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FII Debt Limits in Bond Markets – A Review

India has been gradually liberalizing up its capital account to foreign participation. One of the key such liberalization measures is gradual increase of FII limit in debt markets. The debt markets are in turn divided into two types- Government securities (dated and T-Bills) and Corporate Bonds (listed non-convertible debentures, corporate bonds, commercial papers etc). Limits are prescribed for both kinds of investments, separately and are non-fungible.

This note reviews the gradual liberalization of FII debt limits from a historical perspective. The note will also help understand the various categories under which these limits have increased over the years.

I. Economics of FII Investment

Role of foreign capital flows in an economy is one of the most contentious issues in economics. Unlike real sector globalization, where most economists agree to the benefits the same cannot be said for financial sector globalization. There are some economists who believe that opening up economy to foreign capital is always beneficial. There are an equally large number of economists in the opposite camp which questions the role of foreign capital flows in development of an economy. The experience of countries with financial globalization is also mixed with success in some and failures in others.

However over a period of time, there is some consensus building amidst the two camps. The consensus is on certain types of foreign capital flows being more beneficial than others. Hence, policymakers could gradually open their capital account and allow foreign investment first in certain categories and then in other categories. The capital flows could be classified into two categories:

- **Long-term flows vs. Short-term flows:** Long term flow is mainly foreign direct investment (FDI). Under this, foreign players invest capital by taking direct interest in the domestic business venture making it a longer term investment. The short term flows include Foreign Portfolio/Institutional Investment (FII) which are basically of a short–term nature compared to FDI. Here there is no direct stake like an FDI investment and there is freedom given to FIIs over entry and exit from equity stakes in companies. The investment by FIIs is also called as hot money and is the most criticized category in this financial globalization debate. The preference is clearly for FDI over FII.

- **Equity flows vs. Debt flows:** Another classification is on the nature of investment. Here equity investment is preferred as the investor is taking an equity stake in the business either via FDI route or FII route. However, in case of debt there are concerns because of changes in currency. In case of equity whether a currency depreciates or appreciates, the gains/losses are made by the equity investor. However as debt has to be honored in full, changes in currency leads to problems for the debt issuers. For instance, say a company issues $100 mn of debt and an FII invests $10 mn into the debt issue. The exchange rate at the time of investment is Rs 50/$ implying the FII has to pay Rs 500 mn to the issuer. If the currency depreciates to Rs 60/$, the debt issuer will have to arrange Rs 600 mn against an investment of Rs 500 mn to honor the debts. This suddenly increases the external liability significantly. These lessons were learnt harshly during the South East Asian crisis when the external liabilities of the host countries increased several-fold as their currencies depreciated sharply following the crisis. The crisis further led to lower revenues both for government (tax revenues) and corporates leading to further crisis.

Hence, capital flows in debt is considered riskier compared to equity investments. This includes both kinds of debt inflows – FIIs which invest in domestic companies and External Commercial Borrowings (ECB) raised from foreign markets by domestic companies. Hence, economists advise that there should be restrictions on both kinds of debt flows. These flows should be liberalized gradually as financial markets mature and economies develop over time.

Based on above classification, the preferred investments are FDI, FII in equity and lastly FII in debt. India has also followed this line of foreign investments and interestingly has been more open to FII in equity from the very beginning. FDI is allowed in sectors selectively mostly with a limit which is gradually increased over time. For FII in debt, India has adopted the gradual opening of FII debt limits and ECB policy is reviewed from time to time and changed depending on the situation. When the economic cycle is on upswing and ECB borrowings rise sharply, restrictions are imposed to constrain them and vice-versa when the cycle reverses.

II. FII Investment in Indian Debt Markets – A Timeline

- **1995:** SEBI released regulations for FII investment in Indian debt markets. The debt limit was kept at $1-1.5 bn. FIIs were allowed to invest in debt markets via the 70: 30 route. In this FII investment will be in the 70:30 ratio out of which equity investments shall not be less than 70% of total funds and maximum 30% of investment was allowed in debt.

