

MASALA BOND PROGRAM – NURTURING A LOCAL CURRENCY BOND MARKET

The financing needs of emerging markets are enormous. Sectors such as infrastructure, small business, and housing are vital to a nation's sustainable development and require substantial financing support. Since these sectors primarily generate revenues in local currency, foreign currency financing may incur a mismatch that can expose emerging market borrowers to exchange rate risk in times of high volatility. Local currency bond issuance is a significant potential option that avoids such risks and can support private sector investment in productive sectors of emerging markets.

Of the \$590 billion in infrastructure bonds that companies issued in five large non-Japan Asia countries since 1990, 88 percent were in local currency, with a sharp rise in the local currency financing share since 2001, according to recent Deutsche Bank research. This trend toward local currency financing reflects the substantial economic potential that improved credit quality has brought to emerging market economies.

Yet global investors interested in high-quality emerging market assets available in the onshore bond market still face issues that undermine their overall attractiveness. These include the limited capacity of local bond markets, cumbersome registration processes, foreign exchange administrative procedures, and possible capital controls. As a result, the development of *offshore* local currency bond markets may provide an alternative method for resolving currency and maturity mismatches, and may also help diversify the overall currency market in emerging economies.

The Masala Bond Program

The Indian rupee fell to a record low against the US dollar in 2013 due to capital flight spurred by a severe current account deficit and the tapering of quantitative easing by the US Federal Reserve. In response, IFC and the Indian government discussed how to support capital market development in rupees, both onshore and offshore. They decided that IFC would launch rupee bond programs in both the onshore and offshore markets in order to provide rupee financing sources for IFC projects in India as well as help develop Indian markets by creating an AAA yield curve.

The first offshore bond program of \$1 billion was launched in October 2013. IFC would issue Indian rupee bonds in the offshore market for various maturities and bring the proceeds onshore for investment in the country. From 2013 to 2014, IFC issued seven tranches of offshore rupee-denominated bonds, settled in US dollars and pegged to the rupee foreign exchange rate, for maturities ranging from three to seven years. Though these bonds were settled in dollars offshore, the dollar return is determined by the change in the rupee-dollar exchange rate just as if they were rupee bonds. This enables international investors to assume the exchange rate risk.

Rapid delivery of the program—later named the Masala Bond Program—was achieved with high liquidity, despite the complexity of the bond issuance and turbulence in foreign exchange markets. The program was subsequently extended to a second phase with longer maturities.

IFC issued four tranches of 3-year bonds, one tranche of 5-year bonds, and one tranche of 7-year bonds, for a total of Rs 62 billion, or \$1 billion equivalent, in Phase I of the program, which extended from November 2013 to April 2014. In March 2016 IFC issued Rs 10 billion, 10-year bonds in November 2014 and Rs 2 billion, 15-year bonds in Phase II, through a \$2 billion offshore rupee program. The 15-year tranche of issuance marked the longest-dated bonds in the offshore rupee market at the time. IFC also issued the first Green Masala bond (with proceeds earmarked for specific climate or environmental sustainability purposes), the proceeds of which were deployed in a YES Bank green bond. In March 2016, IFC issued an Rs 300 million Masala Uridashi bond

which was sold to Japanese retail investors subscribed in yen, and the payments were settled in yen.

All issuances attracted a diverse investor base. The 3, 5, and 7-year maturity issuances all received robust interest from global investors and were oversubscribed. The yields of IFC-issued Masala bonds were approximately 100 to 190 basis points below yields of Indian government bonds for corresponding maturities.

Asset managers were the main source of funds (74 percent) for each issuance of IFC Masala Bonds at maturity shorter than 10 years. Private banks stepped in and acted as the second largest investors in the market for the 10-year maturity issuance. Region-wise, US investors dominated investment in the 3 and 5-year issuances. European entities were the biggest investors for issuances with maturities longer than 5-years.

The bond proceeds have been converted from dollars to rupees to finance private firms in India. Specifically, the proceeds of the 10-year Masala bonds were invested in Axis Bank, the leading infrastructure financing institution of India, to support its financing of infrastructure projects. Proceeds of the green Masala bonds have since been deployed in the first green onshore rupee bonds executed by clients such as YES Bank and Punjab National Bank Housing Finance.

Program Strengths

Overall, the Masala Bond Program succeeded in several respects. It had a demonstration impact that prompted additional issuances and created an offshore rupee bond market. It also tested international markets for potential internationalization of the rupee. For Indian entities, the lack of currency risk with such issuances brings greater access to a large global investor base looking for high-quality, rupee denominated assets, which in turn allows for a larger potential program size to be executed in offshore markets. And dollar-settled rupee bonds enable global investors to benefit from India's strong economic fundamentals while avoiding the cumbersome onshore investment route that results from foreign portfolio investment quota limits, sophisticated registration procedures, and currency convertibility issues.

Program Impact

By pioneering the offshore rupee market through the Masala bond, IFC succeeded in setting a pricing benchmark for the market through strategically issuing 3, 5, 7, 10 and 15-year bonds. This paved the way for potential Indian corporate issuers to achieve a more diversified funding source without exposure to exchange rate risk.

Following the successful launch of the Masala bond, Bangladesh, Pakistan, and Sri Lanka have consulted IFC about offshore bond programs. IFC's first Rwanda franc offshore bond was launched in 2015.

