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Weekly Credit Brief

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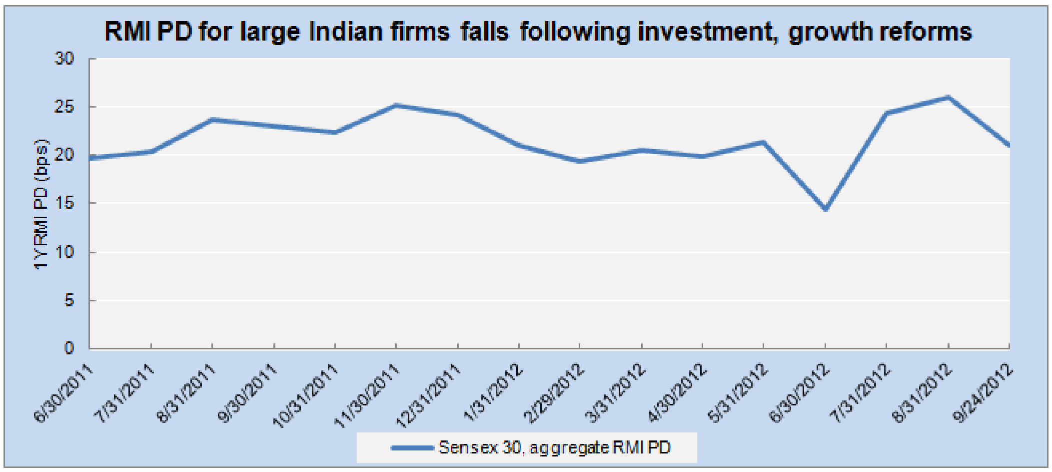
Story of the Week

Ongoing reforms a credit positive for large Indian firms

By James Weston

The 1-year aggregate RMI probability of default (RMI PD) for the largest Indian companies fell last week, after the Indian government announced further reforms aimed at encouraging foreign investment and growth. The aggregate RMI PD for the benchmark Sensex 30 Index fell to a three month low on September 24, following a rapid slew of reforms in the last fortnight. A key change involved a reduction in the income tax paid by non-resident investors on interest income arising from loans to Indian companies. This will likely reduce funding costs for Indian firms, and make it easier to raise funds as global investors seek higher yields.



Reforms address growth concerns: The RMI PD for the largest Indian companies increased in the middle of 2012, on concerns about future economic growth and the government's willingness to implement much needed reforms. Furthermore, widespread blackouts at the end of July, caused by a cascade of problems in the nation's power grids, deepened investor concerns as power deficiencies have significantly affected the growth of the nation's manufacturing base. Reforms announced last week, including the previously mentioned tax cut and tax incentives for Indian equity investors, are aimed at encouraging investment in the real economy and driving future growth.

Further reforms are expected in the near term. The government said it may increase the limit on foreign investment in local insurance companies next week, after increasing the same limit in the aviation and multi-brand retail sectors on September 14. The combined changes will likely revive investor sentiment towards India somewhat. However, hurdles remain for further reforms, as the FDI limit increase in the multi-brand sector has been challenged in the Supreme Court.

Tax reduction: The Ministry of Finance reduced the income tax paid by non-resident investors on interest income to 5% from 20%, for a period of three years. The lower tax rate is effective on all loans and infrastructure bonds originated between July 1, 2012, and June 30, 2015. The Ministry also said companies that meet specified criteria will have issuances automatically approved, avoiding a lengthy approval process. Interest rates in India are the second highest among G20 economies; the tax rate reduction will allow Indian companies to benefit from the low-yield environment overseas to a greater degree.

Moreover, Barclays Capital estimates the reduction in the interest income tax will reduce the cost of foreign borrowing for Indian companies by 75-100bps, assuming a current cost of Libor + 500bps. Barclays also expects the change will produce an additional USD 2bn of FDI inflows per year, as the global hunt for higher yielding securities continues. Furthermore, increasing foreign demand for Indian corporate bonds will once again make foreign currency issuance more attractive to Indian companies, potentially boosting fee income at Indian banks.

India cuts tax on overseas loans (WSJ)

India to get USD 2bn per year inflows on cuts in foreign borrowings tax (Hindustan Times)
Press Release (Indian Ministry of Finance)

In the News
Japan eases monetary policy in surprise move **Sep 19.** The Bank of Japan, following similar actions by other major central banks, enhanced its asset buying program as its projections for a near term recovery in the economy appear weak. Deteriorating exports and factory output have left the Japanese central bankers unconvinced of a revival in global demand and a resultant recovery in Japan's export-reliant economy. With interest rates near zero, the central bank's key tool for stimulating the economy is its open market operations. BOJ increased the size of its asset purchase program by JPY 10tn, and removed the floor on the yields that it accepts for bond purchases. Though the move came as a surprise, it is expected to have a positive impact on Japan's economy by stabilizing currency movements. (WSJ)
Portugal's borrowing costs drop to lowest since 2010 at sale **Sep 19.** Portugal's cost of borrowing dropped to the lowest since 2010 as it sold EUR 1.29bn of 18-month bills, the longest maturity it has auctioned since April. Yields on Portuguese bonds have dropped as the government cut spending and raised taxes to comply with the terms of a EUR 78bn aid plan. The 18-month securities were issued at an average yield of 2.967%. The last auction of similar maturity securities yielded 4.537%. The sale attracted bids for 2.4 times the amount allotted, demonstrating that investors continue to be interested in short term Portuguese government debt. The government aims to regain full access to bond markets by September 2013. If unable to because of external reasons, it would be able to draw further support from the IMF and EU. (Bloomberg)
China releases 'financial 5-year plan,' calls for deposit insurance scheme **Sep 17.** China's State Council announced that it had approved a plan that outlines the country's financial industry development during the 12th Five-Year Plan (2011-15), which serves as a guide for future legislation and policy. Although the plan reiterates the need to deepen capital market development and financial reform, it also included calls for establishing a deposit insurance system and bankruptcy mechanism as part of a framework to facilitate the orderly wind downs of failing financial institutions. For small Chinese banks, these new elements are credit negative because they weaken the government's incentive to provide support to them. (WSJ)

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