- **1996:** SEBI allowed a new category of FIIs – 100% debt FII. These were FII's who were interested only in debt securities could register themselves as entities which shall invest 100% of their funds in debt securities. The overall debt limit was maintained at $1-1.5 bn for FII investments routed through both kinds of categories. Investment was also allowed in corporate bonds of listed (or to be listed) companies. Though, separate limit for corporate bond was started only in Dec-04.

- **1998:** Finance Minister in his Budget Speech for 1998-99 announced FII investment to be allowed in unlisted securities. Thereby, SEBI permitted FII investment in unlisted debt securities.

- **2004:** In the interim period between 1998-04, there were no major changes in regulation of FII investment in debt markets. In Mar-04, the Government clarified that the FII debt limit was a cumulative limit and the limit for 2003-04 was kept unchanged at $1 bn. SEBI also separated the limits under the two routes. Under the 70:30 route there was a cap of $100 mn and for 100% debt route this was kept at $900 mn. It specified that unutilised limits if any shall not be available for investment until fresh limits are allocated.

In Nov-04, the Government debt debt limit was increased from $1 bn to $1.75 bn. The debt limit for 70:30 was raised from $100 mn to $200 mn and $1.55 bn was kept under 100% debt route. Further under 70:30 category, a headroom of $175 mn was kept under which FIIs were free to invest till this limit was exhausted. As FII's reach headroom limit, they will have to approach the SEBI for the allocation of remaining $25 mn. Allocation of limit was done on 'first come-first serve' basis.

In Dec-04, a separate debt ceiling was kept for corporate bonds of $ 500 mn. This was over the $1.75 billion ceiling for government bonds. Since then, limits have been seperate for the two bond instruments. However, separate limits were not reserved for the two FII categories. Therefore in Table 1 it shows that corporate debt limit was introduced in Dec-04 but is not included in any of the categories.

Table 1: Limits for FII Investment in Debt Markets (Old Classification, in $ bn)

	Mar-04	Nov-04	Dec-04	Apr-06	Sep-06	Dec-06	Jan-07
A. 70:30	0.1	0.2	0.2	0.4	0.51	1.21	1.21
i) Government Debt	0.1	0.2	0.2	0.25	0.25	0.6	0.6
ii) Corporate Debt	--	--	--	0.15	0.15	0.5	0.5
iii) Upper Tier II	--	--	--	--	0.11	0.11	0.11
B. 100% Debt	0.9	1.55	1.55	3.1	3.49	2.79	3.39
i) Government Debt	0.9	1.55	1.55	1.75	1.75	1.4	2
ii) Corporate Debt	--	--	--	1.35	1.35	1	1
iii) Upper Tier II	--	--	--	--	0.39	0.39	0.39
Total	1	1.75	2.25	3.5	4	4	4.6
i) Government Debt	1	1.75	1.75	2	2	2	2.6
ii) Corporate Debt	--	--	0.5	1.5	1.5	1.5	1.5
iii) Upper Tier II	--	--	--	--	0.5	0.5	0.5

Source: SEBI

- **2006:** In Apr-06, GoI raised the debt limit in Government debt from $1.75 bn to $ 2bn and in corporate bond from $0.5 bn to $1.5bn. The total debt limit was raised from $2.25 bn to $3.5 bn. Further just like it was in Government debt investments, separate limits were allocated for corporate bonds under both the 70:30 and 100% debt route. Headroom limits were increased in the 70:30 category following rise in overall limit. FII were free to invest till the total investment limit reaches USD 225 million and USD 135 million in Government securities and Corporate Debt, respectively. After exhaustion of these limits permission was to be sought from SEBI as explained above.

It was also clarified that FII investments shall be restricted to only listed debt securities of companies. FIIs subscription to Commercial Papers would also be within the corporate bond ceiling of US $1.5 billion.

In Sep-06, a separate limit was introduced for FII investment in Upper Tier II Instruments above the overall corporate bond limit of $1.5 bn. The overall limit for Tier II bonds was kept at $500 mn with separate limits for the two FII categories (Table 1). The FIIs under 70:30 route were free to invest till the total investment limit reaches USD 90 million and seek SEBI approval for further allocation as was the case in case of Government debt and corporate bond investments.

