DBS Economics & Strategy

India: Onshore bond and FX markets Primer (Update)

Bloomberg

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Report produced with inputs from DBS India Global Financial Markets (GFM) and DBS Singapore GFM WMNC teams.

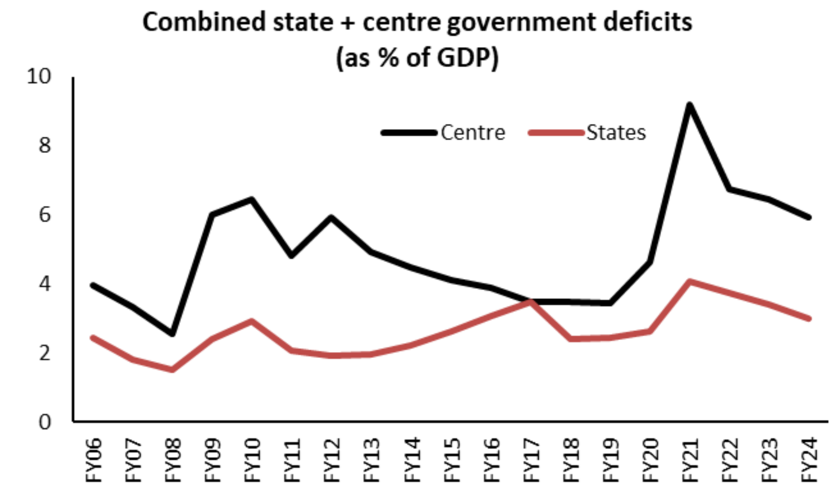
- *We update our India's bond and currency markets primer to factor in a host of recent developments.*
- *India's eligible bonds will be included in the JP Morgan Global-Emerging Markets' index and Bloomberg's EM index in 2024 and 2025 respectively.*
- *This will attract investors to the country's large investable debt markets, providing an exposure to its positive macro-outlook.*
- *Bond market size is comparable to other global mature markets, second largest in Asia ex-Japan.*
- *By type of issuance, the rupee-denominated central government bonds have the largest share at close to half, followed by the state development loans at about a quarter.*
- *On monetary policy, the Reserve Bank of India pursues a flexible inflation targeting framework.*
- *The Indian rupee trading has evolved notably toward a freer float in the past three decades.*
- *Authorities are smoothening the mechanism to promote trade settlement in the INR with key trading partners.*
- *Plans for capital account convertibility remain under study.*

Overview of India's public debt and fiscal backdrop

India is a federal country, with the powers of the government divided between the centre and states through a constitution mechanism, with separate budgetary accounts. The Finance Commission provides the institutional framework for fiscal federalism, which includes sharing and distributing taxes (both vertically and horizontally) between the two.

Under expenditure, the centre oversees the provision of nationally important areas like defence, foreign affairs, foreign trade and exchange management, money and banking, cross state transport and communication. States assume the responsibility of agriculture and industry, social sector services such as health and education, police protection, state roads and infrastructure [I]. There are also responsibilities that fall under the concurrent list, shared by both centre and states. Local bodies look after the provision of public utilities etc.

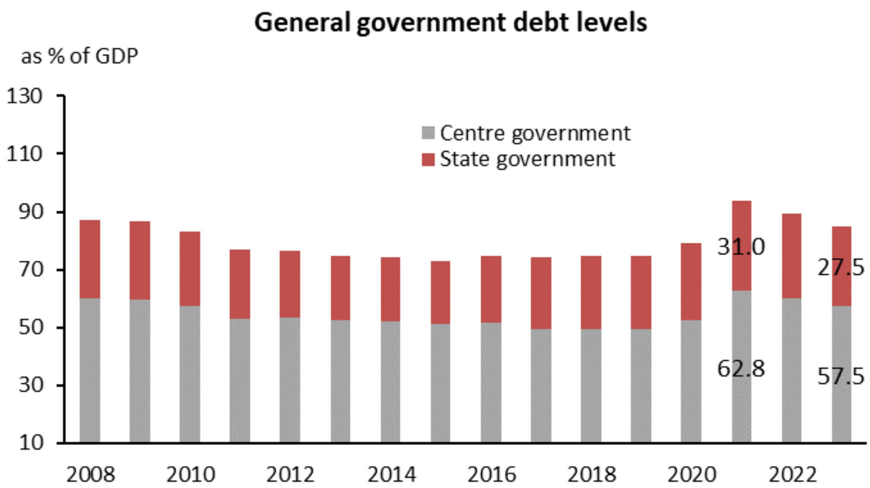
On the revenues end, the centre has the authority to decide on broader tax structure, including income tax and corporate tax, while states decide on sales tax, stamp duties, land revenue etc. Add to this, the centre has higher revenue raising powers, but part of these revenues (based on a pre-determined formula) is shared with the states, which exercises discretion to spend according to its specific needs. Since the **Goods and Services Tax (GST) was rolled out in mid-2017**, there is now a common tax base for most indirect taxes, levied as Centre GST, State/ Union territory GST and Integrated GST. Few product groups are excluded from this framework, e.g., alcohol, tobacco, petroleum products etc.



