



Growing Asia's Markets

India Bond Market Roadmap

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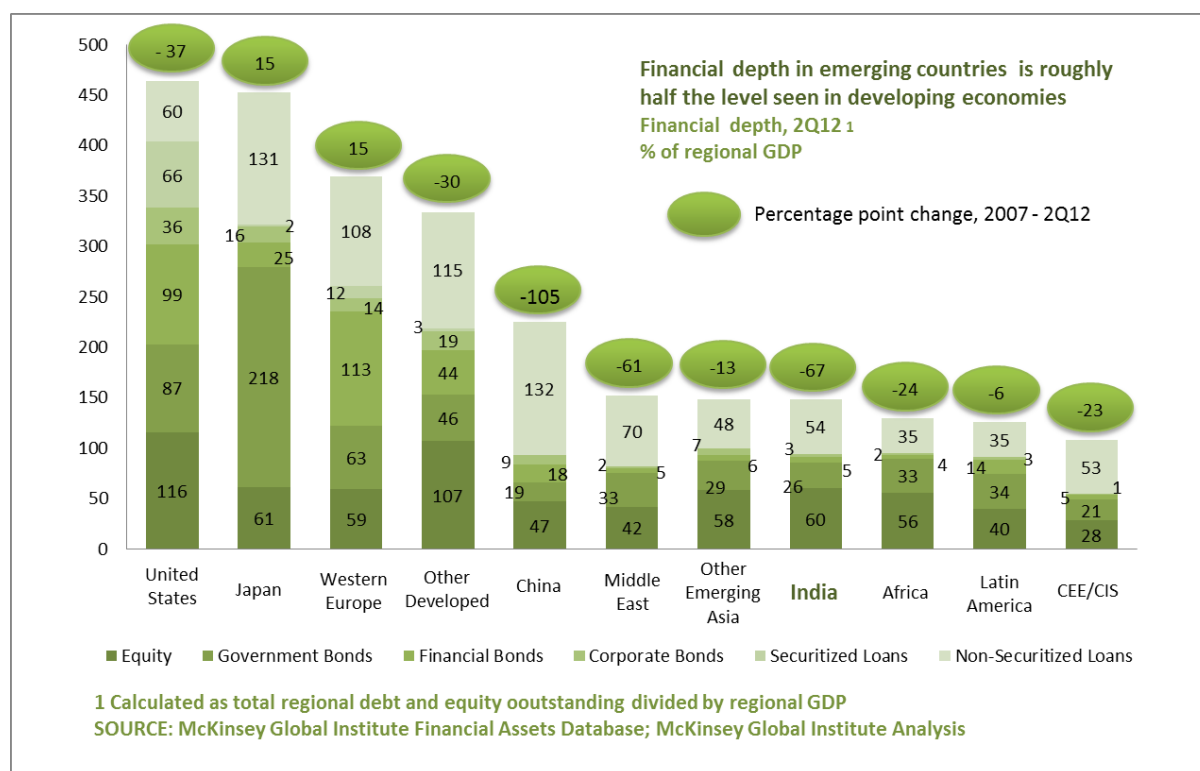
ASIFMA is an independent, regional trade association with over 80 member firms comprising a diverse range of leading financial institutions from both the buy and sell side including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative and competitive Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the US and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

1. Introduction

Over the last decade India has been considered a key growth economy in Asia, one of the “markets to be in” for foreign investors and a target of many international corporations looking to outsource their services to better compete on an international scale. In short, India was considered an emerging success story. However, the reality is now significantly different as the country grapples with serious economic and financial infrastructure issues that are, among other things, impeding foreign investment. This report proposes an approach for the implementation of a consistent and coordinated policy to further develop the Indian bond market for the benefit of India and its citizens. A more structured approach would enable a much safer and more appealing market for

issuers and investors and ultimately result in a stronger overall economy for India.

Unlike most emerging countries, such as China, India has solid aggregate demand and a consumer-driven economy. At the international level, India has fairly diversified exports including software, iron ore, commodities and non-commodities merchandise like machinery and chemicals; however, the prevalence of a consumer-based economy gives the country a great advantage over many other emerging markets that are overly reliant on exports. Nevertheless, the depth of the Indian capital markets lags the mature markets -- and even China -- and languishes somewhere at the lower end of the Asian emerging markets.



A combination of a strong equity culture and persistently high and rising interest rates biases investors against fixed-rate securities, more so if such investors are a) forced to take mark-to-market losses when such instruments are sold and b) typically do not trade their portfolios – traditional public sector banks fall into this category. The advent of floating rate notes (FRNs) and loans priced off a floating rate (such as LIBOR or equivalent “base rate”) does help insulate

financial institutions against higher rates, but this still does not address the issue of mark-to-market (MTM) losses on legacy fixed-rate instruments in bank portfolios and the reluctance on the part of these institutions to take MTM losses. Thus, the reluctance to hold more than the bare minimum in fixed income securities by a number of influential market participants results in an in-built bias against fixed rate securities. Of course, having more tradable floating rate securities such as FRNs

would help address this bias, but FRN issuance has by and large not picked up.

The still-massive government fiscal deficit burdens the banking system as banks must comply with a Statutory Liquidity Ratio (SLR) which contributes to the low depth of the Indian financial bond market. Indian banks are required to “buy and hold” a large portion of Indian government bonds by the SLR. Consequently, this negatively affects both infrastructure funding as well as the private corporate sector, which are ultimately crowded out as banks are required to fund government debt rather than invest in their development. These sectors are therefore unable to benefit from the financing needed for growth and expansion. Perhaps raising the limits for Foreign Institutional Investors (FIIs) and other foreign investors to invest in government securities would lessen the crowding-out effect, and the government could borrow offshore since it has a better credit rating than domestic companies, with the aim to free up capital domestically for the corporate and infrastructure sectors. Clearly, there is an immediate and urgent need to bolster a clear, supervised and straightforward foreign investment regime to encourage investments in the bond market whether it is for government, corporate or infrastructure requirements.

Finally, there are good policy reasons for constraining foreign investment into the Indian capital markets or making that access not as easy as for the capital markets of mature economies. In a high inflationary environment with a significant

current account deficit, India needs to effectively manage its currency. As has recently been seen, foreign money exiting the Indian capital market in significant amounts can put the currency under pressure and create volatility which has negative economic consequences. As with most emerging markets, there is a real desire to attract long term investment rather than speculative “hot” money. However, regulation normally put in place to prefer long term investment can have the opposite effect. Long term investors also need deep, liquid capital markets as this “real money” still may require the option to exit an investment. The more complex the restrictions on market entry, the more likely long term investors will seek flexible markets elsewhere. Therefore, the deeper and more liquid the market, the more likely long term investors will be to participate. Moreover, “hot money” flows can actually act as an early warning mechanism for policy makers to make required changes to their approach before it is too late. When long term investors exit markets, they are far less likely to return in the near term.

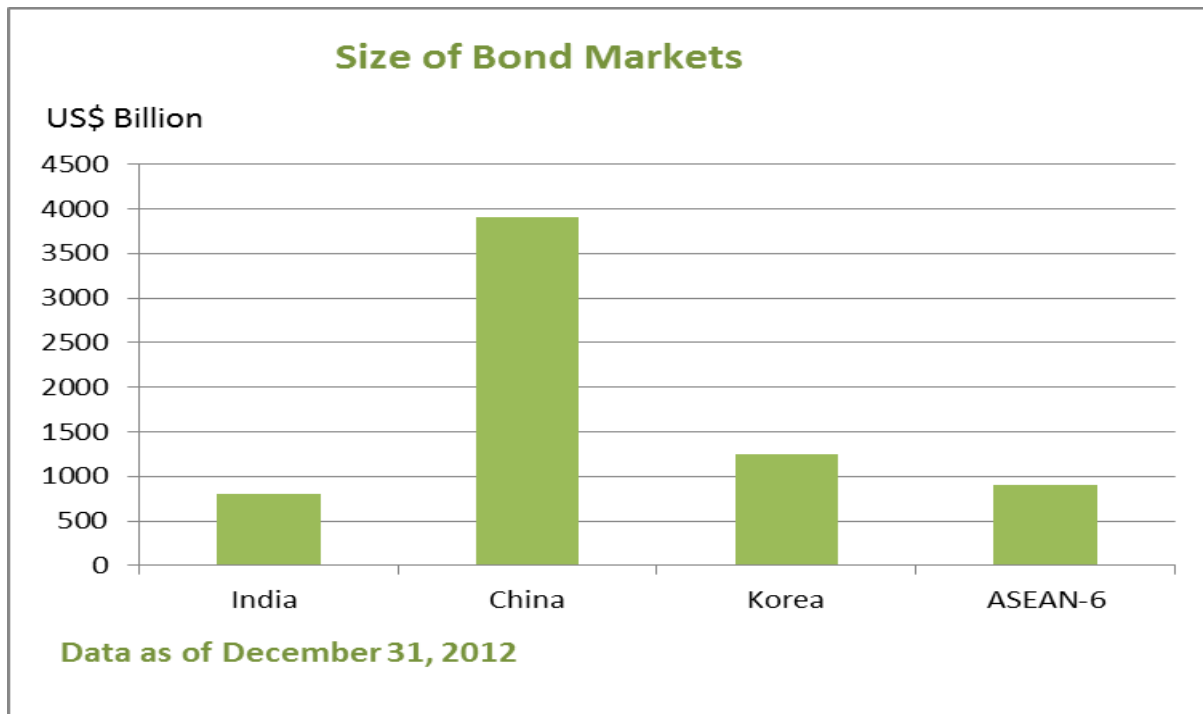
Without doubt India needs to work on is its infrastructure sector. The sector lacks the necessary funding and investment required. For instance, roads and highways are significantly underdeveloped, especially in rural areas. Complex regulation combined with an underdeveloped bond market hinders investment to flow to the infrastructure sector.

2. Current Status of Indian Bond Market

In 2012, the size of the Indian bond market was approximately equivalent to 27% of the Chinese bond market and 69% of the Korean bond market.

Towards the end of 2012, the total volume of outstanding bonds accounted for roughly USD 1 trillion, reflecting an overall increase of 24% from the previous year which both government securities and corporate bonds contributed.