Meanwhile, observing the strong market reaction, in September 2015 the Reserve Bank of India released new guidelines permitting Indian entities to issue in the offshore rupee market, for which both state-owned firms and private firms have expressed an appetite. In July 2016, HDFC Bank, a leading housing finance company in India, completed a successful initial corporate Masala bond issuance and Adani Transmission announced a private placement with Credit Suisse—both below their onshore borrowing costs. National Thermal Power Corporation issued a green Masala bond in August 2016 and Indiabulls became the first high-yield Masala bond issuer.

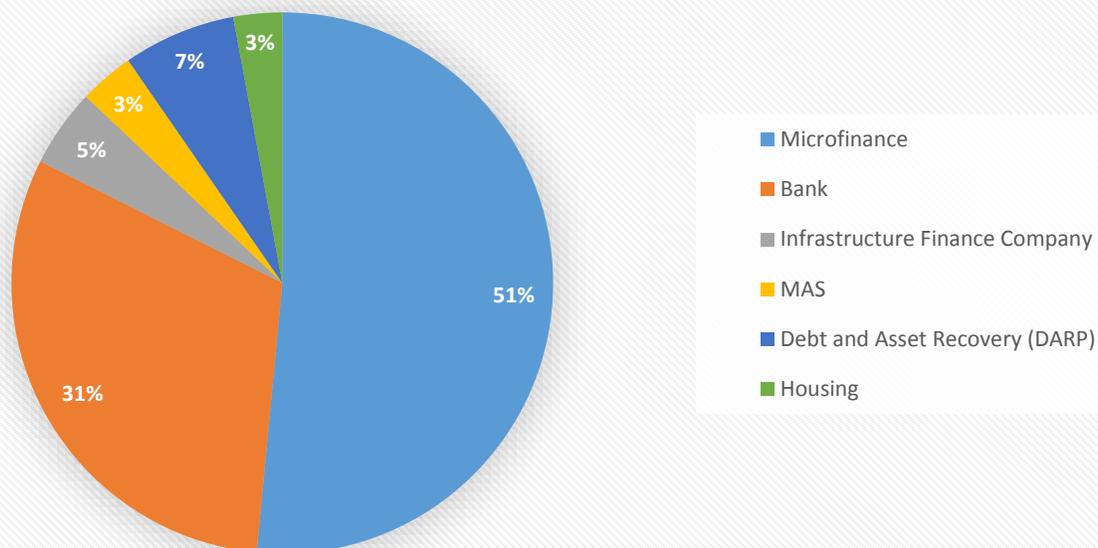
Many additional issuers are now signaling interest, including Power Finance Corp. and Rural Electrification and Indian Railway Finance Corporation, among other private firms. The initial estimates of the rupee offshore bond market were between \$2 billion and \$5 billion equivalent by some market counterparties. Approximately \$3.6 billion has been issued to date.

In the medium to long term, a well-established offshore rupee market could incentivize regulators to streamline listing and disclosure requirements and procedures, eventually leading to a well-developed and liquid domestic bond market that benefits both issuers and investors.

As a further commitment to support India's capital market development and finance projects in infrastructure, IFC launched four inaugural tranches of onshore bonds under the Maharaja Bond Program in September 2014 for Rs 6 billion (\$100 million equivalent) with tenors ranging from five to 20 years. To match the nature of loans to infrastructure projects, the bonds were structured with characteristics of long tenor, amortizing, and the potential for staged disbursements, as IFC is allowed to repeatedly reissue bonds from the same investors up to a preset amount. This innovative transaction structure greatly eases the process of raising funds in the markets to meet infrastructure funding needs.

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Non Convertible Debentures (NCDs) Funded by the IFC Masala Bonds (percentage by sector)



Note: Non-convertible debentures are long-term unsecured bonds that cannot be converted to company equity or stock. They usually have higher interest rates than convertible debentures.

Key Risk and Mitigants

Start-up Risk for Launching New Product: Taking advantage of its international AAA rating, IFC was able to launch the rupee offshore bond market by offering low credit risk products that attract institutional investors, including pension funds.

In addition, IFC's experience developing offshore local currency bond markets substantially strengthened the necessary market institutions, further contributing to the success of the program.

Foreign Exchange Rate Risk: Though they had to bear the foreign exchange rate risk, foreign investors' concerns about exchange rate stability were alleviated by the strong economic fundamentals of India, which had enjoyed a 7.8 percent average annual growth rate over a decade. In addition, the approaching Indian general election of April 2014 lifted expectations for Indian economic growth among both international and domestic investors. That helped restore and boost the appetite for the early tranches of Masala bonds among international investors between late 2013 and early 2014. Capturing that window of opportunity, the IFC-issued Masala bonds received strong interest from global investors despite the severe capital outflows due to rupee depreciation at that time.

Credit Risk: Concerns about credit risk were mitigated by IFC's international AAA rating, which provided comfort to global

investors entering the newly established rupee offshore bond market.

Liquidity Risk: IFC's considerable issuance volume of 3, 5, and 7-year bonds has allowed trading among a sufficient number of buyers and sellers to create a liquid market for those bonds. Investors tend to hold the 10 and 15-year bonds and the Masala Uridashi bonds to maturity, which renders liquidity in those bonds a minor concern for the market.

Conclusion

The Masala Bond program created an offshore rupee-market yield curve stretching from three to 15 years that has deepened India's capital market and made it more resilient, and has paved the way for international investors and domestic entrepreneurs to benefit from India's strong economic fundamentals. The international demand for high-quality emerging market assets remains strong—notwithstanding global financial uncertainties—and will continue to support private sector development in emerging market nations through well-functioning onshore and offshore local currency bond markets. ■

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