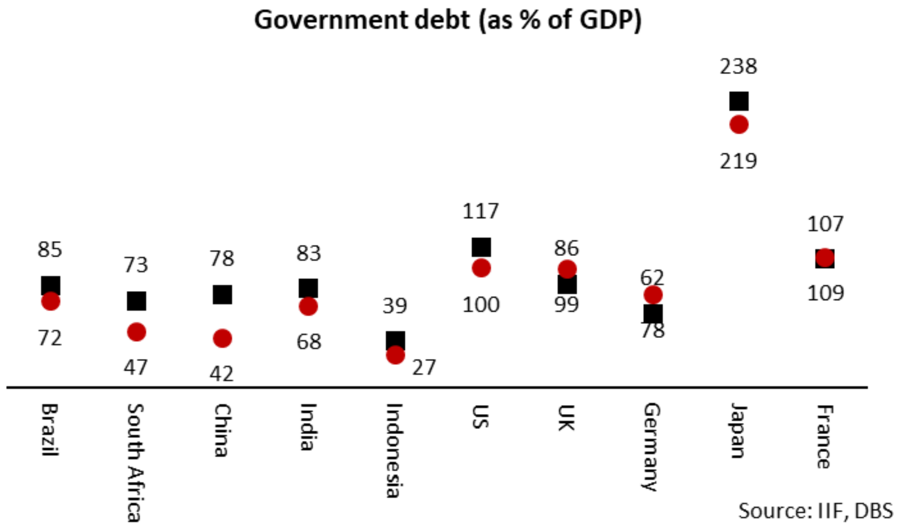
Source: RBI, DBS

The cumulative fiscal deficit as a % of GDP of the centre and states stood above 7% of GDP in FY20 vs average 6.6% in the prior 5 years. The central government kept the deficit below 4% for four years from FY16 to FY19, before a combination of weak revenue growth and higher spending commitments lifted the FY20 deficit to -4.6%. Pandemic related pressures and shifting more off-balance sheet spending on to the books, pushed up the cumulative deficit past 13% of GDP in FY21, before being gradually brought back to the consolidation path. Under the Fiscal Responsibility and Budget Management (FRBM) Act, states are mandated to keep their fiscal deficit under 3% of GSDP i.e., gross state domestic product, barring extraordinary circumstances like the pandemic where some of these provisions were temporarily eased.

General government debt levels stood at ~70% of GDP until 2019, before the pandemic-led impact on growth pushed its up closer to 89%. Fiscal finances have been on the mend in the past two years, albeit moderating at a gradual pace. As of fiscal 2023, the general government debt was closer to 85% of GDP.

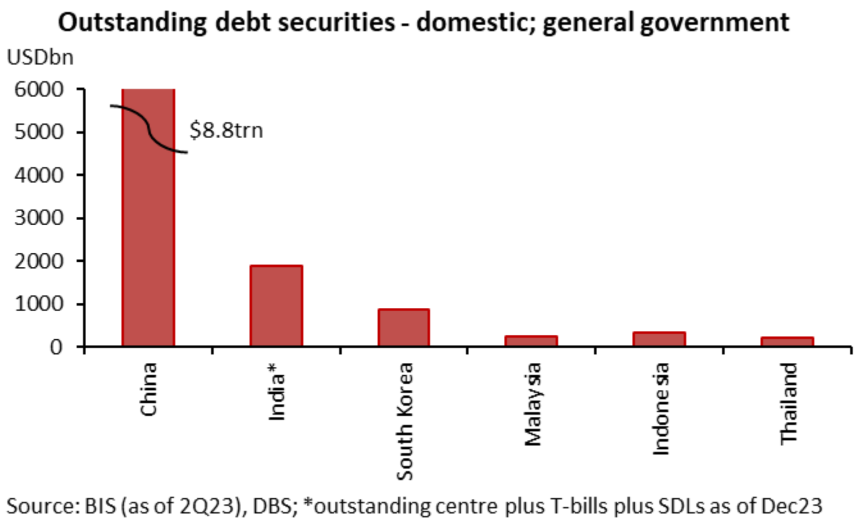


Source: RBI, CEIC, DBS



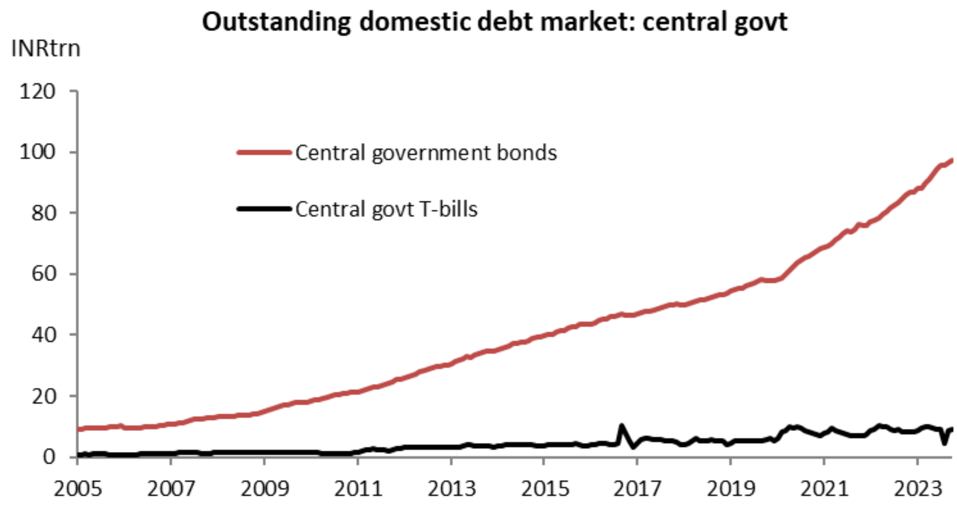
Overview of India's onshore bond markets

India's domestic bonds are the backbone for the overall securities market. We delve into two primary issuers – central government and states. India's outstanding government debt markets is second biggest in Asia (central government), behind China. Rupee sovereign securities can be divided into treasury bills (with original maturity of less than one year) or dated securities/bonds (original maturity of one year or more). Cash Management Bills are a third category, which are short-term instruments to meet the short-term temporary mismatches in the government's cash flows and are issued for maturities less than 91 days. The central government issues both Tbills and bonds (henceforth referred to as GSecs) while states issue dated securities. For all intents and purposes, government bonds are treated as risk-free securities.