Government securities comprise 79% of the total amount of outstanding bonds, a larger percentage than government securities in China, which is 73%, and in Korea, which accounts for only 39%. Last year, the amount of outstanding government securities increased more steeply, at a growth rate of 23% and reaching USD 792 billion, compared to the average rate of 18% per year over the period spanning from 2000 to 2012.



Note: Percentage figures at top of bar chart refer to corporate bonds

The percentage of outstanding corporate bonds to GDP indicates the small size of the Indian corporate bond market. The total share accounts

for 5.48% representing an extremely small proportion of the total. In the Asia-Pacific region, the corporate bond markets of namely Malaysia,

South Korea, Thailand, Singapore and China, exceeds that of India as a percentage of GDP. Only Indonesia has a weaker corporate bond market in the region. Although it is very small in size as a share of GDP, the corporate bond market is actually one of the largest in East Asia outstripping most of these emerging bond markets, with the notable exceptions of China and Korea. However, the non-financial corporate sector is not actively represented in the Indian bond market. In fact, financial institutions, such as banks and non-bank financial, together comprise 72% of the overall amount of outstanding corporate bonds.

As of end 2012, government securities and government bonds accounted for the largest proportion of the market at approximately USD 543 billion or 68%. By contrast, state government as well as municipal bonds amounted to 20% of the total securities, growing on average at an annual rate of 22% from 2000 to 2012. The steady pace of growth can be explained by the increasing need to fund and finance several large-scale infrastructure plans.

3. The Need for a Well-Developed Capital Market

India's growth over the last decade has contributed to the emergence of a large middle class, although the GINI coefficient (a statistical measurement of economic inequality) started climbing over the last twenty years. The availability of capital market instruments will assist in a) the growing pool of middle class savings being used to develop a more sustainable and solid foundation for the Indian economy and b) providing alternative investment vehicles that provide a greater return than that available on bank deposits.

For a number of reasons, the bond market should be the leading force in this important process. First, it would significantly help strengthen and grow the private corporate sector. Corporations currently rely heavily on banks as the major source for financing their businesses. Going forward this must change. Currently, due to a variety of reasons, covered in more depth later in the paper,

The different types of bonds in the Indian bond market can be categorized into the following:

- 1- Government bonds: issued directly by the government of India, the so called G-Sec;
- 2- Borrowing by state governments: made by single states within India;
- 3- Tax free bonds: issued directly by quasi-sovereign companies allow market expansion for investors and, in particular, embody retail interest into the market;
- 4- Corporate bonds: this market must be further developed as proved by the ratio of outstanding government bonds to total outstanding bonds;
- 5- Banks and other financial institutions bonds: they are underperforming;
- 6- Tax-savings bonds: issued directly by the government of India, they provide investors with tax rebates, in addition the normal rate of interest;
- 7- Tax-saving infrastructure bonds: issued directly by infrastructure companies approved by the government, they offer tax rebates along with a decent rate of interest.

the investor mindset tends to hold securities in a hold-to-maturity portfolio. An under-developed bond market gives the banking sector a quasi-monopoly position in the lending market. As a consequence, banks have less and more costly capital to lend to the small and medium-size enterprises.

Establishing regular and fair access to the bond market for the private corporate sector would certainly boost overall business growth. In turn, a more liquid and accessible bond market across sectors, maturities and ratings classes, would create investment opportunities for a growing domestic institutional investor base. This virtuous cycle could assist in attracting foreign investors; thereby help the markets become even more liquid. While it is true that higher rated Indian bonds in the AAA to AA ratings classes have liquidity (due to a large class of investors such as insurance companies being restricted to only investments in high rated bonds), there is a need

to attract additional investors to the lower rated, but still investment grade, and high yield bonds. By easing investment restrictions on certain classes of domestic investors this could help to develop a broader investor base. Additionally, a broader investor base could ultimately function as a shock absorber, creating more stable markets. As the private corporate sector grows, it will constitute a solid foundation for employment, which would in turn contribute to the enlargement of the middle class and continue to further reduce the wealth gap.

Developing a sound bond market in conjunction with creating an adequate credit rating industry would contribute to increased transparency. By doing so, both the private and public spheres would benefit enormously. Higher rated firms in the private sector would benefit as lower borrowing costs would permit more investment-grade corporations to fund themselves at lower rates while investors can use various ratings metrics to distinguish across companies and sectors. Sub-investment grade firms would also benefit as access to funding becomes available (albeit at a higher price). The alternative to these firms is the current situation of largely being shut out of the markets (as banks and other financial institutions consider these High Yield issuers to be poor credit risks). This is clearly not optimal. As far as the public sector is concerned, lower cost of capital (under the assumption that a sovereign or quasi-sovereign issuer is typically highly rated) would increase the amount the government can actually invest to meet the needs of the real economy, including education, health care and infrastructure.

Previous crises have underscored how important it is for companies to rely on a sound bond market. The Indian loan market works through a relationship system and therefore companies are more eager to go through the banking system for

funding. However, the banking sector cannot be the only source of long-term investment financing. At times when the banks' books are weak and banks rationalize and tighten lending, the bond market becomes the cornerstone for keeping the economy going, by providing an alternative avenue for raising capital. Moreover, with the tightened capital requirements under Basel III and with banks having to inject huge amounts of capital to support their balance sheets, a number of banks, both local and foreign, have scaled back their lending activities throughout the Asian region – thus, this is yet another argument in favour of the continued development of local bond markets, as an alternative to the bank loan markets. In addition, companies needing to pay back loans, especially if stipulated in foreign currency, become vulnerable to abrupt changes in offshore interest rates. The recent trend of high exchange rate fluctuation and the significant devaluation of the Indian Rupee have squeezed corporations' profits, in particular if they have to meet foreign exchange obligations. Lowering the level of borrowing stipulated in foreign currency would insulate the domestic financial system, in effect blocking a channel through which external shocks can be conveyed to the country, and therefore alleviating the exposure of the corporate sector to currency and liquidity volatility. This was clearly in evidence during the Asian financial crisis of the late 1990s, when countries with relatively low offshore borrowing by onshore entities (such as India and China) fared better. By allowing new participants to take part in the local currency bond market, credit risk would be smoothed across different sectors of the economy, alleviating the pressure on the banking system and making the financial system as a whole more secure, sounder and less prone to crises and downturns, which have negative knock-on effects on the real economy.

4. Establishing a More Robust Bond Market

Promoting the development and the expansion of bond markets would significantly increase the depth of the financial markets in India. The expansion and deepening of the bond market

would better serve the needs of both the private and public spheres. Further on in the report, the technical aspects for the establishment of a well-

functioning government and corporate bond market will be discussed.

At a very broad level, it is clear that the Indian regulatory and monetary authorities recognize that developed capital markets (and especially well-established bond markets) confer several benefits. However, it is worth recognizing the inherent reservations that authorities in Emerging Market (EM) countries have on the subject of totally free and open capital markets, especially in situations where investor sentiment towards a country or group of countries within the EM or a region, turns substantially negative – the capital outflows and accompanying volatility destabilize not only markets but also the very economic foundations that underpin a stable and functioning society (the Asian crisis of the late 1990s and the accompanying weakness in a number of Asian countries is but one example of this). Thus, the

A. Interest Rate Liberalization

One of the most important factors needed to create a vibrant, attractive and accessible bond market is the freeing of interest rates to reflect market conditions, without artificial caps and floors. In this regard, ASIFMA supports the effort made by the Reserve Bank of India (RBI) in deregulating the interest rate on savings. Before the liberalization, the rate of interest was fixed at 4%; however, since 2011, banks are free to set

B. Government Bonds

To begin, ASIFMA will address the reform put in place by the RBI to remove the cap on the amount of government securities per issuance, which was previously fixed at INR 700 billion. Removing this cap has encouraged many new issuances, outstripping the ceiling which is no longer in place. Currently, there are more than sixteen bonds above INR 700 billion, and at least five securities well above INR 900 billion. This allows large issues to be traded “on-the-run” for a longer period of time without distortions.

Another way to prolong the period a security is traded “on-the-run” could be by allowing on-tap issuances, i.e. issuing bonds from past issues at the original par value, maturity and coupon rate but at

instinctive desire on the part of the leadership in developing economies (India included) to have some reservations to unfettered capital markets is understandable and we acknowledge these reservations. That said, we still believe that as a practical matter, several steps could be taken to improve the functioning and efficiency of markets, without sacrificing prudential control measures that could remain in place to prevent undesirable volatility arising from fickle capital flows. We outline these practical steps and proposed initiatives below. Moreover, as we attempt to explain the best protection against the volatility caused by rapid “hot money” inflows / outflows is the development of deep liquid capital markets with fewer and better designed constraints. Long term investors also need deep liquid markets and frequently are put off by excessive constraints on investment.

their own rates. This is particularly relevant because it leaves each bank the option to decide which rate to apply.

With the introduction of the base rate in July 2010, banks were then able to fix a floor on the lending rate. Banks are also required to publicly show their own base rates in order to render the lending system, as a whole, more transparent and fair.

the current market price. This would relieve issuers from the pressure of their issuances moving “off-the-run” too quickly.

Related is the problem of the issuance calendar. In particular, smoothing out the particularly large issuances over a longer period of time -- perhaps over a year or even longer -- would attract investors’ attention for a more extended period. ASIFMA acknowledge the solid effort of publishing the issuance calendar twice a year, in March and September, thereby alleviating uncertainty in the market and providing investors with more transparency.

A more open and accessible government bond market would also be extremely beneficial for government financing and the real economy development. Adding the Indian government securities to popular bond indices, such as in the J.P Morgan GBI-EMGD index, would likely cause a massive up-tick in government bond purchases, USD 20 to 40 billion according to a research report by Standard Chartered. Large inflows, along with a freer capital control system, which is a prerequisite for being included in popular bond indices, would constitute an avenue for the government to finance its balance of payment current account deficit and to strengthen the Rupee in the medium to long term. Certainly the cap imposed on FII

investments is deleterious. Although there have been recent positive changes towards the simplification of the foreign investment framework for debt, aggregate foreign investment in government securities is capped at USD 30bn. Strong FII inflows are beneficial for the real economy as they contribute to lessening the crowding-out effect on the corporate sector and broaden the investor base for the purchase of government securities, which in turn makes the market more resilient and less volatile. As a result, the combination of all these factors will relieve pressure on the Rupee and finance the deficit the government is running in its current account.

