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Increasing Importance of Foreign Investors in India's Capital Markets

Foreign Investors Increasing Investment in India's Capital Markets

Foreign investors have a large presence in India's capital markets, especially its stock market, where they are making important contributions by supplying liquidity, enhancing market efficiency, and promoting stronger corporate governance.

Over the last six years, foreign investors have been increasing their investments in India's capital markets. According to data from National Securities Depository Limited (NSDL), the largest Indian central securities depository, foreign investors' holdings of Indian stocks at end-June 2018 totaled INR 27.7 trillion, a 2.4-fold increase from INR 11.6 trillion at the end of 2012. Over the same period, foreign investors' holdings of bonds issued by Indian issuers increased 2.4-fold from INR 1.7 trillion to INR 4.1 trillion (Figure 1).

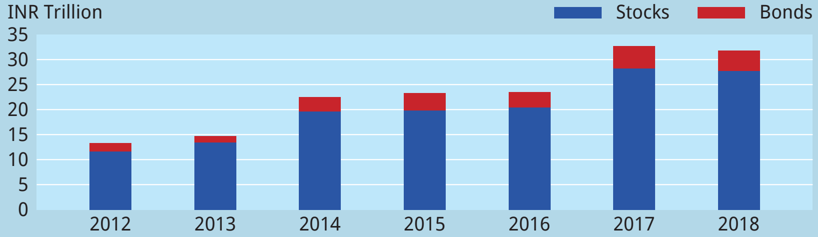
Among foreign investors, mutual funds are the largest holders of Indian securities. As of end-June 2018, foreign mutual funds' holdings of Indian securities totaled INR 15.1 trillion, 47 percent of foreign investors' total holdings. The next largest investor category is the so-called broad-based funds,*[1] which held Indian securities worth INR 5.6 trillion at end-June (18 percent of total foreign holdings).

By country, U.S. investors have invested the most in India, with total investments amounting to INR 10.5 trillion as of end-June 2018, 33 percent of all foreign investment in Indian securities. Among Asian countries, investment from Singapore is relatively high, at INR 2.7 trillion and 8.6% of all foreign investment as of end-June. The increase in investment from Japan has been rather prominent in recent years. Before 2015, Japan was not even ranked among the top 10 in the country rankings for investment in India, but as of end-June 2018 it ranks sixth. Japan's outstanding holdings of Indian securities at that point in time approached INR 1.2 trillion, including about INR 941 billion in stocks and INR 222 billion in bonds. Investments from Japan are mostly via investment trusts. According to the Japan Investment Trusts Association, Japanese investment trusts' total net assets invested in INR-denominated stocks and bonds totaled JPY 1.2 trillion at end-June 2018, nearly quadruple the JPY 297 billion at the end of 2005.

Reasons for Increased Investment by Foreign Investors

The main reasons for foreign investors increasing their investment in India's capital markets can be divided into macroeco-

Figure 1: Foreign Investors' Total Holdings of Indian Securities



Note: 1. Data for 2018 is as of end-June.
2. Investment in hybrid instruments is insignificant and therefore not included.
Source: NSDL

nomic factors and institutional factors.

Macroeconomic factors

Since 2010, India's economy has expanded at an average annual pace of more than seven percent, and India is expected to sustain a high pace of economic growth going forward. According to the International Monetary Fund (IMF), India's real gross domestic product (GDP) growth from 2018 to 2023 is forecast to average about eight percent. The sudden demonetisation (invalidation of large banknotes) carried out in November 2016 and the Goods and Services Tax (GST) introduced in July 2017 caused temporary disruptions of economic activity in India, but robust private consumption and the government's aggressive investment in infrastructure appear to be supporting continued strong economic growth.

Although India has a constant current account deficit, in recent years the deficit has generally been kept at a low level. The deficit was 4.7 percent of GDP in FY2012-2013, but that ratio has been held less than two percent since FY2013-2014 thanks in part to reductions in gold imports and lower crude oil prices. The improvement has contributed to the stability of the rupee against the U.S. dollar in recent years, with INR/USD trending in the 0.014 – 0.017 range since 2014.

