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What's driving demand for INR-denominated supranational bonds?

July 2024

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Standard & Poor's defines supranational institutions (or "supras") as institutions that are owned or established by the governments of two or more countries. They are usually formed by international treaties to achieve specific policy objectives and are not subject to commercial law. Most supras are multilateral lending institutions (MLIs), created to provide loans to countries or guarantee their obligations to facilitate economic development, regional integration, or cross-border trade.

Supranational issuers with Asian or global mandates typically have large loan exposures to India given the country's economic size and development status (Figure 1).

Figure 1 – Supranational issuers and their exposure to India

<table>
<tr><th></th><th>India exposure</th><th>Largest country exposure ex-India</th><th>Region of focus</th></tr>
<tr><td>Asian Development Bank (ADB)</td><td>16%</td><td>14%</td><td rowspan="2">Asia</td></tr>
<tr><td>Asian Infrastructure Investment Bank (AIIB)</td><td>25%</td><td>12%</td></tr>
<tr><td>International Bank for Reconstruction and Development (IBRD)</td><td>8%</td><td>8%</td><td rowspan="5">Global</td></tr>
<tr><td>International Development Association (IDA)</td><td>10%</td><td>11%</td></tr>
<tr><td>International Finance Corporation (IFC)</td><td>14%</td><td>9%</td></tr>
<tr><td>International Fund for Agricultural Development (IFAD)</td><td>6%</td><td>7%</td></tr>
<tr><td>New Development Bank (NDB)</td><td>27%</td><td>29%</td></tr>
</table>

Source: S&P, Invesco. Data as of either June or December 2022 depending on the different institutions.

While supras typically target different sectors or focus areas for each country they provide loans to, the majority finance projects to foster the medium to long term economic growth of the country and increase its GDP per capita. We use the World Bank's lending arm, the International Bank for Reconstruction and Development (IBRD) and the Asian Development Bank (ADB) as examples to illustrate the loan exposures these supras have in India by sector (Figure 2). We find that these institutions are focusing on ESG-related projects on top of projects targeting economic growth and poverty reduction. In India's case, both the World Bank and Asian Development Bank have significant loan exposures to climate-based sectors such as water and forestry, as well as social sectors such as health and education.

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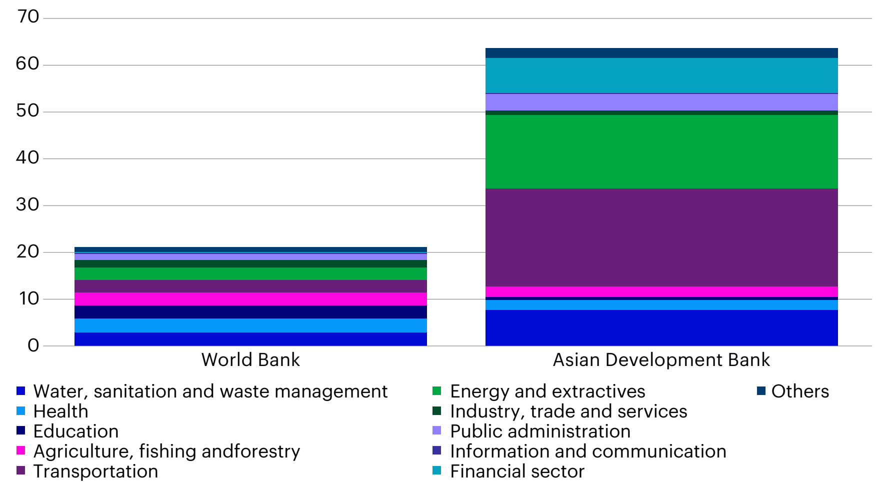
July 2024

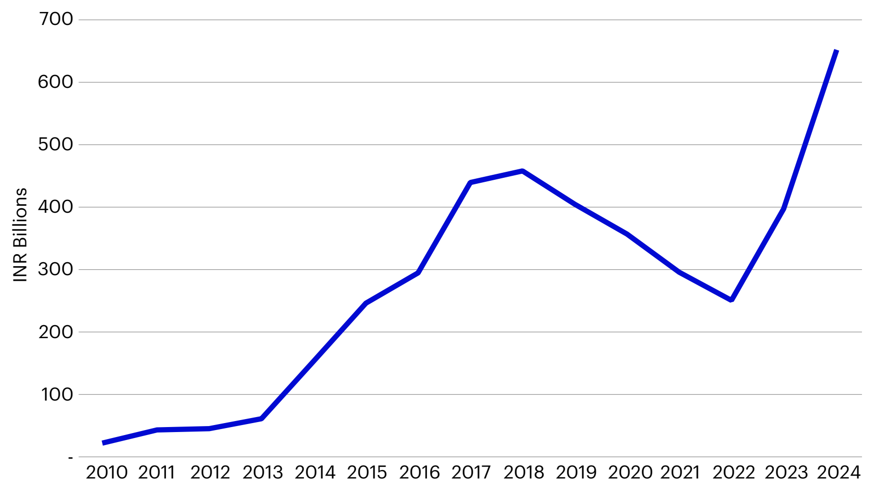
Figure 2 – World Bank and ADB's project exposures by sector (INR billion)



Source: World Bank, Asian Development Bank, Invesco. Data as of June 2024 for World Bank (specifically the lending arm, IBRD) and April 2024 for Asian Development Bank.