In Dec-06, there were further changes in FII debt limits (Table 1). The limits remained unchanged but investments in the two FII categories were reallocated with increase in 70:30 and decline in 100% debt category. Headroom limits were changed for 70:30 route as well. Government debt headroom was increased from USD 225 million to USD 540 mn and corporate bond from USD 135 million to $ 450 mn respectively (90% of debt limit in both cases).

- **2007:** Debt limits were increased for Government debt from $ 2bn to $ 2.6 bn with corporate bond limit remaining unchanged (Table 1). The limits were increased only for 100% debt category.

- **2008:** In Jan-08, SEBI did away with demarcation of FII investments under 70:30 and 100% routes. In its circular, SEBI mentioned that there was no uniformity among custodians with respect to considering investments by FIIs in debt oriented mutual fund units either as debt or equity. From now on, the FII investment was just reported as Government debt and Corporate bond instruments (Table 2). GoI also increased the debt limit under Government debt from $2.6 bn to $3.2 bn. It was also decided that FII investment in debt oriented mutual funds should be considered as investment in Corporate Debt.

Table 2: Limits for FII Investment in Debt Markets (New Classification, in $ bn)

	Jan-08	**Jun-08**	**Oct-08**	**Feb-09**
Government Debt	3.2	5	5	5
Corporate Debt	1.5	3	6	15
Upper Tier – II	0.5	0.5	0.5	0.5
Total	5.2	8.5	11.5	20.5

Source: SEBI

In Jun-08, debt limits were increased. Government debt limit was raised sharply from $3.2 bn to $5 bn and of corporate bond from $1.5 bn to $ 3 bn (Table 2).

In Oct-08, GoI increased the debt limit in corporate bonds from US $3 billion to US $6 billion (Table 2). The enhanced limit for investment in corporate debt was to be allocated among the FIIs on a ‘first come first served’ basis subject to a ceiling of US $300 million per registered entity.

- **2009:** In Feb-09, SEBI raised the corporate debt limits sharply from $6 bn to $15 bn (Table 3). For the first time, limits were allocated to the market participants via an open bidding platform. It was decided to allocate the additional $8bnvia open bidding route and $1bn was kept for first come first serve categories (for investment less than Rs 249 cr).

  In Sep-09, it was also decided that the unutilised investment limits for government debt shall also be allocated as per the bidding process.

- **2010:** In Nov-10, new changes were introduced in FII investment in debt markets. For the first time, government created categories for investments as per maturities of securities. The idea was to shift the FII investments towards longer dated securities. In corporate bond additional effort was taken to shift FII investment in infrastructure sector (Table 3).

  Government debt limit was raised from $5 billion to $ 10 billion with incremental limit allowed for investment in securities with residual maturity of over five years. For corporate bond, limit was also increased by US $ 5 billion to $ 20 bn with incremental limit allowed to be invested in corporate bonds with residual maturity of over five years issued by companies in the infrastructure sector. Both these limits were given new names as Government Bond (Long Term) and Corporate Bond (Long Term). From 2010 onwards, we have a different classification of FII investments in debt markets. SEBI started auctioning free limits under both old and long term categories.

Table 3: Limits for FII Investment in Debt Markets (Changes in Nov-10, in $ bn)

	Nov-10	Mar-11	Aug-11
A. Govt. securities/ T-bills (i+ii)	10	10	10
i) Government Debt - Old (includes Debt oriented MFs)	5	5	5
ii) Government Debt - Long Term	5	5	5
B. Corporate Debt (i+ii+iii)	20	40	40
i) Corporate Debt - Old	15	15	15
ii) Corporate Bond - Long Term	5	25	22
iii) QFI investment in infrastructure debt MFs	--	--	3
C. Upper Tier – II	0.5	0.5	0.5
Total (A+B+C)	30.5	50.5	50.5
Source: SEBI			

- **2011:** In Mar-11, GoI further raised the FII limit in Corporate Bond for long term (infrastructure category) from $ 5 bn to $25 bn (Table 3). Further, these investments were permissible in unlisted bonds issued by companies in the infrastructure sector that are generally organised in the form of special purpose vehicles. Investments in such bonds shall have a minimum lock-in period of three years. During the lock-in period, FIIs will be allowed to trade amongst themselves but not to be sold to domestic investors.