Also, the Modi administration that came to power in May 2014 has improved India's fiscal balance by restraining spending in a move toward fiscal consolidation. As result, the Indian government's fiscal account deficit has shrunk from 4.5 percent of GDP in FY2013-2014 to just 3.5 percent in FY2017-2018. This improvement prompted Moody's to upgrade its rating on India's sovereign debt from its lowest investment grade rating of Baa3 to Baa2 in November 2017.

Strong macroeconomic conditions have also contributed to a solid uptrend in India's stock market in recent years. India's National Stock Exchange's (NSE) NIFTY 50 stock index stood at 10,714 at end-June 2018, a strong 70 percent advance from 6,304 at end-December 2013 (Figure 2). The BSE's S&P BSE SENSEX index also climbed steadily during that same period, rising 67 percent from 21,171 to 35,423.

Institutional factors

Institutional factors that have promoted increased investment from foreign investors include, first and perhaps foremost, simplification of the process for registering as a foreign investor in India. Prior to the simplification, foreign investors had to register as a Foreign Institutional Investor (FII), an FII sub-account, or a Qualified Foreign Investor (QFI) before they could invest in securities on Indian markets. To streamline the operation of the foreign investor system, in 2014 the Securities and Exchange Board of India (SEBI) unified these three foreign investor categories into a single category, the Foreign Portfolio Investor (FPI).

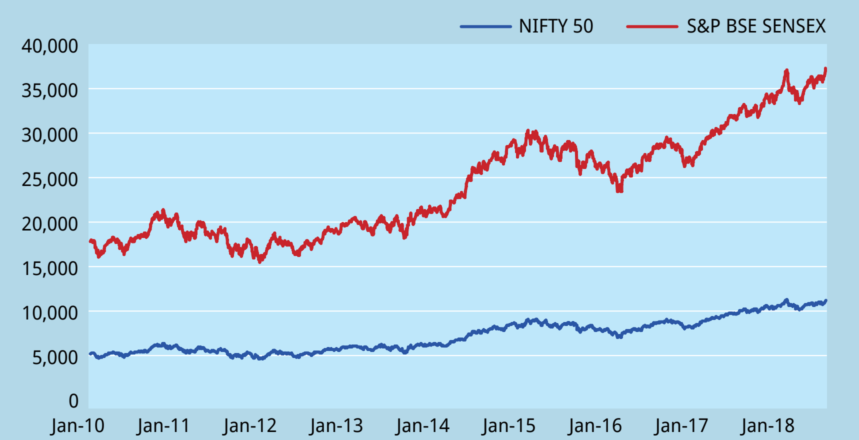
The main change made by this new FPI regime is unification of the system's management structure. Approval and registration of foreign investors was previously carried out by both the SEBI and India's central bank, the Reserve Bank of India (RBI). Under the new regime, registration of FPIs is granted by SEBI-approved custodian institutions, called Designated Depository Participants (DDPs). FPI trading also is now monitored by the DDPs.

In addition, approval procedures have become more efficient. Previously know-your-customer (KYC), or identity verification, procedures were the same for all foreign investor categories, but under the new regime KYC is carried out for each investor category. Foreign investors, or FPIs, are classified into three categories based on their risk profile. Category I includes central banks, governmental agencies, sovereign wealth funds, and international or multilateral organisations. Category II includes banks, asset management companies, investment trusts, insurance companies, pension funds, and university funds. Category III includes endowments, charitable trusts, foundations, corporate bodies, trusts, and individuals.