C. Benchmark Yield Curve

In a properly functioning bond market, the need for accurate and reliable benchmarks is pivotal in both the primary and the secondary markets. In fact, they sway and define the structure of the interest rate and investors' expectations for future interest rate fluctuations, and they are used as hedging tools to balance risk. Therefore, the presence of a liquid benchmark yield curve is the basis for a sound and robust bond market in which government as well as corporate bonds can be traded. By doing so, the markets can achieve a higher efficiency of capital allocation and the government would also be able to better foresee market expectations.

In India, the 10-year, the 5-year and the 2-year government bonds are currently the main benchmarks in the bond market. The establishment of a benchmark at every level of the yield curve, though, would provide investors and issuers a better way to gauge both long- and short-term securities as it would set a "risk free" rate across the yield curve from which corporate and infrastructure bonds can be priced. We strongly encourage the government to continue supplying liquidity. Developing term floating rate benchmarks would as well help issuers swap fixed rate issuance into floating, which is extremely important in a high interest rate environment.

D. Secondary Market Trading

The development of a proper secondary market constitutes the basis of an advanced and sound capital market. Its expansion would bring multiple advantages. First, it would help establish the "risk free" reference yield curve mentioned above. It also allows accurate derivatives pricing and the development of a sound corporate debt market, which would be priced off the curve, while also supporting the growth of solid money markets. Further, it permits government to borrow for longer terms at a lower price, thereby enabling the government to better fund infrastructure and urbanisation projects across the country, which are direly needed in India.

ASIFMA supports and recognizes the RBI's efforts to promote and foster government securities trading in the secondary market, the growth of which is illustrated in the table below. However, the market is still illiquid and therefore in need of a more significant change. The aggregate trading volume is misleading and does not provide the clear picture, since liquidity is fragmented across many individual issues a number of which have very limited trading. Low liquidity results in volatility as even small trades can move the market price significantly and, therefore, it prohibits investors from exiting markets smoothly or rebalancing their portfolios in a cost effective manner.

Volume in Government Bonds Market		
Year	Primary Issuances* (billion)	Secondary Market Trade \$ (billion)
2005-06	1,527	8,648
2006-07	1,668	10,215
2007-08	2,238	16,539
2008-09	3,911	21,602
2009-10	5,821	29,139
2010-11	5,410	28,710
2011-12	6,686	34,882
*Gross for Central and State Governments. \$ Single-Side Volume		
SOURCE: RBI Web Site		

Moreover, four fifths of most issues of government securities are held in “hold-to-maturity” portfolios. This clearly inhibits the amount of trading in the secondary market, reducing the issues actually traded and further dwindling liquidity. Understandably enough, the Indian government put in place a Statutory Liquidity Ratio (SLR) to guarantee liquidity to the banking sector as well as to guarantee a resilient funding source. However, this inhibits the trading of securities in the secondary market. High statutory liquidity ratio (SLR) and cash reserve requirements applied to banks contribute to the “hold-to-maturity” (HTM) bias within the bond market. Under the new regulation the RBI cut the SLR from 25 to 23% in quarterly phases of 0.5%, liberating approximately INR 1500 billion. However, in August 2013 the RBI restored it to 24.5%. ASIFMA urges regulators to revise this decision as it hinders the trading of government securities. Besides SLR, the tendency of interest rates to climb and remain high, due to an attempt to hold against high inflation pushed up by rising food costs, is another cause of distortion. In a period of rising interest rates, banks are aware that this tendency will continue virtually indefinitely and therefore will never sell off bonds recognising losses as they do not have to mark them to market if they hold them in their banking books. As a consequence, they tend to hold them to maturity. ASIFMA urges the government and the RBI to remove the SLR over time in order to eliminate the HTM bias. In fact, banks hold around 28/30% in government securities, clear sign that,

despite the SLR, banks lack a concrete variety of remunerative projects to invest in.

Moreover, if investors held bonds in “held-for-trading” (HFT) portfolios they would not be free to decide when to execute trading. In fact, bonds held in HFT portfolios are required to be traded at the cut off of the 90th day. This enforcement puts pressure on investors and could incur potential losses for them so they are reluctant to keep a float of bonds in their HFT book. If the holding period were extended adequately to relieve investors from the pressure to sell off their bonds inefficiently, allowing a longer time frame within which to allocate bonds in the secondary market, although a stretched period would likely prompt a decrease of illiquid bond trading.

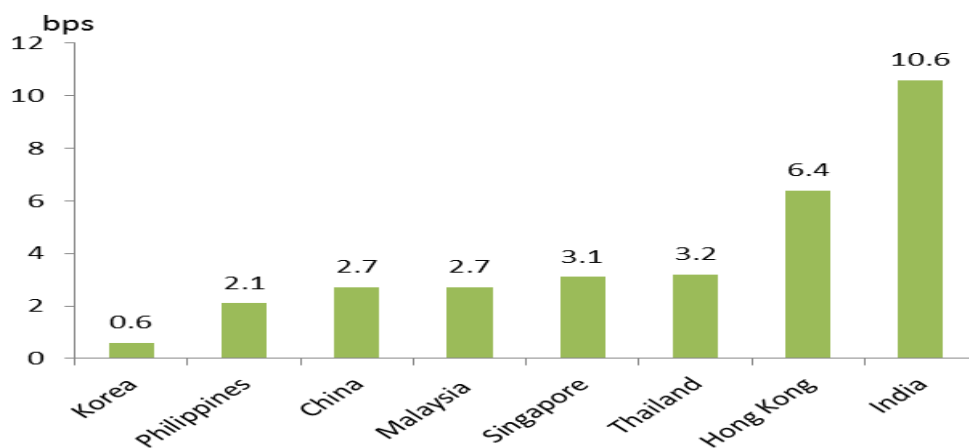
Allowing banks to move their government securities’ purchase they make off their books will free up capital which can then be lent to the corporate sector. By doing so, the bond market will be enriched by a diverse and wider range of participants since more liquidity will be available, creating a multiplier effect and facilitating its depth. Another aspect of the establishment of well-functioning secondary market trading is related to the stability of the financial system as a whole. In the event of a crisis, a well-developed secondary market acts as a shock absorber, lowering general systemic risk and easing cost-effective risk management for market participants. A government bond secondary market relies on seven basic requirements: 1) Disciplined issuance and reissuance programs to support large

benchmark issues (as noted above); 2) Liquid “classic” term repo markets that use standardised master agreement; 3) the ability to cheaply and efficiently short sell government bonds 4) Active, liquid government bond futures markets; 5) A broad range of liquid OTC derivatives contracts and exchange-traded derivatives (effective electronic price discovery, trading, clearing and settlement platforms); 6) A broad, active domestic and foreign investor base (e.g., pension funds, insurers, hedge funds); and 7) Market friendly regulatory, accounting and tax regimes (no

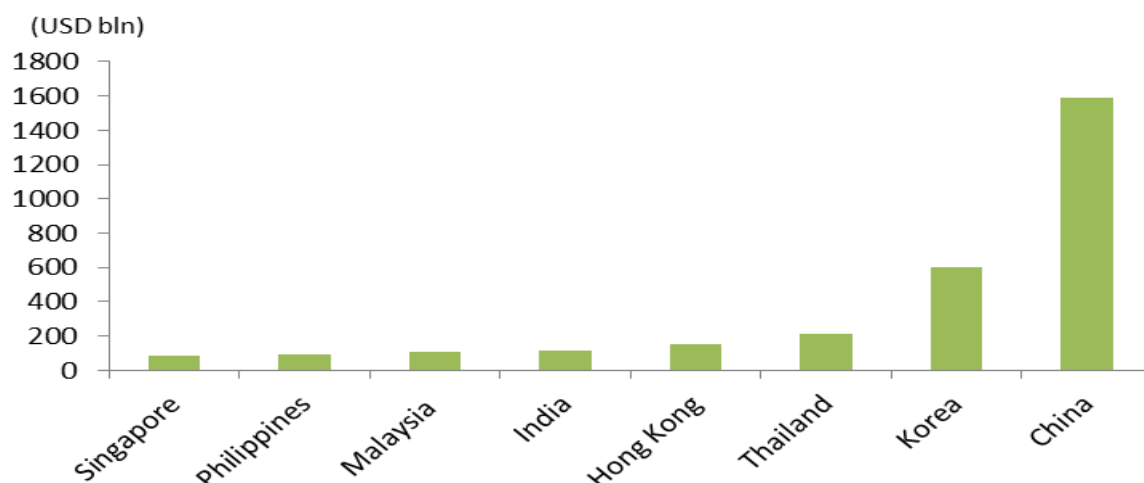
withholding taxes and no transaction taxes). These requirements are further expanded upon below.

The Indian bid-ask spread compared with other Asian government bond markets is extremely high and dysfunctional. In fact, as shown in the graph below, it amounts to over 10 bps, calculated as an average between liquid, semi-liquid, and illiquid government bond securities. A high bid-ask spread is a source of uncertainty for investors in securities, since they may risk recording huge losses if they need to exit the market.

Bid-Ask Spread is extremely high compared with other Asian Government Bond Markets
Source: ADB and CCIL



Government Bond Market Annual Trading Volume
Source: ADB



As a topic for further study, it may be worth carrying out a detailed comparison of bid-offer spreads in Indian government bonds vis-à-vis other

E. Repo Market

In a “classic” repo market, the title of the security is actually transferred as part of the agreement, meaning the counterparty of the agreement actually owns the security. This permits the counterparty to further use the security it owns for a new repo, covering naked short positions, collateral, and securities lending or as a liquidity management instrument. A “classic” bond repurchase (repo) market is also a system whereby the margining of exposure constitutes standard practice.

A properly run and healthy repo market supports primary markets as it provides security dealers with cheap capital to finance their bids at auctions of new issues. It also provides a hedging tool for primary dealers to set off the risk taken on the underwriting of new debt. For instance, a primary dealer can take on a long position in a new issue and, at the same time, hedge his/her position by taking on a short position of a security carrying similar characteristics. The short position can be easily covered by a repo agreement. A term repo market should be created for both sovereign and corporate debt.

The importance for market-makers to “go short” cannot be overstated. If an investor desires to purchase a specific product from a market-maker which is not in its inventory, the market-maker must be allowed to borrow that specific product in the repo market and then deliver. An adequate repo market is fundamental to enhance liquidity and to lower the cost of capital at investors’ disposal, since the interest rate at which a repo agreement is stipulated is generally lower than the borrowing rate.