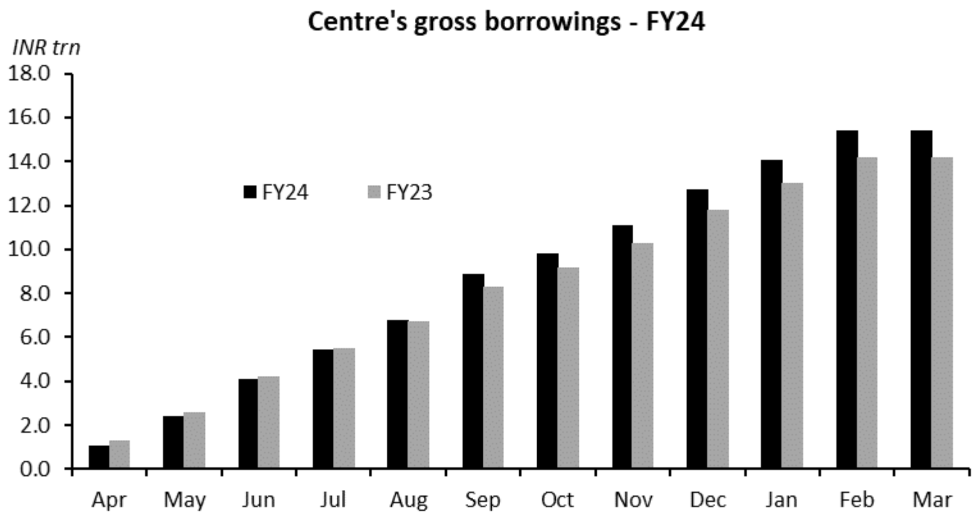


Central government bonds

These bonds are issued to finance the annual fiscal deficit along with development spending. GSecs are predominantly fixed coupon bearing securities, typically covering a duration of 2 to 40 years. The Public Debt Office under the central bank acts as the registry/depository of G-Secs, covering the issuance, interest payment as well as repayment of the securities. T-bills are zero coupon securities and pay no interest. Instead, they are issued at a discount and redeemed at the face value at maturity. These are primarily issued in three tenors: 91-day, 182-day, and 364-day. As of December 2023, total quantum of outstanding central government securities (bonds and T-bills) stood at INR105.2trn i.e., USD1.27trn.



Source: CEIC, DBS



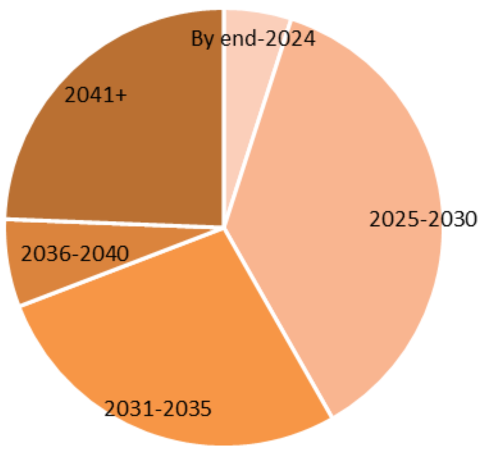
Source: CEIC, DBS

By type of issuance, the rupee-denominated central government bonds have the largest share at close to half, followed by the state development loans at about a quarter and rest corporate bonds.

A customary issuance calendar is released on a semi-annual basis for two halves of the fiscal year i.e., April-September and October-March, while adhoc additions/ reductions can be made in the interim period. This includes details like size of borrowing, tenor, and period over which the auctions will be held. For T-bills, a quarterly calendar for the upcoming quarter is released on the last week of the preceding quarter. Maturity profile of outstanding GSecs is highlighted in the chart below, with it broadly evenly spread across various tenors. One to ten years make up a little more than half of the total issuance.

As a long-standing practice, the RBI provides liquidity to market participants through the repo and marginal standing facility (MSF) window against eligible collaterals, which include GSecs, treasury bills and State development loans (SDLs). GSecs also qualify as part of the commercial banks' Statutory Liquidity Ratio (SLRs).

Maturity of outstanding bond issuances (as of 11-Dec-23)



Source: RBI, DBS

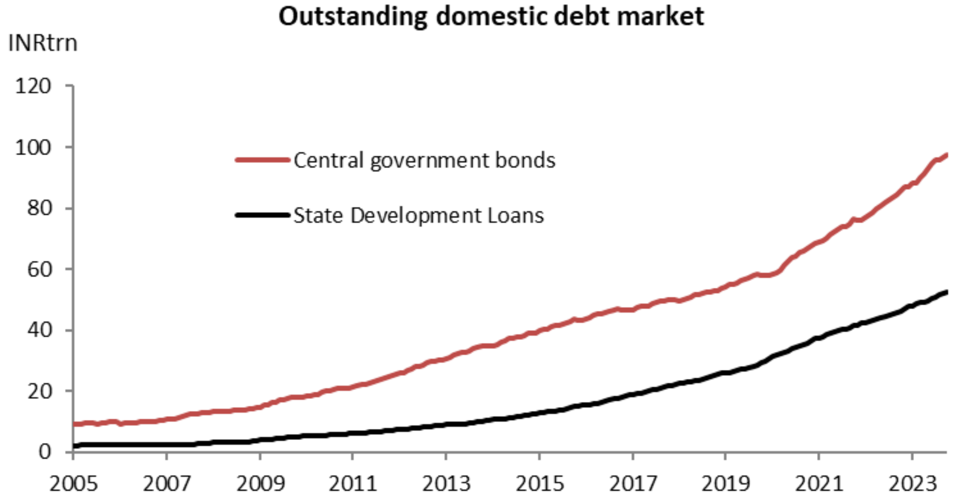
Trading platform and auction: Auctions for GSecs are conducted on the electronic platform called the E-Kuber, which is the Core Banking Solution (CBS) platform of RBI. Members of E-Kuber include commercial banks, primary dealers, insurance companies, provident funds, mutual funds etc. Results of the auction are published by the central bank at stipulated time, which might sometimes be tweaked under exceptional circumstances (e.g., COVID-19 outbreak). Auction for dated securities is conducted on Friday for settlement on T+1 basis. As for T-bills, auctions are usually conducted on every Wednesday, settlement for which is made on T+1 day.

Clearing agency: Clearing Corporation of India (CCIL) is the nodal clearing agency for GSecs. All outright trades are reported on the NDS OM platform by both counterparties within 15ns of trade and details matched, after which the trade is accepted and guaranteed by the CCIL. About the process: a) CCIL receives the trade information; b) participant-wise net obligations on both the securities are worked out; c) payable / receivable position of the account holders is reflected against their respective custodians; d) CCIL forwards the settlement file containing net position of participants to the RBI where settlement takes place by simultaneous transfer of funds and securities under the 'Delivery versus Payment' system. CCIL also guarantees settlement of all trades in G-Secs (source: RBI publication).

State development loans/ bonds:

Like the central government, states also raise funds, through securities called State Development Loans (SDLs) through the bond markets via normal auctions. Auctions for SDLs are held on Tuesday for T+1 settlement. Calendar for probable SDL issuances is issued on a quarterly basis. SDLs qualify for banks under banks' SLR, as well as collaterals for borrowing through market repo as well as borrowing by eligible entities from the RBI under the Liquidity Adjustment Facility (LAF) and special repo conducted under market repo by CCIL. Scale of SDL issuances, meanwhile, continues to climb, as the chart below highlights, vs GSecs.

