India Business & Finance

Foreign investors tuck into India's masala bonds

New Delhi keen for companies to sell debt and reduce dependence on bank loans

Indian finance minister Arun Jaitley © Reuters

YESTERDAY by: Simon Mundy in Mumbai

As Indian banks stagger under a wave of business defaults, some in Mumbai are hoping that their crisis could have the side-effect of catalysing a long-stagnant corporate bond market.

India's securities regulator last week suspended issuances of offshore rupee-denominated "masala bonds", arresting the growth of the new asset class. The abrupt move was prompted by a surge of interest in Indian corporate bonds, in which foreign investment was on the verge of breaching the regulatory limit.

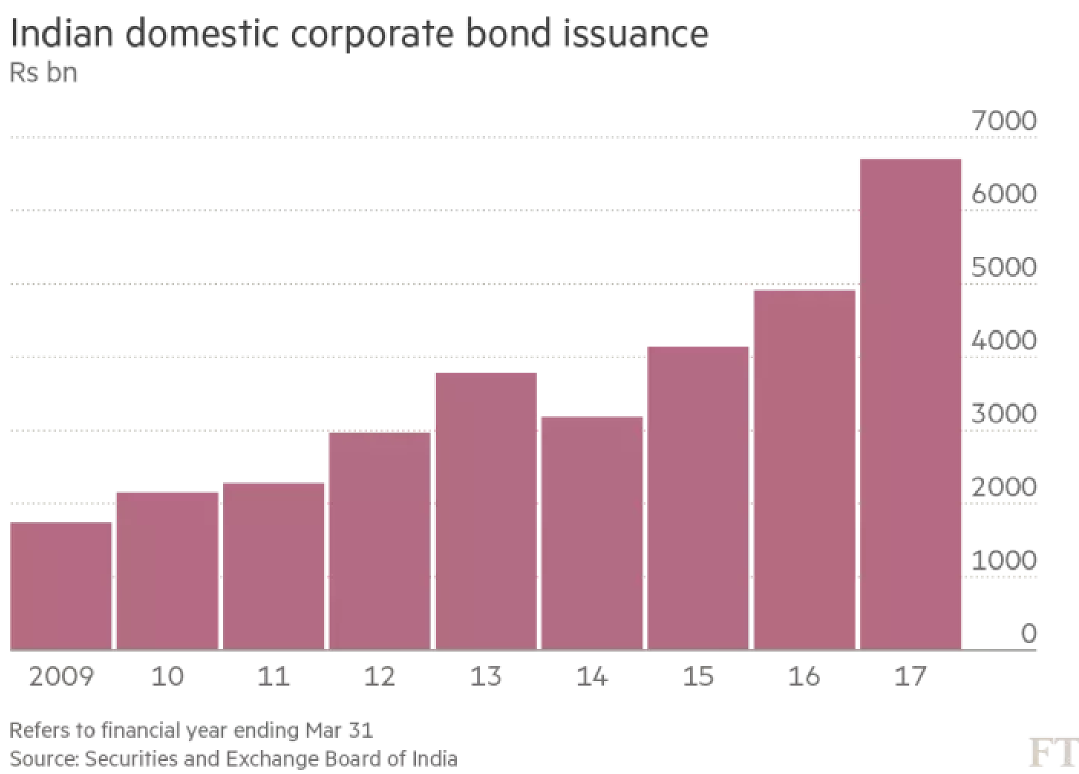
These inflows are part of a broader trend of expansion in a market that has long been viewed as a laggard in India. In the financial year ending in March, issuance of corporate bonds hit Rs6.7tn ($104bn), more than double the figure five years before.

Part of the explanation lies with a squeeze on lending by the country's dominant state-controlled banks, which had traditionally been enthusiastic lenders to big companies. A rash of defaults by major groups in sectors such as power and steel has pushed these banks' impaired loan ratios to nearly 18 per cent.

"Traditionally, people have always turned to the banks," says Prabodh Agrawal, president of the financial group IIFL Holdings. "But now, with the banks not in good shape, that is forcing many corporates to resort to bond issuances. We may be on the verge of a stage of rapid expansion."

Given the huge investment requirements of India's economy — finance minister Arun Jaitley said last year that $1.5tn would need to be spent on infrastructure over the next decade — the government and central bank have been pondering for several years how to ease companies' potentially destabilising reliance on bank funding.

The value of Indian domestic corporate bonds outstanding in 2014 was only 9 per cent of gross domestic product, according to the International Organisation of Securities Commissions — compared with 46 per cent in China and 39 per cent in Brazil.