Enhancing liquidity in the repo market will, in turn, have a knock-on effect on the cash market

F. Futures Market

Further to the expansion of a secondary market, the Indian financial system needs to improve its

Asian jurisdictions for both “on-the-run” and “off-the-run” securities across the yield curve.

stimulating the development of the bond futures market and the OTC derivatives market. Additionally, repos provide primary dealers with a broader range of hedging strategies linking up money markets, bond markets, futures markets and OTC derivatives markets. Moreover, creating the opportunity for the market to lend securities overseas will enlarge the repo market itself.

Nevertheless, the status quo of the repo market in India differs from the classic one as the security title is not actually transferred between the counterparties but rather the security is just pledged, tying the security to the agreement as collateral which cannot be reused by the receiving counterparty, thereby preventing it from being used to provide liquidity in the cash market.

ASIFMA supports the ongoing efforts of the RBI in continuing to develop the markets. However, with regard to the Collateralised Corporate Bond Receipts (CCBR), it is a tool to obviate the need to sign master agreements and also to improve liquidity in the secondary markets. While ASIFMA appreciates the creativity and recognises that this might be a well-meaning step, nevertheless the CCBR falls short of the requirements of the “classic” term repo. In particular, it does not appear that the underlying bond collateral could be “reused” (i.e., sold, pledged or repoed again) which adds little to the liquidity of the corporate bond secondary market. Also, the development of longstanding but critical issues for the promotion of the “classic” term repo, such as suitable bankruptcy treatment (including close-out netting) and use of master agreement, would risk being sidelined. In addition to the above comments, perhaps the central clearing of the repo agreements carried out through a global platform will enhance transparency and thereby liquidity.

government bond futures markets. The establishment of an active, liquid and closely-

overseen bond futures market will be extremely beneficial for all market participants. In particular, it constitutes an efficient tool for investors -- underwriters, primary dealers and so forth -- to hedge risk of exposure to large-value transactions with an actual derivative instrument. As a result, it will also facilitate the growth of the OTC derivatives market and contribute to its stability and security. Also, since an active bond futures market can only function if the market is sufficiently liquid, it will enhance liquidity in the cash market. Functioning as a hedging tool, it will reduce systemic risk thus generating greater market liquidity in the underlying securities market and attracting both domestic and foreign investors and therefore portfolio investments.

Also, since foreign investors cannot hedge their currency exposure, they tend to trade in the Non-Deliverable-Swap (NDS) market, especially because regulators do not have full control over it. Regulators now are trying to bring NDS onshore, to better control the market, even though this calls for a more convertible Rupee.

G. Interest-Rate and Currency Swaps

Interest-rate and currency swaps are key elements of the fixed-income market. In particular, the former gives investors the ability to exchange or swap a fixed interest-rate payment with a floating one. The latter, in contrast, provides investors with the opportunity to exchange or swap the principal and interest rate of a loan taken out in one currency with the same in another currency. These two types of derivatives are pivotal for investors who need them in order to hedge, speculate and offset risk, which generates and enhances liquidity in the fixed-income market.

Swap derivatives entail forward rate expectations. Hence, the swap rate curve has become a truly important benchmark for credit markets internationally and, particularly, in mature markets. In light of this, the non-development of an adequate swap market would be highly dysfunctional for corporations, taking away from

There are a few caveats to be noted in the construction of the bond futures market. In particular, it is highly advisable to not fix or put a cap on the par coupon of government bonds. It is also necessary to create an adequate delivery mechanism whereby the short is able to decide when to deliver, thereby avoiding dangerous squeezes. In fact, if the shorts are not able to decide when to execute the delivery, at the time they are asked to deliver, they may not possess the commodity or security to deliver. Therefore, if the futures contract complies with global standards, it would also help to attract a steady stream of foreign capital, rendering the market as a whole safer and more transparent for investors. In this context, it is worth noting that the RBI is planning to introduce 10Y interest rate futures shortly, to help address the concerns of market participants who could end up with illiquid bonds in the existing delivery based 10-year interest rate futures contract. The Indian authorities could also examine what China and Korea did when these countries introduced their own futures contracts, which have both been successful, despite not fully complying with international standards, especially as far as China's futures contract is concerned.

them an important tool for participating in the bond market.

The reason why these types of swaps are fundamental in a well-developed bond market is that they help the market of a specific country integrate into the broader international financial system by bringing together two counterparties who have different interests in different markets. These tools link up markets and attract a wider number of foreign investors who in turn bring portfolio investments thus enabling the markets to grow even further. A well supervised derivatives market renders the total financial system safer, thus contributing to a general soundness that further spurs investment and growth.

Swap derivatives are also key tools for corporations, as they can profit from more efficient local bond markets. In particular, they help them keep under control and revise their

outstanding debt by adjusting the interest rate according to current or future market conditions. Swap derivatives will boost corporations' confidence by allowing them to access the bond market and raise capital, which contributes to growth and stability.

H. Creditor Rights with Regard to Close-Out Netting

Investors' confidence is fundamental for the growth of the repo, swaps, and other derivatives markets. In order to achieve this, however, creditors' rights must be improved and strengthened to protect investors' capital and liquidity.

An obvious reform that should be implemented by the Indian government is the recognition of close-out netting, a well-established practice in the most advanced financial markets. In the event of a counterparty default, the terminated transactions are valued and netted under close-out netting. Thus, only the net amount is payable by one of the parties. This impedes a party from executing all its obligations without receiving any revenues from the bankrupt counterparty. The immediate implication is that close-out netting allows a party to compute its exposure toward a counterparty on a net basis, thereby alleviating credit risk. Also, it permits a party to keep a lower amount of reserves needed to cover exposure.

With a particular focus on the Indian bond market, the investor's right to off-set in the event of bankruptcy is not well established. Therefore, implementing a close-out netting system will protect investors and give them more confidence to remain in the market. This affirmation is particularly relevant for banks and investment managers who are significantly exposed to counterparty risk as exposures are grossed up and not netted. Thus, these types of institutional investors set limits to reduce the level of exposure in the market, hampering liquidity even further in the secondary market.

In particular, legislation should explain clearly the consequences stemming from a bankruptcy and

As far as systemic risk is concerned, the fear that some counterparties will fail to honour their side of the agreement has been addressed by a few changes in the way transactions will be carried out. Mandatory central clearing, bilateral margining requirements, and the creation of a Legal Identity Identifier (LEI) are all meant to guarantee the security of these transactions.

insolvency event, guaranteeing the enforceability of close-out netting and yielding it over general bankruptcy rules. In order to protect investors' interests, netting should be applicable upon default, even if bankruptcy is not involved, and broad enough to embody a wide range of financial products, including derivatives and title-transfer collateral arrangements, to ensure that obligations to return collateral of equivalent value are netted against obligations under derivatives transactions.

Legislation should as well cover cross-product, multi-branch and multi-currency netting. Also, it should state that the inclusion of non-eligible transactions under the netting agreement would not invalidate close-out netting for eligible transactions under a netting agreement. Besides, if collateral agreements cover both eligible and non-eligible transactions, they should remain protected as far as the eligible transactions are concerned. The standard provisions in ISDA master agreements covering close-out netting provide a frame of reference which Indian authorities could use in developing legislation permitting close-out netting.

Additionally, due to the lack of an efficient recovery mechanism in the bond market, investors are not willing to participate in the high yield market. The regulation is simply neither sufficiently precise nor quick and, as a result, events of bankruptcy are exacerbated. The introduction of a clearer regulation, following the example of Chapter 11 in the US legislation, will help smooth over disputes and increase transparency in the market. More specifically, mechanisms that allow for debtor-in-possession (DIP) financing, processes for the orderly liquidation of bankrupt entities, the quick and easy

facilitation of debt-for-equity swaps and strengthening creditor protections (especially vis-à-vis connected equity shareholders and promoters) are all steps that could be taken, in order to stimulate investor interest in the Indian debt markets. Current regulations, such as SARFAESI (Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests) and BIFR (Board for Industrial and Financial Reconstruction), protect the interests of

I. Corporate & Quasi-Sovereign Bond Market

The corporate bond market in India is almost non-existent. The number of public issues in India is inconsequential and all corporate bond issues are made as private placements. On one hand, private placements reduce issuance costs; however, on the other, public ones are seen as more attractive especially for foreign investors.

As mentioned above, the corporate sector relies too heavily on banks for lending and raising funds to finance their business going forward. Through the banking sector it is not possible for borrowers to restructure the payment schedule, making the bond market a solid alternative for financing. Developing a strong and sound corporate bond market will alleviate the pressure on banks and provide corporations an alternative way to finance themselves. In turn, a corporate bond market would foster competition in the lending sector and contribute to lowering the cost of capital, i.e. lending interest rate. Moreover, since the transparency of corporate bond markets will force corporations to respond directly to the concerns of investors and stakeholders, a deep corporate bond market will improve the corporate governance, efficiency and discipline within the corporate sector.

Institutional investors such as pension funds are not allowed to invest in securities that carry a grade lower than double A. Mutual funds, although they can invest in securities carrying triple B, adhere with the general trend and do not invest in securities below double A. Furthermore, banks are not permitted to guarantee high yield bonds issued by companies. Allowing banks to do so will foster more high yield corporate bond

banks, financial institutions and companies against bankruptcy petition, which is not an ideal situation for development of broad based credit curves.

Liquidation and the disposition of assets in a corporate bankruptcy in India can take an inordinately long time, in some instances several years. This compares unfavourably with the winding down of companies in other jurisdictions.

issuance, thus lowering the cost of capital for companies. Encouraging corporations to issue bonds and having a bigger pool of investors willing to invest will require issuers to issue at different spots on the yield curve. Along with the expansion of the yield curve, the credit rating scale will widen, thus generating differentiation across credits. In addition, it is necessary to deepen the capital structure by having more types of subordinated debt, convertible bonds and preferred stock. ASIFMA advises as well the need to introduce an index benchmark of the most traded corporate securities for active portfolio managers.

Allowing corporations to access the bond market will create more capital at their disposal and stimulate the development of infrastructure. As companies will be able to rely on a safer and more constant stream of capital, this funding could be then be used to finance infrastructure projects.