Outstanding domestic debt market



Source: CEIC, DBS

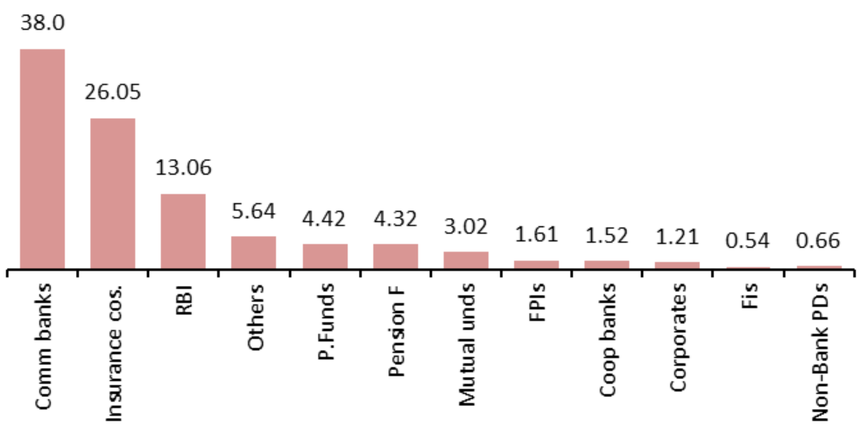
Outstanding SDL issuances stand at INR 51.95trn (i.e., $626bn) near half of the GSecs quantum. Relative to GSecs, SDL market is more illiquid in the secondary markets, owing to few factors including low outstanding stock of multiple SDLs, ownership structure (held till maturity) and limited market makers. With most issues being new papers, market is relatively fragmented, which has left the share of SDL trading is ~5% of the total secondary market trading (see chart above). Amongst states, the top five issuers are Tamil Nadu, Maharashtra, West Bengal, Karnataka, and Uttar Pradesh, earmarking more than half of the total issuance. Top ten states made up almost 74% of the quantum.

KEY INVESTOR CATEGORIES

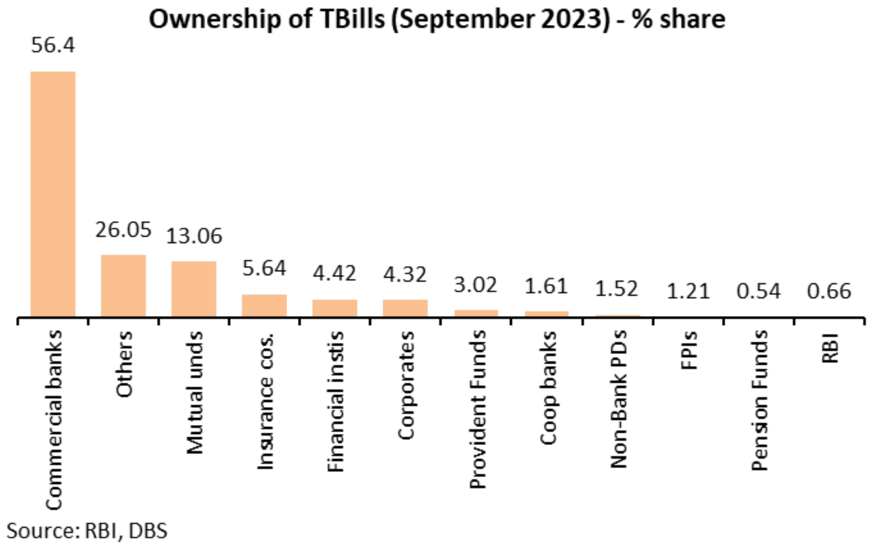
Domestic investors

The Ministry of Finance publishes the ownership pattern of Central Government securities on a quarterly basis with one quarter lag. The latest published data is available in the RBI bulletin published monthly. For GSecs, as of September 2023, commercial banks own 38% of the outstanding issuance, followed by insurance companies at 26%, RBI at 13.% and foreign investors at ~1.6%. Compared to December 2019, this marks an increase in the holdings of commercial banks, RBI, and insurance companies whilst the share of rest has fallen. For SDLs, commercial banks, insurance companies and provident funds made up more than 80% of the ownership in FY23, with the latter two typically holding on to securities for the long-term or up to maturity.

Ownership of central government bond holdings (September 2023) - %



Source: RBI, DBS



Foreign investors

Foreign debt portfolio investors are registered with the securities regulator SEBI and classified under two main brackets – Category I & II based on the risk composition. Long-term investors include sovereign funds, pension funds, foreign central banks, etc. Foreigners' ownership is dominated by the less than 10Y bucket in terms of maturity, with very marginal participation in longer durations.

Inclusion into international fixed income benchmarks

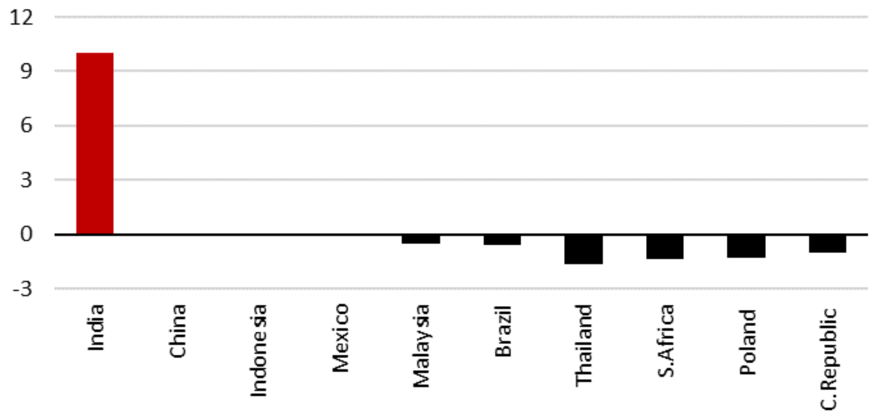
1) **JP Morgan Chase & Co**. announced plans to add the Indian government bonds (IGBs) to its Emerging Markets Bond index in 2024, particularly the GBI-EM Global Diversified Index (India inclusion in GBI-EM) and the related derivative benchmarks. Introduction of the FAR securities (Fully Accessible Route), free of ceilings for foreign investors back in 2020 coupled with more reforms to spur portfolio inflows, likely moved the needle for the provider. India had been on "Index watch Positive" since 2021.