The Reserve Bank of India has added to the pressure on big companies to look to the bond market, by placing limits on the loan exposure that banks can have to individual groups.

The pronounced recent growth in the corporate bond market has also been helped by changes in saving behaviour, as increasingly prosperous and financially literate Indians turn towards mutual funds rather than the traditional asset classes of gold and real estate.

Domestic investment in corporate bonds has long been dominated by pension and insurance providers, who have tended to pursue a "buy and hold" approach, says Karthik Srinivasan, head of financial sector ratings at ICRA, a rating agency. Mutual funds, which are obliged to mark their holdings to market, tend to trade far more actively, he adds.

Secondary corporate bond transactions in India were worth Rs14.7tn ($228bn) in the last financial year, up 149 per cent from five years before.

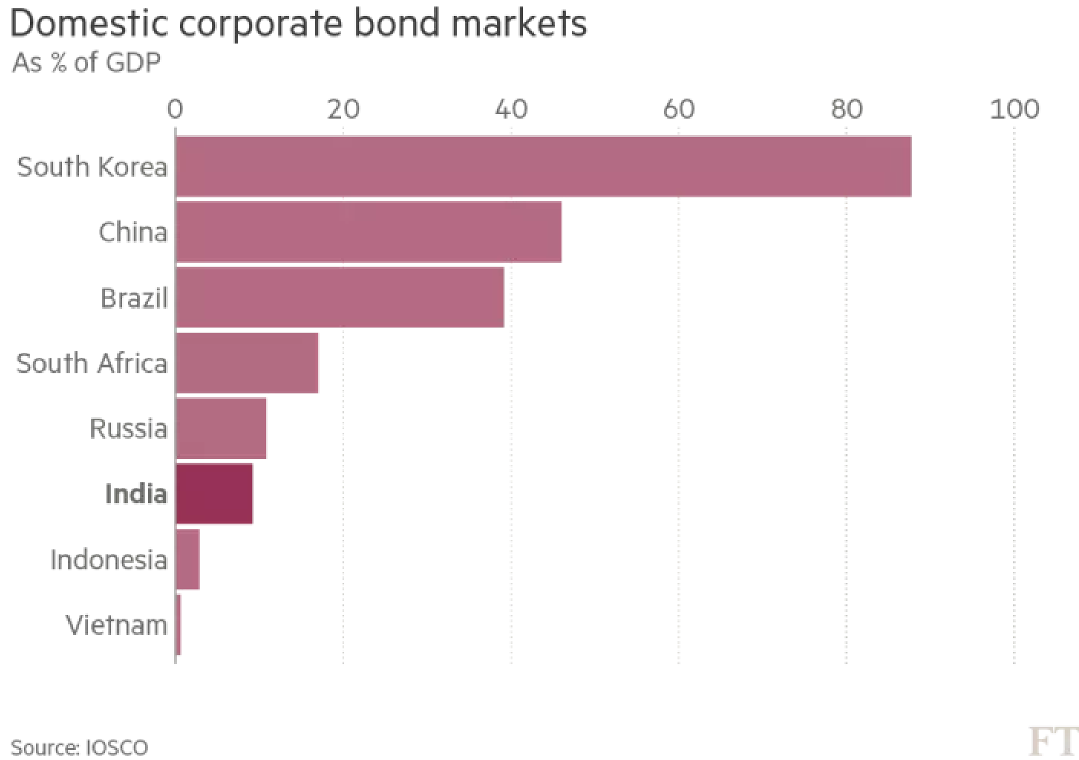
Leo Puri, managing director of UTI, one of the country's biggest mutual fund providers, warns that this trading is still heavily concentrated in paper issued by a small number of large providers — but adds that there is an ever-growing quantity of securities in the market, "as people have found their bank unable to fund them".

"The more issuance, the more investors, and the quicker we're likely to solve this liquidity issue," Mr Puri says.

Another driver of trading volume has been the increased presence of foreign investors. Their holdings of Indian domestic corporate bonds rose 44 per cent to Rs2.3tn in the year to July 20 — pushing up against the limit of Rs2.4tn imposed under India's capital control regime, and prompting last week's intervention by the Securities and Exchange Board.

Foreign investors are showing increasing confidence in India's economic performance and political stability under the government of Narendra Modi, in power since 2014, says Amit Bordia, corporate finance head for Deutsche Bank in India.

"There is a desire to get long-term committed to India in one way, shape or form," he says, noting that Indian companies have also benefited from the broader search for yield by global investors flush with liquidity.