The establishment of a solid corporate bond market will reduce the crowding-out effect on small and medium sized entrepreneurs, allowing them to access the bond market to raise capital and further expand their business and enabling banks that would have loaned that funding to large corporates to instead lend to SMEs.

Further to the expansion of the derivative swaps market, corporations and general investors can use swaps, and in particular credit default swaps (CDSs), to hedge risk in the corporate bond market. CDSs are a fundamental tool for investors as they free up capital to be used for further investments. An adequate swap market will

enhance liquidity in the cash market as bond futures and interest rate swaps do in the government bond markets. Of course, mechanisms need to be put in place to ensure that there is an adequate volume of deliverable obligations referenced to each CDS, to ensure that there are no undesirable short squeezes at the time of CDS settlement in the event of default/restructuring. One of the reasons behind the failure of the CDS to become a common tool is the capital requirements investors need to fulfil, especially for naked sale positions, which is two or even threefold the capital that may be required to hold them to maturity. ASIFMA acknowledges the introduction of "plain vanilla" single name CDS introduced by the RBI in 2010.

We acknowledge all the reforms undertaken by Indian regulators to develop the bond market. The secondary market trade reporting system, for instance, permitted the establishment of a trade reporting platform and information decimation system to render the market more transparent for market participants. Together with listing of issues and private issuance database contributed to an overall increase of the transparency in the market. Further, by reducing the cost and time for public issues, via a simplified listing procedure and reduced disclosure requirements, and by encouraging retail participation in mutual funds and exchanges the corporate bond market gained momentum (source: City of London). However, further needs to be done in this regard.

ASIFMA strongly recommends establishing automatic trading for corporate bonds, similar to government bonds. While exchanges have been allowed to introduce screens for corporate bonds, it has not taken off as volumes will be divided across multiple exchanges. Moreover, exchanges are not the vehicle of choice for bond markets around the world. Mature economies use request for quote systems, which increase liquidity and ease of trading. In addition, the prevalence of electronic trading will increase transparency in the market even further, since market prices will be at the market participants' disposal thus minimizing

price distortions of any kind. It should be noted however that electronic trading is only appropriate for the most liquid corporate bond issues and for small sizes. Large trades and less liquid issues will still be traded over the phone in order to protect the investor from the market moving against them. However, a screen-based trading backed by guaranteed settlement would facilitate the participation of retail investors in the market, increasing, ultimately, its depth. In this connection, SEBI's requirement that stock exchanges are required to provide settlement guarantees for trades settled on DVP III basis and the requirement that these exchanges also create settlement guarantee funds is a positive development. Finally, yet another class of instruments that would encourage retail market participation are inflation indexed bonds, which would encourage retail investors to commit on fixed-income securities for a longer period, as they constitute a hedging tool vis-à-vis inflation.

Each fresh issuance from the same issuer receives a new International Securities Identification Number (ISIN), hence older bonds in the same maturity become illiquid and trade at discounts. Retapping the same issue for a particular maturity, similar to Government Securities, can help maintain liquidity. A major argument against common ISINs is the bunching of maturities on the same date which can lead to asset-liability mismatch; however, this can be resolved by spreading out the redemption amount across the year through amortizing payment.

One of the major issues that corporate Indian issuers face in issuing USD or other non-rupee bonds are the restrictions under RBI's External Commercial Borrowings (commonly known as ECB guidelines). This includes restrictions on size of the offering; all-in-cost ceiling that restricts the coupon that issuers can pay; restrictions on use of proceeds; and restrictions on ability to provide security over assets.

J. Municipal and Local Authority Bond Market

ASIFMA urges the development of a municipal and local authority bond market. ASIFMA also advises the RBI to remove restrictions on infrastructure financing through bond issuance.

The development of a quasi-sovereign bond market is of primary importance for a number of reasons. Both local government and state-owned enterprises such as utilities, power companies and others engaged in different sectors, should be able to issue bonds in the market in order to alleviate pressure on the government deficit, which is quite high. Having a quasi-sovereign bond market would create additional benchmarks and contribute to an overall deeper capital market.

This will then guarantee a more secure, steadier and more reliable stream of capital to be used to finance infrastructure projects, which are greatly needed in India. In fact, a municipal bond is a long-term bond issued directly by the local municipality or state-owned enterprise that can be used to

K. Securitisation and Covered Bond Market

A well-regulated securitization system is commonly recognized as an efficient financing mechanism for mortgage financing, credit cards, auto loans and even infrastructure enhancements and municipal expansion. Covered bonds and high quality securitizations are a means of tapping the capital markets for funding, backed by pools of good quality assets. Under the securitization model, loans are issued by an originator (typically a commercial bank), and then aggregated and packaged into multiple securities with different characteristics of risk and return that appeal to different investor classes.

More specifically, securitization permits banks to move assets, like mortgages, off their balance sheets, thereby reducing their exposure to non-performing loans and freeing up capital to be lent to other borrowers. Securitization will provide banks with flexibility to tap other sources of funding other than deposits. This would also constitute a relevant step forward to bolster the expansion of the investor base to include pension funds, insurance companies, banks, and other

fund infrastructure projects, e.g. public institutions, roads, and highways. The formation of this type of market would enable domestic and foreign capital to mingle, thereby lowering lending pressure on the government and the banking sector.

In some well-established municipal and local authority bond markets, issuers are able to keep interest rates low, stimulated by tax incentives, therefore lowering the overall cost of capital for their financing needs. Implementing tax incentives would attract a wide range of investors, thus increasing the pool of potential buyers which further keeps costs of issuance low.

Finally, a well-established municipal and local authority bond market would create much better transparency in the use of taxpayers' money and the funding of local infrastructure projects. It would set a market rate which would be better linked to the credit risk of these projects.

market participants, by providing safe and collateralized investments to invest in. Through this channel, companies will be able to access capital markets without the need for intermediaries and use a cheaper source of financing since the issuance of debt is collateralized, thereby lowering investor risk.

India was one of the first countries in Asia Pacific to have developed a securitization market. Transactions date back to the 1990s, recording a general increase from the early 2000s onwards. After this, however, the securitization market remained sluggish and incapable of further development, creating an enormous disadvantage for the financial system as a whole. Asset-backed securities are the most traded product, accounting for roughly Rs 250 billion. Mortgage-backed securities grew at a rapid pace, averaging around RS 30 billion. With regard to CDO and CLO, their trading averaged round RS 25 billion up until 2005 and skyrocketed thereafter (source: ICMA Centre). However, for other types of assets the market remained bleak.

Securitization is a channel predominantly used by banks and insurance companies. Since the latter are forced by law to invest in bonds carrying a high grade, with double A being the minimum threshold, issuers structure their securitized assets to guarantee a high rating, which creates holes in the yield curve. ASIFMA applauds the effort of the RBI to introduce subordinate tranches in the market; however, their presence in the market is low and investors are reluctant to buy or trade them.

Securitisation is another tool available with issuers to delink the rating of the instrument from that of the issuer. However, the market has been stalled due to restrictions around minimum holding period (MHP), minimum retention requirement

L. Rates and Credit Market Infrastructure

Shallow financial depth combined with a weak market infrastructure system, such as underdeveloped credit ratings, renders India an overall difficult country in which investors may be reluctant to invest. Additionally, the foreign exchange market is relatively small in size, accounting for roughly USD 55 to 60 billion turnover per day. This less developed foreign exchange market stands in the way of the capital and currency markets, making investors reluctant to participate and the financial sector somewhat volatile.

One of the most important elements missing in India is the credit rating industry, which renders a bond market attractive and accessible. A well-supervised and established credit rating industry will provide investors with a guarantee of the type of securities they are trading. In particular, one of the reasons why investors are not willing to participate in the bond market is the mismatch between the price of the bonds and the actual and real risk they carry. To create a more attractive environment for investments, the credit rating industry must adhere to international best practices. By doing so, investors can take advantage of an international standardized rating, which will in turn make the market more

(MRR), etc. In the case of an issuer providing credit enhancement, the requirement of MHP and MRR should be removed as their commitment to the ongoing performance of the facility is established through the credit enhancement. The taxation structure also needs to be changed from distribution tax at SPV level to taxation in the hands of investors as the current regime is not beneficial for banks/NBFCs who have been the dominant investor class in the securitisation market.

The development of an efficient securitization market can also be extended to local municipalities and authorities, providing them with a cheaper source of capital to fund infrastructure projects by securitising the assets, and selling the bonds to investors to fund its development.

transparent and reliable which will attract both domestic and foreign investors.

With the premise that the government is able to halt the tendency of rising interest rates, banks must also start to recognize mark-to-market losses. By doing so, they would be compelled to trade securities, rather than holding them to maturity. The more advanced the trading in the secondary market is, the more necessary is the establishment of a solid risk management function. If banks can actually develop an independent risk management function, they can become involved in the trading of corporate bonds, at every level of the yield curve. This would give the option of access to the bond market for some corporations whose issued bonds carry a low rating and high yield. This is the stage where an appropriate risk management function kicks in, assessing the bank exposure to a certain type of security and taking further action to hedge and balance out the exposure.

Nurturing a thorough market infrastructure system also entails meeting the need for an international settlement and financing of local bonds. This will help the Indian financial system to be further embodied within the international system. Local bonds will then have a wider range of potential

investors, competing with each other and therefore allowing more efficient and less costly financing. Also, this openness will attract foreign firms and give them the opportunity to participate in the market and to reuse the bonds in their funding efforts.

To further integrate the Indian financial market within the international marketplace, CCPs such as the Clearing Corporation of India will have to be internationally recognized by the European Securities and Markets Authority (ESMA) in order to provide clearing services for all market participants. In doing so, CCPs will comply with the international practice, thus being even more attractive to foreign investors. ASIFMA supports the application made in September by CCIL for ESMA recognition.

The clearing of government securities and corporate bonds by CCIL, the clearing agency for Government securities, and NSCCL, the clearing arm of the National Stock exchange of India, has

M. Broadening the Investor Base

One of the most immediate consequences of a shallow bond market is the high investment volatility in the financial markets. Investors are not eager to invest their capital in direct investments that commit them for several years in shallow markets. They also prefer to engage in portfolio investments in deeper more liquid markets as they can easily recalibrate their exposure by pulling back their capital. Looking at the amount of investments, both direct and portfolio, flowing in and out the country provides a clear picture of how the financial sector in India can be viewed as hostile towards investors. In the period spanning from 2003-04 to 2007-08, the total inflow of capital shot up by over USD 90 billion up to USD 107.9 billion just before the outbreak of the financial crisis impacted it. In the aftermath, there has been a slight pickup.

