that certain specified categories of G-Secs would be available for both non-resident and domestic investors without any limits is also a recognition of the need to integrate our markets with the rest of the globe. In essence, these bonds would not be subject to any limit on non-resident ownership (and not just FPI ownership). Seen along with the April 2019 monetary policy announcement where RBI was looking to permit G-Sec trading through International Central Securities Depositories (ICSDs), this is a significant announcement as it paves the way for certain G-Secs to be a part of Global Bond Indices (GBI) that might lead to significant inflows (upwards of $50 billion) from passive foreign investors (indexed to bond indices) over a period of time.

The proposal to increase FPI limits in corporate bonds from the current 9% of outstanding to 15% also underscores the importance being assigned to capital markets. Though this might not have an immediate impact as the current FPI limit in corporate bonds is only ~ 60% utilised, it is a medium- term positive. This, along with the measure to extend the exemption (at 5%) of withholding tax on interest payments for corporate bonds for another three years, makes the investment environment attractive. The 100% tax exemption on interest, dividend and capital gains income for Sovereign Wealth Funds (SWF) for investments in infrastructure is also another welcome move. It will attract further capital flows that will enable India to fund its priority projects. Additionally, the regulators have also recognized the trading of INR in offshore centres (called NDFs) and talked about RBI's proposal to permit Rupee Derivatives at GIFT City.

All these measures have a significant medium-term impact on capital flows into the country and thereby alleviate any pressures in currency markets. The reforms announced should go a long way in improving access to capital for Indian players and also lower the cost of capital, thereby resulting in favourable outcomes for the Indian economy.

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