Under the new, more efficient regime, the number of registered foreign investors has steadily increased each year. As of end-June 2018, the total number of registered FPIs was 9,136, compared with 8,557 entities registered as FII, FII sub-accounts, or QFIs at the end of 2013.*[2]

The second institutional factor is the relaxation of bond investment regulations. In September 2016, SEBI decided to allow Category I and Category II FPIs to directly access the corporate bond market. Previously, FPIs had to invest in these bonds through brokers. In addition, in February 2017 SEBI approved FPI investments in unlisted non-convertible corporate bonds and securitised instruments. More recently, in April 2018, SEBI raised the cap on aggregate FPI investments in any central government security from 20 percent to 30 percent. Moreover, the requirement for FPIs to invest in government and corporate bonds with a minimum residual maturity of three years was withdrawn, subject to the conditions.*[3]

Figure 2: NIFTY 50 and S&P BSE SENSEX



Note: Data is on a daily basis.
Source: Bloomberg

Main Obstacles to Attracting Foreign Investors

As shown above, the SEBI and RBI have implemented various measures designed to promote investment in India's capital markets by foreign investors. However, obstacles remain. The main unresolved issues are as follows.

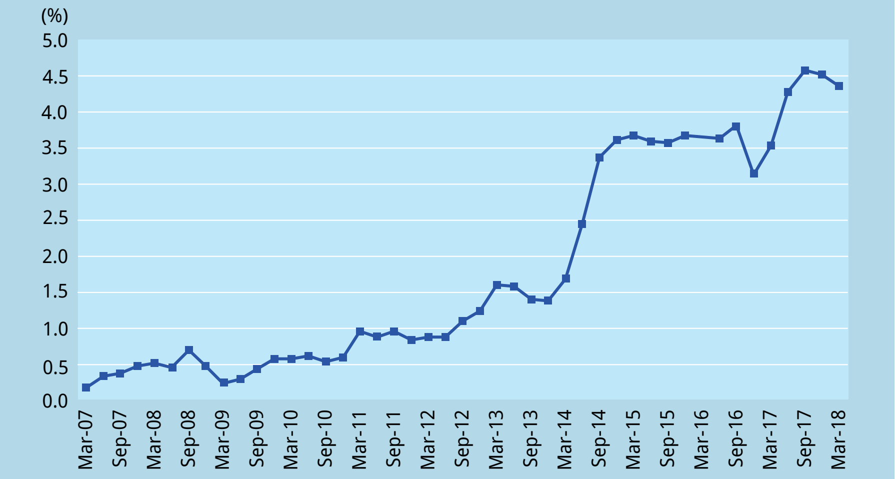
Limits on bond market investments

Foreign investors' presence in India's bond market is still quite small, with FPIs holding just 4.4 percent of total outstanding government dated securities as of end-March 2018 (Figure 3). While that ratio has been rising gradually, it remains much lower than foreign investors' share of the outstanding government bonds of other Asian countries such as Indonesia and Malaysia which stands at 39 percent and 29 percent respectively at end-March 2018.*4

The reason for this small ratio is the limit on FPIs' holdings of India's government bonds. To avoid volatile asset flows and maintain the stability of India's macro economy, SEBI has set a limit on FPI holdings of outstanding issues of Indian securities. As of end-June 2018, the limits are INR 2.86 trillion for central government bonds, INR 419 billion for state development loans (SDLs), and INR 2.67 trillion for corporate bonds. In 2014 when the foreign investor categories were unified under the FPI category, the limits on investment by foreigners were USD 30 billion (equivalent to INR 1.54 trillion) for government securities and USD 51 billion (equivalent to INR 2.44 trillion) for corporate bonds. Since then, the limits have been raised in stages. From October 2018, those limits are scheduled to be raised again, to INR 3.16 trillion for central government securities, INR 452 billion for SDLs, and INR 2.89 trillion for corporate bonds. The increases in these limits have opened up room for additional investments in India's bond market by FPIs, but FPIs' current holdings as a percent of the limit on those holdings is higher than it was in 2014 (Figure 4).