A diversified and wide investor base is pivotal for guaranteeing steady and strong demand for all bonds and stability of investments. An appropriate investor base should include both domestic and foreign investors and all type of institutions,

been functioning smoothly, thereby giving more credit to the clearing system as a whole. The use of clearing systems for the reporting of usage of not just cash bonds/securities but also derivatives instruments such as futures, CDS and other swaps is an encouraging step, since the focus will then be on the reporting of risk, rather than the restriction of derivatives usage. Also, tailoring the use of these derivatives instruments in line with the usage of similar instruments globally will encourage usage and acceptability.

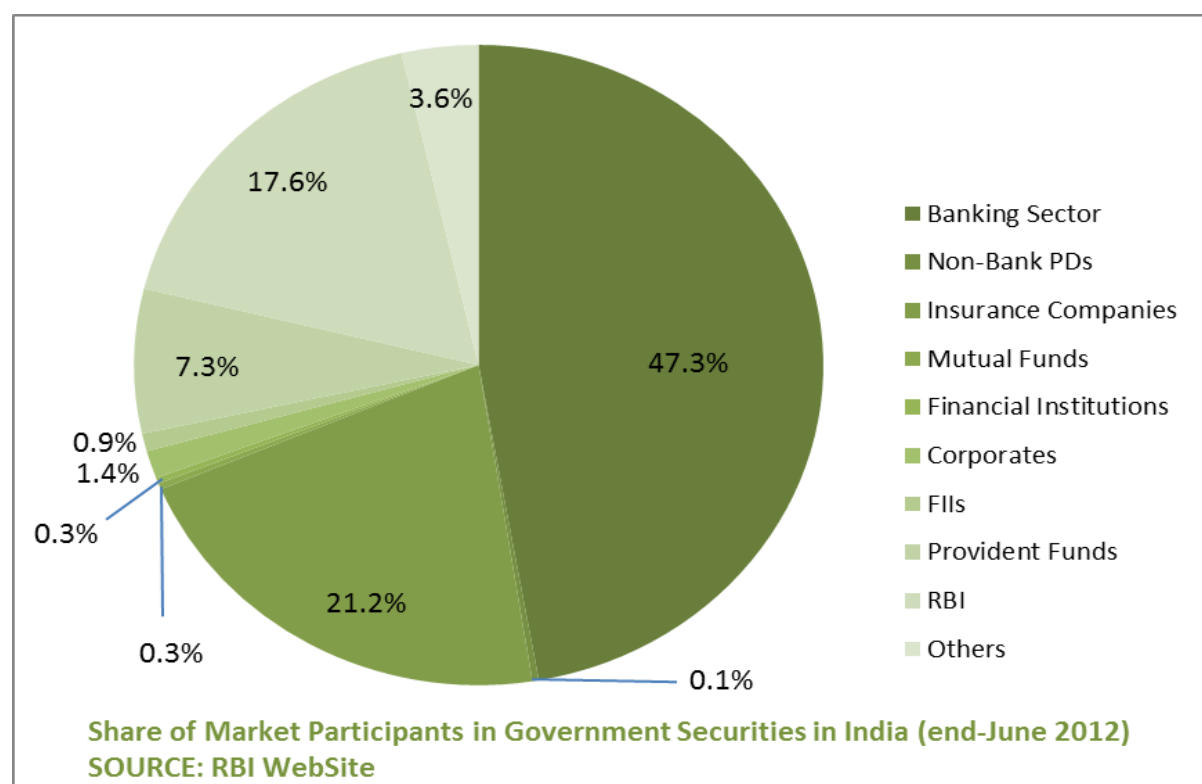
Nonetheless, bridging the local settlement system with International Central Securities Depository (Euroclear/Clearstream), ICSDs now allow easier movement of global collateral across borders via their “collateral highway” / “liquidity hub” would constitute a further step in the development of the bond market. Combined with offshore settlements could create the basis for using local bonds as collateral in the event that market participants need access to USD cash, as we have seen recently.

spanning from commercial banks to insurance companies, pension funds, hedge funds and mutual funds in addition to individual investors. With specific reference to pension and provident funds, it is worth relaxing investment norms to allow these entities to invest in lower rated credits, subject to limits. Also, if these pension funds/other institutions were to use CDS to hedge their exposures to individual issuers, credit risk should be counted as an exposure to the hedge counterparty rather than the issuer. In addition, it is vital to include in an investor base different time horizons, risk preferences and trading motives to ensure sustainable active trading and high liquidity. Moreover, a broad investor base will contribute to the growth of transactions and competition within the market, thus lowering the cost of capital as well as systemic risk as it functions as a shock absorber.

To begin with, the investor base in India is extremely narrow. Since there is not enough diversification of security products, mutual funds and hedge funds are very small. Pension provident

funds are also not developed. ASIFMA advises the authorities to foster the growth of institutional investors to tap the market. Also, fostering asset managers to create funds for investing in corporate bonds would be a significant step forward for developing the market. Since FIIs have limited access to the bond market due to a quota which is too small in size, allowing offshore bonds in Rupee and rendering the currency more convertible, through changes in the account structure of the issue would permit them to participate in the bond market, thereby

broadening the investor base. Having FIIs willing to buy government securities would boost liquidity, due to the inclusion of more market participants, and benefit locally, as there would be more money and, thereby, more possibilities to raise capital. Also, allowing primary dealers to undertake FX transactions in both OTC and currency futures markets would help them better offset risk, as FX and interest rates are closely correlated, and therefore better serving FIIs. Thus, giving primary dealers an “authorised dealer” license would be a welcome step.



ASIFMA welcomes the government’s intention to align the Know Your Client (KYC) rules according to international standards and best practice. The designation of a risk-based ranking for foreign investors will identify the parties carrying a low risk profiles. Too stringent rules stand in the way of new investment in the country or new entrants in the financial system. Another important step is the abolishment of the SEBI requirement of double filing under KYC rules if the applicant has already filed them with any other jurisdiction or parent country which is an FATF member. The broadening of the investor base will be beneficial for foreign firms willing to put up capital

for direct investments in factories or infrastructure projects. Currently, there is a tremendous need to clarify foreign investment rules. If these are uncertain, not fully disclosed and subject to changes, foreign companies will not commit resources and capital with the risk of a recording losses. Allowing them to participate in the bond market and shaping a precise, investment-oriented framework for foreign direct investment is the right path to sustainable economic growth. More investment opportunities available within the country will stimulate faster economic growth, thereby helping to further expand the middle class. The presence of a strong middle class is a

clear sign that the wealth and well-being of a country's population are rapidly increasing. The important next step is to include them in the financial sector via long-term investment in pension funds, mutual funds or insurance companies. Putting in place a set of regulations to protect individual investors' rights is a strategy that will serve this purpose as well. Individual investors' confidence will be boosted along with the overall trustworthiness of the entire financial system.

ASIFMA urges the RBI, SEBI and the Minister of Finance to coordinate their efforts in order to broaden the foreign investor base through the following five measures: 1) significantly raising government securities' FII limits. This will attract more real money through long term investors, initially to the government securities market, then later to corporate bonds and then later on to infrastructure bonds. 2) As a practical matter, the government should at periodic intervals assess the foreign investment caps and fix debt limits, based on the percentage of outstanding government

securities. 3) Eliminate foreign investor tax assessments on government securities income, which is currently not in line with the international norms for investment in government securities. 4) Review and eliminate any barriers to foreign investor participation in government security auctions. 5) Allow FIIs to execute term repos and reverse term repos on an equal footing with domestic investors. 6) Streamline on-boarding of foreign investors and harmonize KYC rules with international best practices.

As for domestic investors, fostering a culture among individual/retail investors that encourages investment in fixed income products, rather than simply leaving their money in bank deposits, would be a positive development. In this context, the further development of an industry centred on wealth management and retirement planning for middle class investors (as opposed to only wealthy private banking clients) would be a welcome development. Further liberalization of the life insurance and annuity sectors would be an added benefit in this regard.

N. Taxation

Along with the development of a sound and efficient bond market, the taxation system should keep pace and ensure it can accommodate structural changes. A sluggish taxation system will only hamper the effort and the reforms put in place by the RBI, SEBI and Minister of Finance.

ASIFMA applauds the Indian authorities for bringing down the withholding tax to 5 % on interest payable to FIIs and QFIs on rupee denominated bonds of an Indian company or government security for a period of two years (to 31 May 2015).

In general, withholding taxes and taxes on capital gains are costs that end up being passed back to the borrowers who raise the funding in the international capital markets. The international capital markets provide funding not just to businesses in India, but also businesses in other markets in other countries. Indian based businesses seeking to access the international capital markets are effectively competing with

businesses based in other countries to access the same source of funding. As long as the international capital markets have greater depth and better pricing than the domestic capital markets, Indian based businesses will need to "absorb" the costs of any withholding taxes and taxes on capital gains on international investors who supply capital not just to India but also to other countries that do not impose withholding taxes and taxes on capital gains. Also, smoothing out tax discrepancies between equities taxed at 0 % compared to bonds taxed at 10 / 20 % may help retail investors get involved in the bond markets.

A key competitor to Indian based businesses for funding is not just businesses in developing countries, but also developed economies such as businesses in the United States, or foreign multinationals that are ramping up their activities in the United States. In our view, the current landscape for the foreseeable future puts businesses in developing countries in competition with businesses globally for cost effective funding.

It is a common misconception that businesses in certain developing countries offer outstanding returns on investments for investors, and therefore investors should bear the cost of the withholding tax. Businesses that offer outstanding returns in India deserve a lower cost of funding commensurate with the risk reward opportunities that they present. However, these excellent businesses are competing with other excellent businesses in developing and developed countries. For instance, take a business that has low risks and excellent returns, and it is able to raise funding at 1%. If this business were located in the US - it would have access to a 1% cost of funding. In India, its cost of funding will be grossed-up for Indian withholding taxes and capital gains taxes. The point therefore is that while India offers certain excellent investment opportunities, these excellent businesses are competing against other excellent businesses in other countries for funding.

The higher risk businesses are competing against other higher risks businesses for funding from investors with a higher risk appetite.