Operational details

- The main GBI-EM GD index accounts for $213bn AUM of the estimated $236bn benchmarked to the GBI-EM group of indices;

- Onboarding process will start from June 28, 2024, with the inclusion of the FAR-designated government bonds to be raised by 1% over 10 months to March 31, 2025;

Proposed change in index weights - March 2025 vs current (%) - countries with top 10 weights



Source: JP Morgan factsheet, DBS

- The country's weightage will climb from 1% to 10% in the GBI-EM Global Diversified index, and ~8.7% in the GBI-EM Global index. The other countries with 10% weight (as of Mar25) will be China, Indonesia, and Mexico, whilst Malaysia and Brazil's weight will moderate from 10% currently to 9.49% and 10% to 9% respectively;
- As a start, 23 government bonds with a combined notional value of $330bn are eligible, which are under the FAR. At the start of the

inclusion period, eligible securities with maturities beyond Dec26 will be considered;

- A significant majority leaned towards India's inclusion in the index, according to the factsheet. 73% of the benchmarked investors favoured India's inclusion, with a preference to kickstart the process in Jun24, whilst 17% were neutral and 10% disagreed;
- Details on the tax treatment are awaited. Commentary from the government officials suggest no concessions have been made on the tax front. Separately, indications from one of the JPMorgan bond indices (GB-EM Global 10/1 index) to provision/ account for the impact of withholding taxes on earned interest on international investors, suggests this might become the broader practise;
- Russia's exclusion from the index last year and the consequent reweighting exercise (to make the index better balanced) also provided a window for India's inclusion. The latter makes the index more diversified whilst also enhancing the yield marginally. Inclusion of the IGBs will raise the index's yield by 33bp (GBI-EM Global) and duration by 0.19y (effectively to 5.3y)

2) **Bloomberg Index Services will include India's government bonds in its Emerging Markets local currency index and related indices**.

Inclusion into the specified Bloomberg indices will be carried out in a phased manner over ten months, starting January 31, 2025. The FAR securities (i.e., bonds available under the freely accessible route, without ceilings for foreign portfolio investments) will have an initial weight of 10% of their full market value, will be raised in increments of 10% until they reach 100% by October 2025.

Once the inclusion into the Bloomberg EM 10% country capped Index is complete, India's FAR bonds will be fully capped at 10% weight within the index. This will make the INR (Indian rupee) the third largest currency component, following the CNY and KRW within the EM Local Currency Index. As of January 2024, the index would include 34 securities and represent 7.26% of a $6.18trn index on a market value weighted basis. The count for China (CNY) stands at 154 and South Korea (KRW) at 66 as of late-2023. Notably, securities will be excluded from the Bloomberg Global Aggregate and related indices, while the provider continues to monitor market developments. This inclusion will result is an estimated $2-$3bn incremental flows into the markets.

Key channels for foreign investors to route investments:

- *General Route*: This route is open to all eligible and registered FPIs for investments into IGBs and corporate debt. These investments are subject to investment limits (see table below for reference). The ceilings undergo regular assessment, on the tenor of holding, investment limits, duration, and classification of investors. At present the combined IGB debt limit stands at INR5trn ($60bn), with sectoral and group exposure limits. Over time, restrictions on holdings have been eased to accommodate interests of more investors and special windows have been introduced as discussed below.

Utilisation of FPI debt limits (INRbn)

Category	Upper limit		Investments		% utilised
	INRbn	US$bn	INRbn	US$bn	
Central government bonds (all categories)	2679	32.3	645	7.8	24.1
Government bonds (long-term FPIs)	1370	16.5	69	0.9	5.1
State Devet Loans (all categories)	928	11.2	7.8	0.1	0.8
State Devet Loans (long-term FPIs)	71	0.9	-	-	0.0

As of 12Dec23; assumed USDINR = 83.0; Source: CCIL, DBS

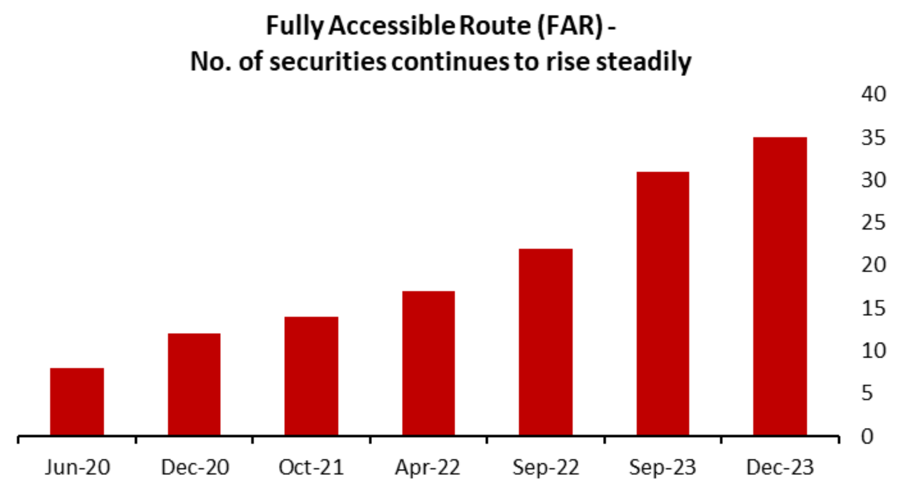
Tenor of the investments should be minimum 3years, subject to following exceptions: a) maximum 30% of investments can be in any tenor in case of G-sec/T-bills and in tenor exceeding one year in case of corporate bonds; b) re-investments for the limits in hand to be concluded within 2 days, else limit lapses; c) re-investment of coupons is in addition to this limit; d) hedging of IR and FX risk, but cancellation and re-booking is subject to restrictions; e) single security investment cannot exceed 30% of the outstanding stock; f) there are also restrictions on single entity and group of entities in terms of total amount of the limit used. Foreign investors can hedge FX onshore, alongside the interest rate risks in the deliverable markets, but not tap funding needs.