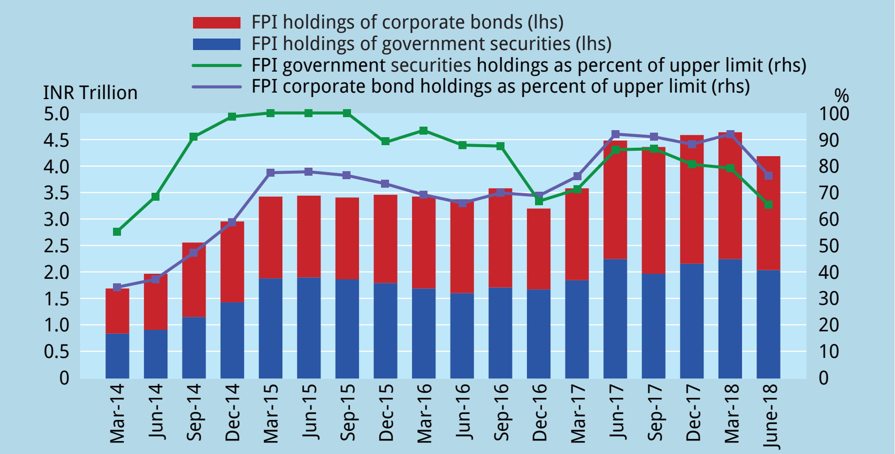
One negative aspect of the low ratio of FPI holdings to total outstanding government securities is that it precludes the inclusion of India's bonds in global bond indices maintained by major index providers. In general, inclusion in global bond indices requires a foreign investor holding ratio of at least 10–20 percent.*5 With index-linked investment on the rise, global investors have no real need to include India's bonds in their portfolios. Consequently, when global financial market volatility is rising, investors do not hesitate to pull funds out of the Indian market. For example, immediately after the U.S. Federal Reserve Board mentioned the possibility of tapering of its quantitative easing in May 2013, foreign investors withdrew a large amount of funds from India's bond market, leading to net outflows totaling INR 508.5 billion in 2013, which in turn led to a significant depreciation of the rupee.

Figure 3: FPIs' Share of Outstanding Indian Government Bonds



Source: RBI

Figure 4: FPI Holdings of Outstanding Indian Bonds as Percent of the Limits on Those Holdings



Source: NSDL, The Clearing Corporation of India Limited

Active offshore trading of Indian stock index futures

At present, the majority of trades in India's stock index futures are conducted in offshore markets. For example, stock index futures for the NIFTY 50 and S&P BSE SENSEX are both actively traded on the Singapore Exchange (SGX) and the Dubai Gold and Commodities Exchange. On the SGX, NIFTY 50 Index Futures transactions accounted for 14 percent of all stock future trades for the period from January to June in 2018. Moreover, trading volume of NIFTY 50 futures on the SGX exceeded that on the NSE as of 2017.*6

Indian equity derivatives trading volumes are also greater in offshore markets than in the domestic market. One reason for this is that foreign investors that have not registered with India's financial regulators have limited access to India's stock market. Previously, such foreign investors were able to access India's stock market by purchasing Participatory Notes (PNs) issued by FIIs. However, stricter reporting requirements for the issuance of PNs introduced since 2012 to strengthen measures against monetary laundering have led to a large reduction in foreign investors' investment in India's stock market via PNs. Meanwhile, offshore trading of Indian equity-related products has increased.

Tax-related obstacles

To date, India has adopted a tax system that is generally favourable for foreign investors. According to a survey implemented by PwC, around two out of three respondents felt that tax rates on capital gains from their securities investments in India were moderate or low.*[7] While India still has a short-term capital gains tax and a securities transaction tax (STT) on transactions on securities, it abolished its long-term capital gains tax in 2004.

However, the Indian government's recent announcement that it was considering re-introducing the long-term capital gains tax as part of the Union Budget for FY2018-2019 sent shockwaves through the market. Moreover, it evidently does not intend to allow a deduction for STT paid when calculating capital gains, so essentially FPIs will be subject to double taxation in the form of the STT and a capital gains tax. India is the only major Asian country to have both a capital gains tax and an STT. If India's tax system continues to include such disadvantages for FPIs, the ability of India's capital markets to compete with the markets in other Asian markets could be reduced.