The foregoing therefore supports the proposition that the costs of withholding tax and capital gains taxes are effectively passed back to the borrowers.

Once it is accepted that the costs of the tax are effectively borne by Indian borrowers, the key issue is then whether the higher costs of funding reduces economic expansion, and whether the tax collected from the economic expansion exceeds the withholding taxes and the taxes from the capital gains. It is beyond the scope of this paper to articulate a definitive analysis as to whether the taxes raised through withholding taxes and capital gains taxes is outweighed by the reduced taxes that would have been collected through increased economic activity and growth, if any.

Another key impact is that the effective tax rate of the Indian businesses that bear the cost of these taxes, is therefore higher than the headline tax rate. This would therefore distort economic decisions between business opportunities that rely on the depth of funding provided by the

international capital markets, and business activities that do not.

A related but important point is that where the businesses are not making a profit or are marginally profitable, for example, because they are in a start-up stage, the imposition of taxes on these businesses are precisely at the juncture when the burden of taxation should not be imposed. As may be observed, these taxes are imposed on the gross-funding cost of the businesses rather than the economic profit derived by the businesses.

Lowering the tax on interest payment to FIIs and QFIs is a wise move, particularly to encourage foreign investors to participate in the corporate bond market and to provide the corporate sector with a new channel of offshore financing. However, ASIFMA advises to keep the 5 % withholding tax for a more extended period of time, perhaps up to five years, to further incentivize foreign investors. There currently is no clarity on what is going to happen to the tax rate once the granted period expires, forcing investors to take a more reluctant and conservative approach. Furthermore, the tax could be reduced to zero for purchase of longer tenor bonds in infrastructure. In doing so, foreign investors will be more prone to direct investments beneficial for the real economy. In addition, the treatment of debentures is currently unclear and ASIFMA recommends that debentures should be treated in the same manner as corporate bonds.

With regard to the General Anti Avoidance Rule (GAAR), the authorities have recently announced that GAAR will come into force with effect from tax year 2015-16 and the Central Board of Direct Taxes has notified the rules (Rules) for application of GAAR. Although the India authorities have accorded their time and effort in considering issues that have been consistently highlighted by the industry, the recent Rules still fall short of providing assurances to the FIIs that their investments in India, particularly those routed via Mauritius or Singapore, would not be subject to GAAR.

The Rules clarify that the GAAR provisions would apply to all tax benefits obtained after 1 April 2015 with the following exemptions:

- An arrangement where the aggregate tax benefit of all the parties to the arrangement in the relevant tax year does not exceed INR 30 Million
- An FII who has not taken any benefit under a tax treaty entered into by India with another country or a specified territory and has invested in listed or unlisted securities with prior permission of the competent authority in accordance with SEBI (Foreign Institutional Investor) Regulations, 1995
- A non-resident investor who has invested in an FII directly or indirectly by way of an offshore derivative instrument or otherwise. Therefore the fear of GAAR applying to P Note holders goes away.
- Any income derived from transfer of an investment made before 30 August 2010 (the date of introduction of Direct Tax Code Bill 2010) by such person

The Rules also state that where a part of an arrangement is declared as impermissible, GAAR provisions would apply only in relation to such part and not to the entire arrangement.

The Rules also provide various forms for reference by the Assessing Officer (AO) to the Commissioner and returning such reference by the Commissioner back to the AO in case GAAR provisions are not to be invoked. The time limits for such procedure are also laid down under the Rules.

Unfortunately, the rules provide that GAAR will not apply to FIIs only if they do not claim the treaty benefits. Given that most of them claim the capital gains exemption available under the Mauritius and Singapore treaties, they will be subject to GAAR even though the Shome Committee had recommended that the GAAR application be limited to cases of blatant abuse and contrived tax avoidance transactions.

ASIFMA recommends that guidance be developed to provide clarity that GAAR rules do not apply to

FII capital market transactions where the main purpose of these transactions are to provide investment products to international investors rather than to derive a tax benefit. The impact of GAAR rules is wide-ranging and it is therefore strategic to issue a well developed set of interpretational guidance, so that the tax landscape in India achieves clarity and consistency.

In order to develop guidance rules that provide clarity to business transactions, input from the various industries is required. ASIFMA and the CMTC would be happy to be a part of this process to provide the relevant business information, so that the guidance rules developed are articulated with relevant details of the business transactions and in the context of the issues faced by the industry.

Clarity is particularly important in industries with a high volume flow, such as the capital markets and international trade. Investors react to uncertainties, whether business or regulatory or tax uncertainties by pricing in the risks of these uncertainties. These uncertainties therefore impact cost of funding and pricing of bond issues. Interpretational uncertainties are “man-made” uncertainties and therefore in general well within the capability of the industry and the relevant authorities to work together to articulate a fix, and together develop a better “product” – being a set of tax rules that are sound from a policy perspective, and provide interpretational clarity.

FIIs are also concerned about the scope of the grandfathering provision in the rules. Their investments prior to April 2015 are protected only in respect of tax on income from a transfer of those investments (i.e., capital gains). Other types of income from these investments (e.g., dividends and interest) will come under the purview of GAAR. This may not be a substantive issue for the FIIs given that dividends are exempt in the hands of investors, and FIIs may not have much income from other sources.

Further, India has well established tax treaties with countries such as the United States of America, Switzerland, Luxembourg, the United Arab

Emirates and Finland, all containing precise limitation of benefits (LOB). Hence, where tax treaties provide for LOB clause and the LOB conditions are fulfilled by a tax resident of a foreign country, the provisions of GAAR should not be invoked.

With the endeavour to augment and instil confidence in market participants, the GAAR guidelines state that the provisions of the GAAR would not in any case be invoked in the case of non-resident investors of the FII. Whilst this is clearly a wise decision that all market participants will benefit from, it should be further elucidated that GAAR should not apply to any transaction between overseas parties whose value is determined by reference to FII transactions. What still needs to be clarified is the specific criteria which determine the transactions under the application of GAAR and also the computation of tax liability of the FII. We therefore recommend that in case a FII chooses to take treaty benefits and in case as a result of GAAR, there is a denial of treaty benefits, taxes will be assessed at the FII level and any losses of the FII (including past losses) will be permitted to be offset against the FII's income, as the provisions of the Act itself states.

As the Minister of Finance indicated earlier this year, all the transactions made until August 30, 2010, will be grandfathered. This decision does provide certainty in respect of all the transactions that occurred up until August 2010; however, the retroactive application of GAAR to all investments, which took place between August 30, 2010, and

the date GAAR came into effect, is deleterious for market participants, since they made those investments because they were not subjected to taxation. ASIFMA therefore advises the government to remove the retroactivity of GAAR.

With regard to the indirect transfer tax, FIIs are concerned about any potential unintended application of the indirect transfer provisions to portfolio investments. FIIs need clarity about the application of the indirect transfer tax provisions to offshore transactions in order to avoid multiple layer taxation. As far as the direct investments are concerned, indirect transfer tax provisions should not apply to income deriving directly or indirectly from assets on which taxes are payable or have already been paid in India or are exempted from tax in India under a treaty or applicable domestic law provisions. This would also include income from distributions by the offshore entity to its shareholders/ unit holders or investors through dividends, buy backs or other methods. This would also include a scenario in which an investor is redeemed with cash contributed by another investor.

With regard to synthetic investments, indirect transfer provisions should not apply to income arising "in consequence of" or "by means of" or "by reason of" transfer of Indian assets, where the gains have either been subjected to taxes in India or exempt from tax in India under a treaty or applicable domestic law provisions. Given the current status, investors are concerned that offshore transactions may be subjected to taxation multiple times.

O. Regulatory Process

India's regulatory and jurisdictional uncertainty is a serious impediment for foreign-invested financial institutions, effectively serving as a non-tariff trade barrier. Regulatory transparency and consistency,

market consultation processes, sufficient notification of new rules and time for public comment are vital to well-functioning financial markets.

5. Appendix

Topic	Specific Ask	Recommendation	Rationale
General Economy	Stabilization of the economy through more steady and less volatile economic growth.	This transition can be facilitated and accelerated through the development of robust capital and bond markets.	Alleviating poverty among the population through a larger corporate sector and new infrastructure needs will require a more balanced and stable growth model fueled by increased spending.
Capital Markets	Indian capital markets must be further developed for India to sustain its economic growth and fund its social and infrastructure initiatives.	Government policies are needed to encourage the development of capital markets in ways that will support its widespread economic and social development initiatives, including the further stabilization of its economy, increasing access to credit, funding municipal infrastructure projects, developing social safety nets and fostering its sweeping urbanization program.	The substantial infrastructure still needed to spread development, extend social safety nets, improve productivity and sustain high economic growth requires the efficient mobilization of private and public capital that only robust capital markets can facilitate.
Bond Markets	India must develop deep, liquid and transparent bond markets.	India can achieve this by: liberalizing interest rates, enhancing its benchmark yield curve, establishing a secondary and futures market for government bonds, transitioning from a pledge repo system to a classic repo system, allowing for interest-rate and currency swaps and securitization, ensuring creditors' rights, broadening the investor base, and increasing regulatory and legislative transparency.	The expansion and deepening of the bond market would better serve the needs of both the private and public spheres in India, especially given the tightened capital requirements under Basel III. Further, robust bond markets are also particularly important to the evolution of the Indian banking sector, whereby capital is not available for the corporate sector.