Snapshot - two other windows

Nuances	Voluntary Retention Route (VRR)	Fully Accessible Route (FAR)
Instruments	IGBs, corporate bonds, SDLs	IGBs (permissible instruments)
Lock-in period	Subject to terms, 3years	No limits
Investment limit	~$30bn (as of late-23)	No limits
FX and IR hedging	Yes	Yes

Details are as below:

- *Fully Accessible Route (FAR)* investment route has been made available for foreign portfolio investors. Under this avenue, certain specified instruments of GSecs would be opened fully for non-resident investors without any investment caps/restrictions, apart from being available to domestic investors as well. The scheme is designed to provide unfettered access to FPIs to certain notified liquid instruments, in case the overall FPI limit is completely utilized and is directed towards facilitating inclusion into bond index.



Source: CCIL, DBS

These securities include a) all new issuances of GSecs of 5Y, 10Y and 30Y tenors from FY21. New tenors might be added or changed from time to time; b) specified existing securities as highlighted in the table below. Notably, the current outstanding FAR securities notional is approximately USD 466bn of which about USD 330bn will be eligible for JPM index inclusion. Corporate bonds are not included in the FRA window and there is no minimum lock-in period. Currency and interest rate hedging are permitted.

- *Voluntary Retention Route (VRR)* was introduced in March 2019, targeting long-term and stable investments into domestic debt markets. This was done by freeing up investments from a host of regulatory and operational norms, provided 75% of their Common Portfolio Size (CPS) are invested within 3monts from the date of allotment and retained for a minimum of three years. This route is fungible between GSec and corporate bonds. FPIs are also allowed to invest in Exchange Traded Funds that invest only in debt instruments. Add to this, investors can freely book and cancel interest rate and FX hedges. Investment limit was raised to INR1.5trn in January 2020. These limits are available 'on tap' as well as allotted on 'first come, first serve' basis.

Taxation[1]

For FPIs, all interest income earned on Indian government bonds is subject to the withholding tax. This tax typically ranges from 5%-20%, hinging on type of the bond, tax treaties and whether the interest earned is considered as connected income in India. The government has entered into Double Tax Avoidance Agreements (DTAA) with several countries, which determines the taxability of various income (incl. capital gains, dividend & interest income) earned in India, by the resident entity of the country with which India has entered a DTAA. On the capital gains front, short-term capital gains (STCG) on government bonds are taxed at the applicable income tax rate for foreign investors and arises when the securities are sold within a year of purchase. Additionally, foreign investors typically face a tax rate of 10% without the benefit of indexation, as long-term capital gains on their bonds and arises when the securities are sold after one year of acquisition. Lastly, there is no withholding tax on capital gains for foreign investors in government bonds. The entity may avail the benefits of the DTAA provisions wherever such provisions are more beneficial vis-à-vis provisions

[1] As applicable at the time of writing

of the income tax. Overall, these tax liabilities should be cleared before the funds are repatriated to the host country. Details are available here.

Other bond categories

- *Corporate bonds*: Issuances by domestic corporates/ financial institutions and denominated in INR, with funds tapped for venturing in new M&A, expanding business, financing current growth or capex generation.
- *FRBs i.e., Floating Rate Bonds* are characterised by 6M T-bills linked to the base rate plus a fixed spread. These provide protection against interest rate risks as they adjust to market conditions. The fixed spread is decided through auction mechanism during first issuance.
- *Sovereign Green bonds*: Marked their debut recently and are issued by the government to reduce carbon footprint in public sector projects. These securities are included in the regular borrowing calendar issued by the central bank.
- *Inflation Indexed Bonds (IIBs)* are bonds wherein both coupon flows and principal are protected against inflation
- *Special securities* are issued when required to government-owned entities like oil marketing companies, fertilizer companies etc. and typically long dated securities and carry a marginally higher coupon over the yield of the dated securities of comparable maturity. A recent example was the issuance of bank recapitalisation bonds by the government to specific public sector banks in 2018
- *Tax free bonds*: issued directly by quasi-sovereign companies allow market expansion for investors and, in particular, embody retail interest into the market;
- *Tax benefit bonds*: savings by infrastructure or non-infrastructure companies; they provide investors with tax rebates, in addition the normal rate of interest

Credit default swaps

Credit default swaps provide market participants is similar to insurance against credit risks against specific entities/ asset class. The RBI issued guidelines for the operational framework for the introduction of plain vanilla OTC single-name CDS for corporate bonds, in October 2011. Two counterparties can participate in these markets: a) Users: entities permitted to buy CDS contracts only to hedge their underlying credit risk on corporate bonds; exits are permitted by unwinding them with the original counterparty or by assigning them in favour of buyer of the underlying bond. This includes banks, primary dealers, mutual funds, etc; b) Market makers: Entities permitted to quote both buy and/or sell CDS spreads; they can buy protection without having the underlying. Eligibility criteria for market-makers, including banks and non-bank financial companies have been specified in terms of minimum CRAR, NPA threshold, minimum net owned funds etc.

Since this framework was outlined, efforts to develop and deepen the CDS markets have been ongoing. Last year's Budget also outlined plans for the government to work with the central bank and securities regulator SEBI to streamline initiatives. For now, volumes are thin and hence trading interests are weak. Few regulations also require an reassessment, including clarity on the 'netting' of marked-to-market (MTM) positions against the same counterparty for capital adequacy and exposure norms, for instance, in absence of which exposures are capital-intensive.

Sovereign ratings

India currently has a sovereign rating of BBB- with a stable outlook from S&P, Moody's, and Fitch – a grade above investment grade. Ratings have largely been stable apart from outlook changes in the past decade, except a rating downgrade by Moody's in June 2020, from Baa2 to Baa3, before dialling the outlook back up to 'stable' in October 2021. The framework of the rating agencies is not made public, though the main pillars likely are: a) broader macroeconomic backdrop (growth, external sector etc.); b) Fiscal/ public debt levels and outlook; c) institutional architecture; d) Others, including politics, geopolitics, and financial sector outlook. Authorities have made a strong case for India's credit rating to be upgraded from current levels, citing strong growth potential, improved liquidity and external balance metrics and stronger institutional backdrop.