GIFT International Financial Services Centre — Promising New Global Financial Centre

With greater trading of Indian equity-related products on offshore markets than on the domestic market, India's major stock exchanges would like to see liquidity return to the home market. The Indian government established the International Financial Services Centre (IFSC) at the Gujarat International Finance Tec-City (GIFT), a special economic zone, aiming to make it a global financial hub. GIFT IFSC offers a wide range of financial services to resident and nonresident investors alike by attracting foreign financial institutions to set up local branches and/or subsidiaries inside GIFT. Stock exchanges, clearing houses, and depository institutions also are participants in GIFT. BSE inaugurated its operation within GIFT IFSC through its subsidiary India International Exchange (India INX) in January 2017, followed by NSE's launch of its subsidiary NSE IFSC in June 2017.

Foreign investors that have already registered as FPIs can make investments at GIFT IFSC without going through an additional registration process. In addition, foreign investors that have not registered as FPIs can participate as an Eligible Foreign Investor by passing a KYC process.

Tax incentives have been implemented as an added attraction to foreign investors to GIFT IFSC. Specifically, SST, commodity transaction tax, long-term capital gains tax, and stamp duty have been eliminated. In addition, removal of capital gains from the sale of short-term derivatives was proposed in the Union Budget for FY2018-2019 to promote greater participation by foreign investors.

GIFT IFSC mainly offers trading in Indian stock index and individual stock derivatives as well as global equity index and currency derivatives. In addition, FPIs are able to invest in commodity futures. Initially, trading on the India INX and NSE IFSC exchanges was limited to derivatives, but the breadth of available financial products was expanded to meet the needs of issuers and investors, and bond trading is now also available.

Reflecting investors' positive reaction to the initiatives described above, trading values on both the India INX and the NSE IFSC are on a gradual upward trend. Daily trading turnover was less than USD 100 million in June 2017 but one year later had expanded to over USD 700 million. Although the combined trading turnover of its two exchanges is still much smaller than those for the BSE and NSE, GIFT IFSC is listed as one of the 15 global financial centres likely to become more significant.*[8]

To further promote investment by foreign investors at GIFT IFSC, in May 2018 SEBI permitted investments via Segregated Nominee Account Structure. This structure enables foreign investors that do not register themselves to make investment in GIFT IFSC. As noted earlier, stricter requirements for the issuance of PNs reduced non-FPI foreign investors' exposure to India's equity market, but the ability to invest via Segregated Nominee Account Structure is expected to bring foreign investors back to Indian equities.

Foreign Investors Are One Key to Achieving the Indian Government's Policy Goals

The importance of attracting foreign investors to India's capital markets is not limited to increasing trading volume and expanding market scale. It also is a key to achieving the policy goals of the Indian government. Two government policies that capital markets are expected to play an important role in achieving are the promotion of infrastructure development and the use of renewable energy.

Promotion of infrastructure development

The quality of infrastructure in India is much lower than that in advanced nations.*[9] Consequently, the promotion of infrastructure development is one of the biggest challenges to sustaining the high growth of the Indian economy. According to the Economic Survey 2017-18, it is forecasted that around USD 4.5 trillion worth of investments is required by India till 2040 to develop infrastructure. Private-sector funds will be indispensable to meeting the demand for funds required by India's need for enormous investment in infrastructure development. However, the limited amount of funds available via bank loans, currently the main source of private-sector funding, accentuates the importance of the capital markets. In addition to promoting the issuance of tax-free bonds by infrastructure-related agencies and long-term bonds for infrastructure development by banks, the government has introduced new types of infrastructure-related financial products.

One such product is infrastructure investment trusts (InvITs) whose regulations were introduced by SEBI in 2014. In March 2016 IRB InvIT established by IRB Infrastructure Developers, a major Indian real estate developer, was registered as the first InvIT in India. Currently, six trusts are registered with SEBI, two of which are traded on stock exchanges. To promote investment in InvITs, in January 2018 SEBI released a circular that allows strategic investors to invest not less than five percent and not more than 25 percent of the total offer size of a single InvIT.