Interest-Rate Liberalization	Interest rates must be further liberalized.	Interest rate liberalization is the first step toward creating deeper, more liquid bond markets and can only be achieved through eliminating restrictions on the all-in-cost ceiling imposed on External Commercial Borrowing (ECBs) and on ability to provide security over assets.	Further liberalization of interest rates and capital controls will benefit the Indian corporate sector by allowing issuers to issue at every level of the yield curve. Investors, in turn, will be more likely to buy since the price and interest rate of the bond will match its real risk. This will enable the shift from a model overly reliant on banking lending to one with more competitiveness, contributing to an overall lowering of the cost of capital.
Benchmark Yield Curve	Stronger and more dependable benchmark yield curves must be developed.	The 10-year, 5-year and 2 year government bonds are currently the most reliant benchmark yield curves in Indian markets for the most actively traded bonds across a range of given maturities – which are called the “on-the-run” issues. ASIFMA strongly urges regulators to establish benchmarks at every level of the yield curve providing investors and issuers with a tool for better gauging both long- and short-term securities.	The existence of a common benchmark yield curve, grounded on a liquid government bond market, is critical to the financial sector’s ability to reach efficient capital allocation and for government policy makers to gauge market expectations, as much of the analysis and pricing activity that takes place in the bond markets revolve around the yield curve.
Secondary Market Trading	Indian regulators must foster the development of a secondary market for government bonds.	A government bond secondary market relies on seven basic requirements: 1) Disciplined issuance and reissuance programs to support large benchmark issues; 2) Liquid “classic” repo markets that allow easy short selling of government bonds; 3) Active, liquid government bond futures markets; 4) A broad range of liquid OTC derivatives contracts and exchange-traded derivatives contracts; 5) High-quality, efficient and cost-effective electronic	The growth of a secondary market for government bonds is integral to the overall development of the Indian bond market and provides several important benefits to market participants of all types, including: the establishment of “risk free” reference yield curves and “risk free” assets, like U.S. Treasury Bonds; supports the development of sound corporate debt and money markets; and enables the government to borrow for longer terms at lower

		<p>price discovery, trading, clearing and settlement platforms; 6) A broad, active domestic and foreign investor base; and 7) Market friendly regulatory, accounting and tax regimes: no withholding taxes and no transaction taxes. Additionally, stabilizing the interest rates, eliminating the Statutory Liquidity ratio (SLR), extending the bond holding period and allowing banks to trade government bonds will increase liquidity in the secondary market, drawing a wider pool of investors and freeing up capital for the corporate sector. This will create a multiplier effect and help deepening the depth of the financial sector in the economy</p>	<p>funding costs – allowing the government to fund large, country-wide infrastructure and urbanization programs.</p>
Repo Market	<p>India must develop a repo market that is aligned with international standards.</p>	<p>India's current repo market (pledge repo system) must be transitioned to a classic repo market (international standard).</p>	<p>A "classic" bond repo market allows: (1) market participants to use the bonds they hold for additional purposes, such as further repos, covering short positions, securities lending, and collateral (a pledge repo system does not allow that as the bond title is not transferred); (2) allows market makers, who are critical for developing liquidity in any market, to 'go short,' which enhances liquidity in the cash market and thereby serves as a key prerequisite for the development of the bond futures market and the OTC derivatives market, which requires a sufficiently liquid cash market; (3) allow primary dealers to hedge risk with a wider array of hedging strategies.; and (4) broaden funding markets and serve as a critical link between money markets, bond markets, futures markets and OTC derivatives markets.</p>

Futures Market	<p>Once the cash markets are sufficiently liquid, India should further develop its government bond futures market.</p>	<p>In shaping the government bond futures contract ASIFMA recommends to not fix or put a cap on the par coupon and to create an adequate delivery mechanism, whereby the short is able to decide when to execute the delivery. The future contracts ought to comply with the international standards in order to render the market safer and more transparent for investors. However, examining how China and Korea shaped their futures contracts may be a helpful guideline, although not fully complying with international standards.</p>	<p>An active, liquid, and closely supervised government bond futures market would allow participants to hedge large-value positions quickly and reduce risk more effectively, while at the same time deepening the underlying bond and derivative markets. The experience of other countries shows that bond futures enhance the liquidity of the underlying cash markets as market participants are able to manage the risk of their bond inventories more effectively. Additionally, bond futures markets are particularly beneficial to market-makers because futures enable them to hedge their positions, thus reducing risk and allowing them to offer tighter bid-ask spreads.</p>
Interest-Rate & Currency Swaps	<p>It is imperative that India develops an interest-rate and currency swap market.</p>	<p>Interest rate liberalization and deeper, more accessible financial markets will create the conditions necessary for an interest-rate swap market to develop in India.</p>	<p>Interest-rate and currency swaps are an integral part of the fixed-income market. These derivative contracts are an essential tool for investors who typically use them to hedge, speculate, and manage risk, and generate greater liquidity in fixed-income markets. Importantly, interest-rate and currency swaps allow companies to keep under control and revise their outstanding debt by adjusting the interest rate according to current or future market conditions.</p>

Close-Out Netting	<p>The rules governing creditors' rights, more specifically close-out netting, and an efficient recovery mechanism must be strengthened and clarified in order to ensure confidence in the enforceability of transactions and contracts.</p>	<p>A clear change to Indian law is required to recognize close-out netting, an established practice in all advanced financial markets, and to establish an efficient recovery mechanism.</p>	<p>Close-out netting reduces credit risk by allowing a party to calculate its exposure to a particular counterparty on a net basis. Close-out netting will also result in cost reduction, allowing parties to use credit lines more efficiently and to maintain lower reserves to cover exposure. Because of uncertainty regarding the enforceability of close-out netting in India, a company's exposure to an Indian counterparty will be treated on a gross basis for regulatory capital purposes. With the increased cost of capital under Basel III, the impact on risk-weighted assets is much greater for such non-netted trades, driving up costs considerably. This also makes it extremely difficult for India to develop liquid derivatives and repo markets, both of which are required if their capital markets are to become deep, liquid and opened to foreigners.</p>
Corporate & Quasi-Sovereign Bond Market	<p>India must develop a more well-rounded corporate debt market.</p>	<p>Allowing institutional investors to invest in securities that carry a grade lower than double A, creating attractive low-graded investment opportunities and letting banks guarantee companies' high yield bonds will foster more high yield corporate bonds issuances, luring a larger pool of investors.</p>	<p>In India, a well-developed corporate bond market would serve several functions: (1) it would enable companies to raise funds even if they are not favored customers of the large, domestic commercial banks; (2) it would allow companies to match the durations of their assets with the maturity of their liabilities; (3) with the rise of pension funds, social security funds, and insurance funds, the combination of a government and corporate bond market is key to ensuring that these funds can match their future payment obligations; and (4) promote greater transparency and improved corporate governance through increased disclosure.</p>

Municipal & Local Authority Bond Market	<p>India must develop a robust municipal bond market.</p>	<p>India's planned urbanization initiative will require local governments to quickly enhance their infrastructure. In order to overcome the financing challenges of rapid urbanization and allay concerns about shadow banking in local government lending, ASIFMA encourages India to develop a municipal bond market, which will require Indian authorities to create the necessary financial infrastructure and to remove restrictions on infrastructure financing through bond issuance.</p>	<p>The creation of a municipal bond market would allow a combination of domestic and foreign private capital to finance municipal infrastructure projects, significantly easing local municipal dependence on Indian central government, and significantly increasing the amount of longer-term capital available for large-scale infrastructure development.</p>
Securitization	<p>India needs to expand and increase access to its existing securitization markets.</p>	<p>Securitization requires a stable and predictable operating environment. India must establish clear legislative, legal and regulatory guidelines for market participants, incentivize the development of high-quality data for proper risk assessment, and increase foreign participation.</p>	<p>Securitization allows banks to move illiquid assets, like long-term loans, off their balance sheets, reducing the build-up of risky assets and providing banks with the ability to continue lending. In India, securitization will increase banks' flexibility to tap additional sources of cash and liquidity, significantly broadening their ability to support economic growth. Additionally, it will provide companies with a cheaper source of capital, lowering the excessive reliance on banks for lending. It will also provide government and local municipalities with cheaper capital to finance themselves. Importantly, securitization also allocates risk with capital, avoiding middleman inefficiencies and can enable companies to access capital markets directly, in most cases at lower cost than the cost of issuing direct debt (such as bonds or commercial paper), as it is collateralized, decreasing investor risk.</p>

Rates & Credit Market Infrastructure	<p>There is a clear need to establish a credit rating industry in India, creating an accessible and attractive market for investors.</p>	<p>In a system with stable interest rates, banks may recognize mark-to-market losses, trading securities and investing in corporate bond sector. By so doing, banks will develop their own risk management department, better assessing credit exposure.</p>	<p>A well-supervised and established credit rating industry will provide investors with a guarantee of the type of securities they are trading, ensuring a match of bond price, coupon and risk. Establishing a sound credit rating industry, based on international standards, will attract more domestic and foreign investors. Allowing the participation of both domestic and foreign credit rating agencies would provide healthy competition for domestic rating agencies and help improve overall standards of analysis and transparency.</p>
Broadening the Investor Base	<p>India must foster a broad investor base, which allows foreign and domestic financial institutions (ranging from commercial banks to insurance companies, pension funds, hedge funds, as well as individual investors) to compete on an equal playing field.</p>	<p>In India, the investor base is extremely narrow and there is no diversification of products, prompting mutual, hedge and pension provident funds to be very constrained in size. Fostering institutional investors to tap the market and spurring asset managers to invest in corporate bonds will help deepen the financial markets going forward.</p>	<p>A broad investor base with different time horizons, risk preferences and trading motives is vital for stimulating active trading and high liquidity, enabling the government, corporates or financial institutions to execute their funding strategies under a wide range of market conditions. More specifically, a broad investor base provides an important source of stability and liquidity to financial markets, aids in the efficiency of price discovery, reduces market volatility, and stimulates economic growth.</p>
Taxation	<p>Market participants need more clarity on the implementation of the withholding tax, GAAR and indirect transfer tax.</p>	<p>Indian regulators must be more transparent regarding the grandfathering of the transactions that occur between 30 August 2010 and the exact date GAAR will come into force in 2015, otherwise causing harmful distortions in the market. Indian authorities should as well clarify which participants and which products the indirect</p>	<p>Clarifying the retroactivity of the GAAR is advisable to increase transparency in the market and to draw more investors. Further keeping the withholding tax low at 5% will enhance investors' expectations and spur them to invest in the market. Grandfathering purchases of longer tenor bonds will then incentivize investors to commit their capital for the</p>

		transfer tax will apply to. ASIFMA also advises to keep the 5% of withholding tax for a longer period of time and to clarify what is going to happen next. Purchases of longer tenor bonds in infrastructure could then be grandfathered.	development of the infrastructure sector.
Regulation of Financial Markets	India's financial regulatory authorities must become more transparent when drafting and implementing new regulations.	Indian regulators implement bylaws that foster greater regulatory transparency and consistency, genuine market consultation processes, ample notification of new regulations and sufficient time for public comment.	Regulatory transparency and consistency, market consultation processes, sufficient notification of new rules and time for public comment are vital to well-functioning financial markets.



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