TABLE: Sovereign ratings (foreign currency-long term)

	Moody's		S&P		Fitch
Aaa	Singapore	AAA	Singapore	AAA	Singapore
Aa1		AA+		AA+	
Aa2		AA		AA	
Aa3		AA-		AA-	
A1	China	A+	China	A+	China
A2		A		A	
A3	Malaysia	A-	Malaysia	A-	
Baa1	Thailand	BBB+	Philippines; Thailand	BBB+	Thailand; Malaysia
Baa2	Indonesia, Philippines	BBB	Indonesia	BBB	Indonesia; Philippines
Baa3	**India**	BBB-	**India**	BBB-	**India**
Ba1		BB+	Vietnam	BB+	Vietnam
Ba2	Vietnam	BB		BB	

Source: Bloomberg, DBS

Ratings marked in red are sub-investment grade

Local Currency Long term rating			
Country	**Moody's**	**S&P**	**Fitch**
China	A1	A+	A+
Indonesia	Baa2	BBB	BBB
India	Baa3	BBB-	BBB-
Mexico	Baa2	BBB+	BBB-
Malaysia	A3	A	BBB+
Brazil	Ba2	BB-	BB
Thailand	Baa1	A-	BBB+
South Africa	Ba2	BB	BB-
Poland	A2	A	A-
Czech Republic	Aa3	AA	AA-

India's monetary policy framework

The Reserve Bank of India adopted an inflation targeting framework in consultation with the government, which took effect in August 2016. CPI is the primary target, set at 4%, with the upper and lower tolerance limits at 6% and 2% respectively. Rate decisions are arrived at by a Monetary Policy Committee, comprised of three external members and three Reserve Bank of India officials, head by the Governor. Failure to achieve the inflation target is if: (a) average inflation is more than the upper tolerance level of the inflation target for any three consecutive quarters; or (b) the average inflation is less than the lower tolerance level for any three consecutive quarters (Source: www.rbi.org.in)

Key instruments (direct and indirect) used to implement the framework include:

- Repo Rate: The (fixed) interest rate at which the RBI provides overnight liquidity to banks
- Reverse Repo Rate: The (fixed) interest rate at which the RBI absorbs overnight liquidity
- Liquidity Adjustment Facility (LAF): Consists of overnight as well as term repo auctions.
- Standing Deposit Facility (SDF): The SDF was introduced in April 2022; this is a collateral free liquidity absorption mechanism provided by the central bank, from the banking sector to the RBI. As of December 2023, RBI allowed a reversal of liquidity facilities under both SDF and MSF even during weekends and holidays with effect.
- Marginal Standing Facility (MSF): A facility under which banks can borrow additional amount of overnight money from the RBI by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit at a penal rate of interest
- Corridor: The MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate
- Bank Rate: It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. Aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.
- Cash Reserve Ratio (CRR): The average daily balance that a bank is required to maintain with the RBI as a % its Net demand and time liabilities (NDTL)
- Statutory Liquidity Ratio (SLR): The share of NDTL that a bank is required to maintain in safe and liquid assets, such as, unencumbered government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector
- Open Market Operations (OMOs): Both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.
- Market Stabilisation Scheme (MSS): Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills.

Gujarat International Financial Tech-City (GIFT) City

About:

- The GIFT International Financial Services Centre (IFSC) is a special economic zone and financial centre, set up in Gujarat, Western India. This zone is a specially delineated duty-free enclave, seeking to provide business and regulatory environment, comparable to the leading financial centres in the world, to the likes of Singapore, Dubai, and London. The workings are regulated by a unified financial regulator, IFSC Authority, and will be vested with the powers of four related regulators – SEBI, RBI, IRDAI and PFRDA.
- Authorised dealers may undertake customer (persons resident in India and persons resident outside India) and inter-bank transactions beyond onshore market hours. Indian banks which operate International Financial Services Centre (IFSC) Banking Units (IBUs) or have a branch in GIFT City can offer NDF with effect from June 2020. This can be done via their branches in India, their foreign branches or through their IBUs.
- Several tax incentives have been extended to draw firms to establish a base in the GIFT City, including a 100% tax holiday for 10 years for the income generated in the International Financial Services Centre (IFSC), GST exemption on export of services/ import of goods and services and benefits as the units in the IFSC are considered as person resident outside India for FX regulations (Source: EY).
- A wide array of industries is eligible to establish offices in the zone, including firms operating in the IT software field, ITES (Enabled Services), NBFCs, emerging technologies like AI, Big data etc.
- Several banks, including DBS Singapore, have opened branches in recent months, with the initial bout of strong demand witnessed in booking offshore loans (exempt from withholding tax).

Overview of India's foreign exchange market

Brief history

- With the breakdown of Bretton Woods system in the early 1970s and a consequent switch towards a system of managed exchange rates, alongside the declining share of the UK in India's trade, the Indian rupee (INR) was delinked from the pound sterling in September 1975 [II].

- Between 1975-1992, the INR exchange rate was determined by the RBI within a nominal band of +/- 5 per cent of the weighted basket of currencies of India's major trading partners.

- Faced by balance of payment difficulties in the 90s, the INR witnessed a two-step downward adjustment of 18-19% in July 1991, in a bid to improve competitiveness and move towards greater exchange rate flexibility. With the introduction of the Liberalised Exchange Rate Management System (LERMS), a two-tier system was introduced which was followed by downward adjustments and convergence of the exchange rates in 1993.

- With this and achieving current account convertibility in 1993-94, the exchange rate has since become market determined.

- Capital account convertibility i.e., conversion of the domestic currency into a foreign currency without restrictions, to enable a resident to acquire any foreign asset or on conversion of a foreign currency to the domestic currency to enable a non-resident to acquire a domestic asset, remains under study. While benefits include unrestricted global capital flows, which could result in better and more efficient allocation of the global pool of savings to the more productive uses, there are also inherent risks by way of heightened sensitivity to macroeconomic conditions, speculative influences and likely rise in volatility.

INR fixing mechanism

In 2018, the Financial Benchmarks India Private Limited (FBIL) took over from RBI the responsibility of computation and dissemination of reference rate for USD/INR and other major currencies. The FBIL computes and publishes the dollar/rupee reference rate using the transaction level data available on the electronic trading platforms between 11.30 and 12.30 hours (Indian Standard Time – IST). A 15-minute random window is selected within this band to compute the USD/INR Reference Rate.