In addition, the Indian government set up the National Infrastructure and Investment Fund (NIIF) in 2015 to promote funding of important national infrastructure projects. The government initially targeted size for NIIF of INR 400 billion, with a 49 percent capital contribution from the government and the remaining from domestic and international investors such as sovereign wealth funds, multilateral development banks, pension funds, and public sector enterprises. After discussions with some potential investors, in October 2017 NIIF entered into an investment agreement worth USD 1 billion with a wholly owned subsidiary of the Abu Dhabi Investment Authority. Next, in January 2018 NIIF announced that it had partnered with DP World, a Dubai-based port management company, to establish an investment platform for ports, terminals, transportation, and logistics businesses in India. While NIIF is moving forward at a gradual pace, it is expected to play a more important role in promoting foreign investors' participation in India's infrastructure sector.

Promotion of renewable energy use

India's government plans to expand the nation's renewable energy capacity to 175 GW by 2022.*10 Achieving that goal is estimated to require a funding of around USD 200 billion. It will be difficult for domestic banks and institutional investors to meet the huge demand for funds required by this ambitious plan. Foreign investors will therefore have an important role to play. From this perspective, the Indian government is increasingly focusing its attention on green bonds, which are growing in popularity among institutional investors, especially in the advanced economies.

SEBI issued a concept paper for issuance of green bonds in December 2015, and a circular on disclosure requirements for issuance and listing of green bonds in May 2017. Prior to these developments, Yes Bank, a major Indian commercial bank, issued an INR 10 billion green bond in February 2015, the first green bond by an Indian issuer. Thereafter, green bond issuance spread from banks to domestic corporations, such as major energy companies NTPC and Greenko.

To date, many green bond issues by Indian issuers have been in overseas markets, with SGX the preferred exchange for listings. However, in January 2018 Indian Railway Finance Corporation made the first green bond issue to be listed on the India INX, a USD 500 million bond. In March 2018, Indian Renewable Energy Development Agency issued an INR 19.5 billion green Masala bond, the first green bond to be listed on the NSE IFSC. Looking forward, GIFT ISFC is expected to assume a greater presence as a market for listing green bonds by domestic issuers to attract foreign investors.

In Conclusion

Foreign investors are expected to play an increasingly important role in India's capital markets, not just as providers of short- and medium-term funding to domestic issuers but also as a source of the stable long-term funding needed to support infrastructure development in India. To attract more foreign investors to its capital markets, India must create institutional frameworks that are more user-friendly and convenient for foreign investors while also raising corporate governance including disclosure standards to the levels seen in the world's more advanced economies.

Also, to increase the stability of its capital markets, India needs to raise awareness among domestic investors. The decline in bank deposit interest rates since the demonetisation has prompted more Indians to purchase mutual funds, thus broadening the nation's investor base. Given this changing environment, sufficient investment education will be made available to investors in outlying regions as well as to those in the nation's major cities.

Going forward, India's financial regulators and the stock exchanges have important roles to play in promoting investment by foreign investors and nurturing domestic investors in order to ensure the sound development of India's capital markets.

Notes

*1 A broad-based fund is a fund established or incorporated outside India that has at least 20 investors with no investor holding more than 49 percent of the shares or units of the fund.

*2 "FPI count grows marginally in 4 years," *Business Standard*, 28 June, 2017.

*3 Investment in government securities with residual maturity below one year by an FPI under either category must not exceed 20 percent of the total investment of that FPI. Also FPIs are only permitted to invest in corporate bonds with minimum residual maturity of above one year.

*4 These figures were obtained from AsianBondsOnline. https://asianbondsonline.adb.org/new/data-portal/

*5 "Jury is out on the impact of RBI's foreign portfolio investor measures," *Business Standard*, 7 May, 2018.

*6 ASIFMA. (2018) "Accessing India's Equity Markets – Reform, Perform and Transform."

*7 PwC. (2018) "Foreign Portfolio Investor Survey 2016-17-India moving in the right direction."

*8 Z/Yen and China Development Institute. (2018) "The Global Financial Centres Index 23."

*9 According to the World Economic Forum's "Global Competitiveness Report 2017-2018," India's quality of overall infrastructure ranks 46th among the 137 ranked countries and regions.

*10 Based on the Paris Agreement, an international framework for global warming countermeasures, the Indian government also has committed to reducing the greenhouse gas emissions intensity of its GDP by 33–35 percent below 2005 levels by 2030.

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