RBI govt in talks to review FII limit in domestic debt

Raghuram Rajan says limits would be reviewed and revised over the medium term at regular intervals

The Reserve Bank of India (RBI) on Tuesday said that it is in talks with the government to set up a medium-term framework for participation of foreign institutional investors (FIIs) in the domestic debt market, but stopped short of increasing the limits set on FII purchases.

"The Reserve Bank is talking to the government about a medium-term framework for FPI (foreign portfolio investment) limits in debt securities," Rajan said at a press conference following the release of the monetary policy review.

"This will include a target for what fraction of the sovereign bond market would be constituted by FPIs in the medium term," he said.

Limits would be reviewed and revised over the medium term at regular intervals, and would also be denominated in rupee terms, he said.

"An announcement of staggered changes in limits every six months with these being released on a monthly or quarterly basis—which we have to determine," he said.

At present, foreigners can invest up to $30 billion in government debt and $51 billion in corporate bonds issued by Indian companies.

"That limit will change from dollars to rupees now. But obviously, it will bear some relationship to the current rupee investment which is already there and it will be incrementally based on that. It will move up on an incremental basis as we have announced," said the RBI governor.

Moving towards a limit in rupee terms will mean a one-time adjustment as the current dollar limit is converted at an exchange rate of 49.77 per dollar. The change may open up room for another Rs.30,000 crore in foreign investment in debt markets, Mint reported on 7 July.

He, however, said that these changes would be announced at an appropriate time, taking into account global developments such as the possibility of an interest rate hike by the US Federal Reserve.

Rajan said the framework will create space for participation of long-term investors such as pension funds and sovereign wealth funds as well as usual medium-term investors and importantly, those coming through international central securities depository such as Euroclear (Belgium-based financial services company) and Clearstream (post-trade services provider run by Deutsche Börse AG).

The overall goal is to attract foreign portfolio investors but within prudential limits, Rajan said.

In a conference call with analysts later, Rajan said it was "prudent" for RBI and the government to wait for the US Federal Reserve's rate action before deciding on the FPI framework.

"I am not worried about the effects of the Fed's action on India but there could be volatility, it could be small or a large one. We need to see it through and most predictions are for Fed's actions to be in September; so, it's prudent to wait because it will not cost us too much because of the state of liquidity in the market currently. Once we have seen through the external side of the consequences, we will have room to act," Rajan said.

Bankers and analysts said it is unlikely that the limit will be changed in a hurry and will not have a big impact on the market.

Manoj Rane, managing director and head, global markets and treasury for India at BNP Paribas SA said even if the limit on FII investments in government securities is changed to rupee-denominated, it will not be a big rise as is expected in some parts of the market.

"There is some discomfort about the kind of money coming into the debt market, that it is not long term. Having said that, there is clearly a need felt to open the debt market further to foreign investors, but it is likely to be done gradually and in a calibrated manner, as in the past," Rane said.

Foreign investors have eagerly bought into Indian debt since the start of 2014, due to the wide differential in yields in India and in developed markets. The rupee's stability has also lured investors to Indian debt. Since the start of 2014 till July 2015, net investments from FIIs in the debt markets have added up to $32.63 billion, higher than the $23.23 billion invested in the local equity market in the same period.

Foreign investors own less than 5% of outstanding government bonds in India, lower than other emerging markets such as Malaysia (45%), Indonesia (38%) and Turkey (23%), said a special report by DBS Bank Ltd post the RBI announcement on Tuesday.

In a note on Tuesday, DBS economists Eugene Leow and Radhika Rao said even in an "optimistic scenario" assuming that the FII quota expands $5 billion (approximately Rs.31,500 crore) every six months, foreign ownership would only increase by about 1% to 1.5% every year.

"The positive spillover into gilts is likely to take place over an extended period, provided risk appetite is in favour. In light of the domestic and external considerations, we reckon that a slow-paced expansion of FPI quota remains the most likely outcome as India seeks to avoid being overly reliant on foreign funding," the economists said.

"One of the key reasons behind the authorities' hesitance to open the domestic bond market to foreign investors in the past is the sizeable (and rising) scale of government borrowings. This in turn has its roots in the economy's persistent fiscal deficits," DBS said.

"Thereby in a bid to ring-fence borrowing costs from external volatility, the authorities have been wary of increasing the FPI debt quotas too hastily," the economists added.

The government has borrowed more than Rs.5 trillion from the local debt market in the last four fiscal years. It has budgeted a gross borrowing of Rs.6 trillion this fiscal. On Tuesday, the yield on India's 10-year benchmark bond fell to 7.77% but recovered to close at 7.84%, compared with its Monday's close of 7.82%.

The rupee ended higher at 63.75 compared to Monday's close of 64.04.

(HT Mint)