In Aug-11, Qualified Foreign Investor (QFI) were allowed to invest in Mutual Fund debt schemes which invest in infrastructure debt (Table 3). A separate ceiling of USD 3 billion was created out of the total long term corporate infrastructure limits of USD 25 billion. So, corporate bond (long term) limit became $22 bn. In Aug-11, it was also decided that Non-Banking Financial Companies (NBFCs) categorized as Infrastructure Finance Companies (IFCs) by the Reserve Bank of India (RBI) shall also now be considered eligible issuers for the purposes of FII Investment under the corporate debt long term infra category.

In Sep-11, the $22 bn under Corporate bond (long-term) was further bifurcated in three categories (Table 4):

i) One year lock in & one year residual maturity- $5 billion earmarked for FII investments in those bonds that have an initial maturity of 5 years or more at the time of issue and a residual maturity of 1 year at the time of first purchase by an FII. These investments are subject to a lock in period of 1 year wherein FIIs can trade amongst themselves but cannot sell to domestic investors during lock in period.

ii) Three year lock in & three year residual maturity- The remaining USD 17 billion limits available to FIIs can be invested in long term infrastructure bonds which have an initial maturity of 5 years or more at the time of issue and residual maturity of 3 years at the time of first purchase by an FII. These investments are subject to a lock in period of 3 years wherein FIIs can trade amongst themselves but cannot sell to domestic investors during the lock in period.

iii) Reckoning of limits for Infrastructure Debt Funds (IDFs): Investment by FIIs in infrastructure debt fund schemes under the IDF route shall be reckoned under USD 17 billion.

Table 4: Limits for FII Investment in Debt Markets (Changed in Sep-11, in $ bn)

	Sep-11	Nov-11
A. Govt. securities/ T-bills (i+ii)	10	15
i) Government Debt - Old (includes Debt oriented MFs)	5	10
ii) Government Debt - Long Term	5	5
B. Corporate Debt (i+ii)	40	45
i) Corporate Debt – Old	15	20
ii) Corporate Bond - Long Term (a+b+c)	25	25
a) QFI investment in infrastructure debt MFs (including investment in IDF)	3	3
b) One year lock in with one year residual maturity by FIIs	5	5
c) Three year lock in with three year residual maturity by FIIs (including investment in IDF)	17	17
C. Upper Tier – II	0.5	0.5
Total (A+B+C)	50.5	60.5

Source: SEBI

In Nov-11, GoI increased the FII debt limits for both Corporate and Government bond categories by $ 5bn each. The increase was in the old sub-categories for both kinds of bond investments (Table 4). The incremental limit could be invested in any maturity.

- **2012:** In Jun-12, GoI increased the FII debt limit from $5 bn to $ 10 bn in the Government Bond (long term) category. Further, it lowered the residual maturity of the category from 5 years to 3 years (Table 5).

  There were changes in the corporate bond (long term) category as well. The lock-in period for investments under this limit has been uniformly reduced to one year and residual maturity of the instrument at the time of first purchase by an FII/ eligible IDF investor would be at least fifteen months.

  In Sep-12, QFIs were allowed to invest in Corporate Debt – Old category as well upto $1 bn (Table 5). There have been no changes in the limit structure since Sep-12.