Normally, the data are sourced from the electronic platforms of Refinitiv and CCIL. Cross currency reference rates against the euro, pound, and yen are calculated using the EUR/USD, GBP/USD and USD/JPY quotes in the selected 15-minute window.

Examples of FX products available in the onshore market

Onshore FX products

- FX Spot
- FX forwards
- FX options
- Cross currency rate swaps

Offshore FX/ interest rate products

- Non-deliverable forwards
- Non-deliverable interest rate swaps
- Non-deliverable currency swaps
- Non-deliverable FX options

Other regulatory and recent developments in the domestic markets

Regulatory framework

Hedging exposures of Indian subsidiaries

With a view to providing operational flexibility to multinational entities and their Indian subsidiaries exposed to currency risk arising out of current account transactions emanating in India, RBI has allowed Non-resident parent of an Indian subsidiary to handle the foreign exchange transactions of its subsidiary for booking derivative contracts to hedge the currency risk of and on the latter's behalf. The non-resident entity may contract any product either under the contracted route or on past performance basis, which the Indian subsidiary is eligible to use. The profit/loss of the hedge transactions shall be settled in the bank account and books of accounts of the Indian subsidiary. The non-resident entity should be incorporated in a country that is member of the Financial Action Task Force (FATF) or member of a FATF-Style Regional body. The transactions under this facility will be covered under a tri-partite agreement involving the Indian subsidiary, its non-resident parent/ treasury, and the AD bank.

Facilities for Hedging Trade Exposures, invoiced in Indian Rupees

RBI allows Non-Resident Exporters and Non-Resident Importers to hedge the currency risk arising out of genuine trade transactions involving exports from and imports to India or invoiced in INR using plain vanilla forwards and foreign currency-INR Options. These contracts, once cancelled, shall not be eligible to be rebooked. The contracts may, however, be rolled over on or before maturity subject to maturity of the underlying exposure. On due date, settlement can be done through the correspondent bank's Vostro or the AD bank's Nostro accounts.

Foreign Institutional Investors (FPIs)

FPIs are allowed to hedge currency risk on the market value of the entire investment in equity and/or debt in India as on a particular date. They are also allowed to hedge Initial Public Offers (IPO) related transient capital flows. The exposure can be hedged through forward foreign exchange contracts with INR as one of the currencies and foreign currency-INR options and foreign currency–INR swaps for IPO related flows.

Foreign Direct Investment (FDI)

Investors are allowed to hedge exchange rate risk on the market value of investments made in India since January 1, 1993, subject to verification of the exposure in India. Investors are also allowed to hedge exchange rate risk on dividend receivable on the investments in Indian companies and to hedge exchange rate risk on proposed investment in India. Hedging can be done through forward foreign exchange contracts with INR as one of the currencies and foreign currency-INR options.

INR-denominated Bonds (Masala Bonds)

Eligible entities can issue INR-denominated bonds overseas both under the automatic route and the approval route. Under the automatic route, the amount of borrowing will be up to INR USD 750mn per financial year. The overseas investors are eligible to hedge their exposure in INR through permitted derivative products with AD Category I banks in India. The investors can also access the domestic market through branches/subsidiaries of Indian banks abroad or branches of foreign banks with Indian presence on a back-to-back basis.

Onshore banks access to NDFs and regulatory changes

In 2019, the RBI set up a Task Force on Offshore Rupee Markets, which has spurred several measures on its recommendations. The RBI noted the growing size of the rupee NDF market here, saying while the INR NDF market was comparable in size to the onshore deliverable forward market, according to the BIS Triennial Surveys for April 2013 and April 2016, by the 2019 edition, the size of the market had increased to become almost thrice as large as the onshore market.

Measures introduced by the central bank:

- From January 2020, AD Category-I banks have been permitted to offer FX prices out of their domestic books, either by an onshore sales team or through their overseas branches, to obviate time zone hinderances to trading.

- In the same month, exchanges in the GIFT City International Financial Services Centre (IFSC) were allowed to offer INR derivative contracts with settlement in foreign currency.

- In June 2020, banks in India which operate IFSC Banking Units (IBUs) were permitted to participate in the NDF market. This allowed the lenders to trade contracts with foreign entities or between themselves.

- In June 2023, local lenders with a IFSC Banking Unit were permitted to offer NDF forwards to residents onshore. This step enabled banks to offer enhanced FX hedging opportunities to the customers and develop the INR NDDC (non-deliverable derivative contracts).

Framework for trade settlement in Indian Rupees

In a circular in July 2022, the RBI sought to enhance the mechanism to smoothen settlement of trade transactions in the INR.
Other details included[2]:

[2] PIB, RBI, PWC

- All Category-I Authorised Dealer (AD) banks have been permitted to open special rupee vostro accounts of the correspondent bank(s) of a partner trading country.

- Opening of Special Rupee Vostro Account (SRVA) will require prior approval of RBI. The bank willing to open Special Rupee Vostro Account for bank of the partner country should have a good level of business resilience and financial health. Second, they need to have experience in facilitating trade/investment transactions and capability to provide other financial services. Third, AD banks should have good correspondent relationships with banks in partner countries.

- In the case of an Indian exporter undertaking exports of goods and services through this mechanism, the export proceeds shall be paid in INR from the balances in the designated special vostro account of the correspondent bank of the overseas importer. On the other hand, for an Indian importer, the payment shall be credited to the special vostro account in INR against the invoice for the supply of goods and services from the international exporter.

- The surplus balance in these special vostro accounts can be used for: a) Payments for projects and investments; b) export/Import advance flow management; c) can be invested in government treasury bills, government securities, etc. in terms of extant guidelines and prescribed limits, subject to the Foreign Exchange Management Act, 1999 ('FEMA') and similar statutory provisions. (FAQs are outlined here)

- Subsequently, the government announced that central banks in about 18 countries had been permitted to open the special account for settling in the INR, as of March 2023.

- In the early stages, expectations are that countries that have been taken off the SWIFT payment gateway will be able to trade through this route. Eventually, higher settlements in the INR will lower currency volatility.

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