Foreign bullishness has been boosted further by a law passed last year in India's parliament, which aims to dramatically accelerate the country's corporate insolvency regime, until now one of the slowest-moving in the world.

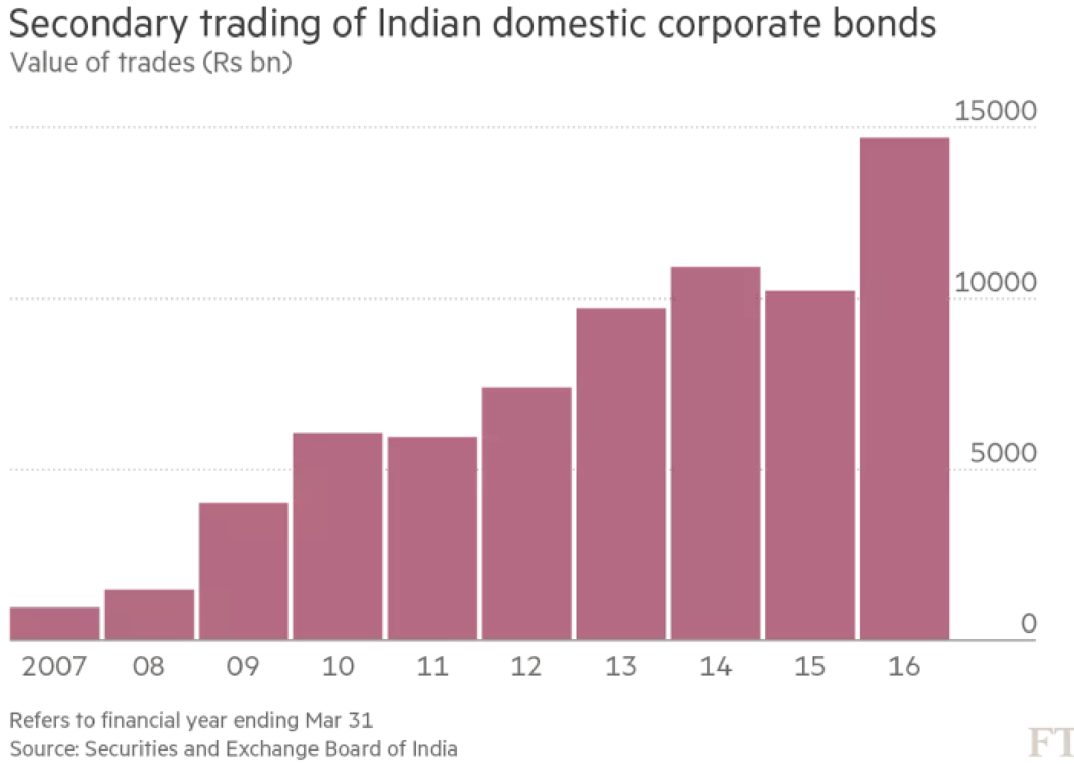
A study by the rating agency Crisil of five other countries that pursued similar reforms, including China and Brazil, showed that the pace of growth in bond issuance nearly doubled in the five years following the changes.

India's new law will be "critical" in giving bond investors confidence that they will recover value in the event of a default, says Pawan Agrawal, chief analytical officer at Crisil.

Last year's launch of the first corporate masala bonds, meanwhile, was widely hailed as a vital new source of funding for Indian companies, enabling them to capitalise on increased foreign appetite for exposure to India, without taking on additional currency risk.

Since then, however, some have complained of mixed signals from the authorities over the new asset class.

In apparent response to the interest shown by some relatively high-risk borrowers, the Reserve Bank of India last month imposed new rules stating that the yield on newly issued masala bonds must be at most 300 basis points above sovereign debt of equivalent duration.



“These recent changes to the regulatory framework represent an obstacle to the further development of the Indian capital markets,” the Asia Securities Industry & Financial Markets Association wrote in a report this week. “It is best left to the market to decide pricing levels.”

Others raise concern about persistent “crowding out” of corporate borrowers by the government, despite recent fiscal restraint from Mr Modi’s national administration.

State-level governments have been tapping the bond markets with growing enthusiasm to fund populist policies — soaking up so much investment that corporate bond yields remain at levels unattractive to many potential issuers, says Sajjid Chinoy, an economist at JPMorgan.

But such problems cannot outweigh the deeper factors that are pushing the shift in Indian corporate debt towards the bond market, argues Rajesh Mokashi, chief executive of Care Ratings.

“The pace of growth will continue,” he says. “There is a structural transformation taking place that has not been seen before.”