Table 5: Limits for FII Investment in Debt Markets (Changes in Jun-12, in $ bn)

	Jun-12	Sep-12
A. Govt. securities/ T-bills (i+ii)	20	20
i) Government Debt - Old (includes Debt oriented MFs)	10	10
ii) Government Debt - Long Term	10	10
B. Corporate Debt (i+ii+iii)	40	46
i) Corporate Debt – Old	20	20
ii) Corporate Debt – Old (QFIs)	--	1
iii) Corporate Bond (Long Term) (a+b+c)	25	25
a) QFI investment in infrastructure debt MFs (including investment in IDF)	3	3
b) One year lock in with 15 month residual maturity	12	12
c) Investment in IDF	10	10
C. Upper Tier – II	0.5	0.5
Total (A+B+C)	65.5	66.5

Source: SEBI

III. FII Investment in Indian Debt Markets – Summary

Overall, this is how the FII debt limits have evolved since 1995. The journey has been eventful from a total debt limit of $1 bn in 1995 to a limit of $66.5 bn as on Nov-2012. The system of allocation has also moved from a first come first serve basis where free limits are allocated using state of the art auction system. SEBI also announces the auctions for free limits if any in any of the categories on a regular basis.

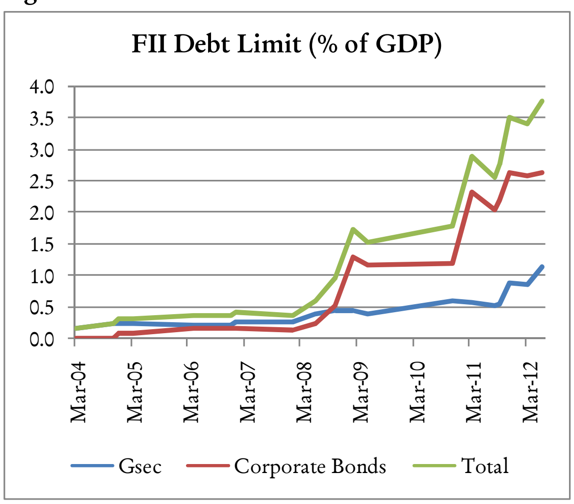
The profile of FII investment has also been streamlined from the earlier 70:30 and 100% FII to single FII who is allowed to invest across maturities. Efforts have also been made to incentivize

FII into investing in longer dated securities in both Government debt and corporate bond categories. Though, from the initial specified residual maturity limits in long term investment, residual maturity has been lowered for Government debt. This was done based on lackluster demand for investment in 5 years and higher maturity.

GoI has increased the debt limit significantly in the 2000s. This is in line with the developments in Indian economy and maturity in financial markets. The debt limit as a % of GDP has increased significantly from 0.2% of GDP (only Government debt) in 2003004 to 3.8% of GDP (1.1% in Government debt and 2.6% in corporate bond) in 2012-13 (as of date).

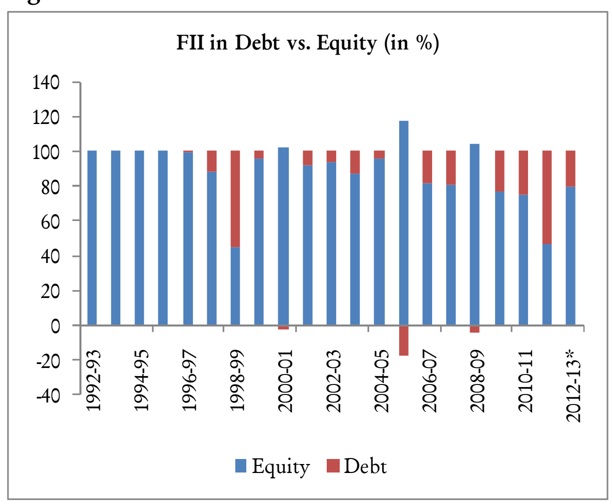
In terms of gross market borrowing, the limits have increased from 11% (7.5% in Government debt and 3.5% in Corporate Bond) in 2007-08 to 66.6% of Gross Market Borrowing in 2012-13(20% in Government debt and 46.6% in corporate bond). Therefore, in the last couple of years GoI has become more aggressive to open the corporate debt markets to FIIs and is more cautious in its approach for opening up Government debt market.

