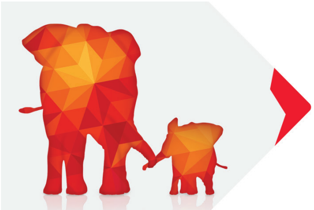

A NOTE FROM OUR FIXED INCOME DESK

eastspring investments
A member of Prudential plc (UK)

INDIA: A HUNDRED SMALL STEPS

September 2016

The Reserve Bank of India (RBI) recently unveiled a comprehensive set of measures to bolster the expansion of corporate bond markets in India, often viewed as one of the more underdeveloped segments of the country's financial system. Some of the key directives include expanding the collateral base for accessing central bank liquidity, allowing banks to issue Masala bonds, and easing restrictions for foreign investors on corporate bond trading platforms.

While immediate market impact is not expected, these reforms should propel the bond market forward as an alternative funding platform to support the diverse financing requirements of a growing Indian economy, in our view.

In the past decade, banks have largely borne the responsibility of providing debt capital for many long-term projects in India. Banking assets currently make up around 76% of GDP[1], far higher than outstanding Indian corporate bonds (15% of GDP). Bad debt has since been on the rise in the banking sector, and prospects of weaker profitability coupled with the still grim outlook for non-performing assets will continue to attract further provisioning requirements from RBI. The central bank under Governor Rajan has been progressively rolling out new measures to clean up bank balance sheets, most recently having released a framework to reduce excessive concentrated risk in banks.

The confluence of these developments form a very positive long-term investment case for Indian corporate bonds, although some caution is warranted. For one, attractiveness in the market for offshore investors is highly dependent on India sustaining a positive macro story. External demand for Indian bonds in both the local and hard currency space has generally held firm this year as investors look for higher yields from countries and/or sectors with stable macro fundamentals. Reform measures passed in recent months have not only directly benefited the Indian economy but also instilled a higher degree of confidence over the Modi administration. Any policy missteps could result in significant shifts in investor risk perception.

Insufficient facilitative infrastructure across India's financial system is another concern. Specifically for corporate bonds, the lack of a reliable benchmark yield curve restricts accuracy in corporate debt security pricing. A credit default swaps market which allows credit risk to be traded also does not exist despite regulatory guidelines for them being in place.

Overall however, the Indian corporate bond market is still very much in its infancy and we are optimistic that proactive policy and regulatory changes will incrementally alleviate concerns over market depth and liquidity in the longer term.

[1]SEBI, IMF, RBI, as at March 2016.

SOME OF THE KEY REFORM MEASURES ARE DETAILED BELOW:

1 RBI will actively consider corporate bonds as eligible collateral for liquidity operations

Currently, only government securities are allowed under the Liquidity Adjusted Facility (LAF) window, a monetary policy mechanism for lenders to borrow money. Once implemented, an expanded central bank collateral base should boost corporate bond market liquidity.

2 Increase in the aggregate limit for partial credit enhancement (PCE) provided by banks

PCE was first introduced in September 2015 as a means for corporate entities to lower borrowing costs. It enhances the credit rating of bonds which enables corporates to access funds from the bond market at better terms. Banks are now permitted to provide PCE of up to 50% the bond issue size, a notable increase from the 20% ceiling set last year. Credit enhancements provided by individual banks cannot exceed 20% of the bond issue size.

3 Banks will be allowed to raise capital through Rupee-denominated bonds overseas (Masala bonds)

These instruments constitute as additional tier-I (AT1) and tier-II capital, which will expand funding avenues for lenders as they seek to shore up core capital reserves. As a way of incentivising long-term bond issuance, the framework also stipulates that banks can issue Masala bonds to finance infrastructure and affordable housing.

Under the existing structure, only corporates and non-banking lenders can issue Masala bonds. Enabling banks to participate in this space opens up the market to a much larger investment pool.

4 Increased participation in the corporate bond market

Registered brokers authorised as market makers will be permitted to participate in the corporate bond repo market. A corporate bond repo is when an entity pledges corporate bonds with another to raise funds, with the pledger later agreeing to repurchase the bonds at a specified price. Only bilateral repurchases of corporate bonds are currently allowed and these are restricted to regulated entities (e.g. banks, insurance companies and primary dealers).

This new measure bodes well for secondary market liquidity as trading is currently low with purchases largely limited to long-term domestic investors who tend to hold assets to maturity.

5 Easing of restrictions for Foreign Portfolio Investors (FPI)

FPIs will be allowed to trade corporate bonds over-the-counter (OTC) without the involvement of brokers. This operative will later be extended to include electronic trading — a framework to introduce electronic dealing platforms for corporate bond repos is expected to be released by the end of this year.

Disclaimer

This document is produced by Eastspring Investments (Singapore) Limited and issued in:

Singapore and Australia (for wholesale clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore, is exempt from the requirement to hold an Australian financial services licence and is licensed and regulated by the Monetary Authority of Singapore under Singapore laws which differ from Australian laws.

Hong Kong by Eastspring Investments (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong.

United States of America (for institutional clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore and is registered with the U.S Securities and Exchange Commission as a registered investment adviser.

European Economic Area (for professional clients only) and Switzerland (for qualified investors only) by Eastspring Investments (Luxembourg) S.A., 26, Boulevard Royal, 2449 Luxembourg, Grand-Duchy of Luxembourg, registered with the Registre de Commerce et des Sociétés (Luxembourg), Register No B 173737.

United Kingdom (for professional clients only) by Eastspring Investments (Luxembourg) S.A. - UK Branch, 125 Old Broad Street, London EC2N 1AR.

Chile (for institutional clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore and is licensed and regulated by the Monetary Authority of Singapore under Singapore laws which differ from Chilean laws.

The afore-mentioned entities are hereinafter collectively referred to as **Eastspring Investments**.

This document is solely for information purposes and does not have any regard to the specific investment objective, financial situation and/or particular needs of any specific persons who may receive this document. This document is not intended as an offer, a solicitation of offer or a recommendation, to deal in shares of securities or any financial instruments. It may not be published, circulated, reproduced or distributed without the prior written consent of Eastspring Investments.

Investment involves risk. Past performance and the predictions, projections, or forecasts on the economy, securities markets or the economic trends of the markets are not necessarily indicative of the future or likely performance of Eastspring Investments or any of the funds managed by Eastspring Investments.

Information herein is believed to be reliable at time of publication. Where lawfully permitted, Eastspring Investments does not warrant its completeness or accuracy and is not responsible for error of facts or opinion nor shall be liable for damages arising out of any person's reliance upon this information. Any opinion or estimate contained in this document may subject to change without notice.

Eastspring Investments (excluding JV companies) companies are ultimately wholly-owned/indirect subsidiaries/associate of Prudential plc of the United Kingdom. Eastspring Investments companies (including JV's) and Prudential plc are not affiliated in any manner with Prudential Financial, Inc., a company whose principal place of business is in the United States of America.

eastspring investments

A member of Prudential plc (UK)