Figure 1



Source: SEBI

Figure 2



Source: SEBI

The share of debt investments in FII has also risen over the years following hike in debt limits. In period debt investments have averaged around 22-24% of total FII investments (in 2011-12 share of debt touched 53.3%). In 2012-13, the share has been around 22% till Nov-12. From 1992 onwards, India has received a total net FII investment of $156.7 bn out of which equity forms 123.9 bn and debt forms $32.6 bn. This makes share of debt at 20.8% in the overall FII investments. In Dec-09, the share of debt was a meager 9% in total FII investments received till date (around $80 bn). Share of FII in G-sec ownership has increased from 0.5% in Mar-08 to nearly 1% in Mar-12.

Clearly, FIIs have invested increasingly in India's debt markets as well. GoI could also look at linking these debt limits with GDP/Market Borrowing/Outstanding Bonds and increasing these debt limits as any of the mentioned variables increase. However, it is one thing to have higher limits in FII debt investments and another to see response for the same. We will turn to this issue in our next sub-topic.

IV. FII in Indian Debt Markets – Issues

Despite the increase in FII debt limits, response is only seen in Government debt and is muted for corporate bonds. SEBI shares debt utilization data only since Aug-11, hence our analysis is limited for the period. We have also simplified the format of classification of FII investment in debt markets and limiting the classification to just Old and Long term categories.

Table 6: Utilization of Debt Limit (Actual Investment/ Debt Limit, in %)

	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Nov-12
A. Govt. securities/ T-bills						
i) Government Debt - Old (includes Debt oriented MFs)	98.1	77.5	89.1	93	94.7	95.7
ii) Government Debt - Long Term	86.8	82.4	69.6	31.8	73.5	80
B. Corporate Debt						
i) Corporate Debt – Old	94.2	71.9	85.7	84.2	90.9	91.0
iii) Corporate Bond - Long Term	0.5	7.4	10.9	17.9	41.9	20
C. Upper Tier – II	--	3.7	0	0	0	0

Source: SEBI

The data clearly shows the preference of FIIs for Government debt compared to corporate bonds. In both Government debt and corporate bond categories preferences is high for old sub-categories where there are no restrictions on maturity of debt instruments. In long-term category there is preference for Government debt but muted response for corporate bonds. Within corporate bond long term infrastructure category, response in seen only in 1-year lock-in with 15 month residual maturity (which started from Jun-12). There is no response for Upper Tier-II bonds barring month ending Dec-11.

GoI has been making efforts to encourage higher investment in infrastructure is to be routed through corporate bond markets. However, because of inactive secondary market in corporate bonds, even FIIs have shown little interest. Therefore FII debt limits may have been raised over the years, its utilization especially in corporate bond – long term category has not been enthusiastically received by FIIs.

V. Conclusion

GoI has opened up FII limits in debt instruments gradually over the years. Interestingly, the pace of liberalisation has remained and infact increased post global financial crisis. Before the Lehman crisis, limit in Government debt was $5bn and in corporate bond was $3 bn. This has increased significantly to $20 bn and $46.5 bn in corporate bonds as of today. GoI has indicated that these limits are likely to be increased again.

Post global financial crisis, economies are debating over merits and demerits of portfolio investment in debt markets. There is rise of skepticism over FII investment in general and even more so in case of FII in debt markets. Indian policymakers have so far ignored these developments and have opened its debt markets increasingly to FIIs. This approach has been criticized by some economists as well.

Despite recent increases, Indian approach has always been a cautious one. The policymakers were not aggressive pre-crisis when there was a general consensus to liberalize rapidly. The rise in debt limits post-crisis has also been done because of significant increase in government borrowing program. The higher interest rates offered by GoI on its debt instruments has led to wider participation by FIIs as yields are near 0% in other parts of the world.

The next challenge for policymakers is to encourage FII participation in corporate debt for infrastructure projects. Despite repeated attempts to revive the corporate bond market, the secondary market activity has remained sluggish. With pickup in secondary markets in corporate bonds, FIIs are likely to line up for India's corporate bonds as well.

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