Given their significant exposure to India over the past decade and a half, it is natural that these supras have been raising more and more funding denominated in Indian rupees (INR). In the past couple of years, we have noticed a pickup in the issuance of INR bonds by supras. The total supra-issued INR bonds outstanding has more than doubled from the recent trough in 2022 (Figure 3).

Figure 3 – Total INR bonds outstanding issued by supranationals (2010 – 2024 YTD)



Source: Bloomberg, Invesco. Data as of 18 Jun 2024.

We expect to continue to see supra issuers borrowing in INR to fund their projects in India. However, given the liberalization of India's domestic bond market, it remains to be seen whether this issuance will shift from offshore to onshore.

Invesco

What's driving demand for INR-denominated supranational bonds?

July 2024

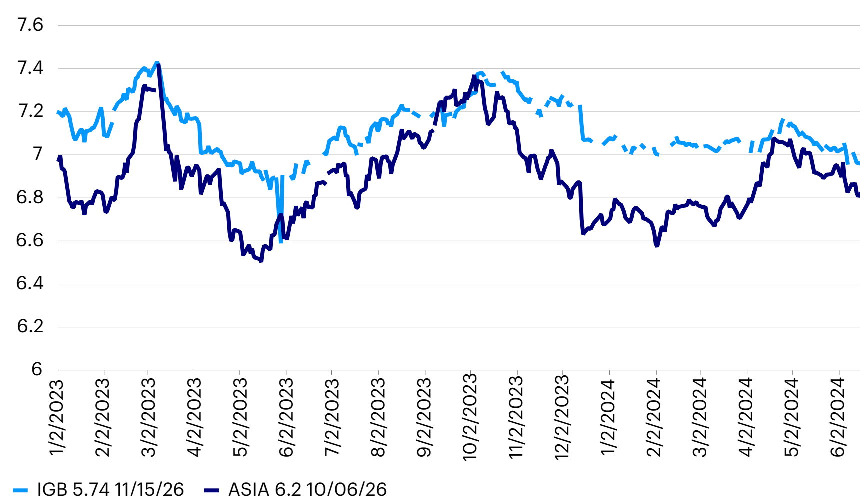
How can investors allocate between onshore and offshore INR bonds?
At present Indian government bonds (IGBs) are subject to withholding taxes while this is not the case for supra-issued INR bonds. Several supranational issuers including the IBRD, ADB and Asian Infrastructure Investment Bank (AIIB) enjoy the highest credit rating (AAA). Thus, it is safe for investors to assume they are taking on minimal credit risk when investing into these bonds. At the same time, looking at the onshore market, IGBs are seen as risk-free as these securities are backed by the Indian government.

For offshore investors deciding between the two, supra-issued INR bonds could be attractive if the yield offered is comparable to IGBs with the same maturity. IGBs are highly liquid which can help investors minimize transaction costs. While supra-issued INR bonds although still quite liquid with bid-offer spreads of around 3 to 5 basis points, are certainly not as liquid as IGBs where bid-offer spreads can be as low as 1 basis point or less.

Currently, the volume of supra-issued INR bonds outstanding is quite low and amounts to around 0.6% of Indian government bonds outstanding. Given the large size of the domestic IGB market, offshore market events typically have a limited impact on these securities. IGB prices are more affected by domestic macro factors such as growth, inflation, fiscal and monetary policies as well as external factors such as commodity prices. Liquidity conditions also play a role. Given that the INR is not yet a freely convertible currency, offshore liquidity conditions can often be quite different to those onshore. As all supra-issued INR bonds are offshore securities, their prices are subject to offshore liquidity conditions as well as being impacted by onshore IGB yields.

Investment implications of recent market conditions on the demand for INR-denominated supranational bonds
For the past year or so, we've seen supra INR bonds trading inside IGBs in terms of yield (Figure 4). This is logical given that investors face a lower tax burden when buying supra-issued INR bonds relative to IGBs. Nevertheless, current spreads between supra INR bonds and IGBs are at tighter levels. In the chart below we find that the supra-issued INR bond yield briefly surpassed the IGB yield in September 2023. This was largely due to extremely tight offshore liquidity conditions as US inflationary pressure was building up and the market was adjusting its expectations of Fed rate cuts.

Figure 4 – Bond yield comparison since 2023 (% p.a.)



Source: Bloomberg, Invesco. Data as of 20 June 2024. Note: We use ASIA, the ADB-issued INR bond with a 6.2% coupon rate and maturity date of 10/06/26 as the example for a supra-issued INR bond. We use the 5.74% coupon IGB with a maturity date of 11/15/26 as the example for an IGB.

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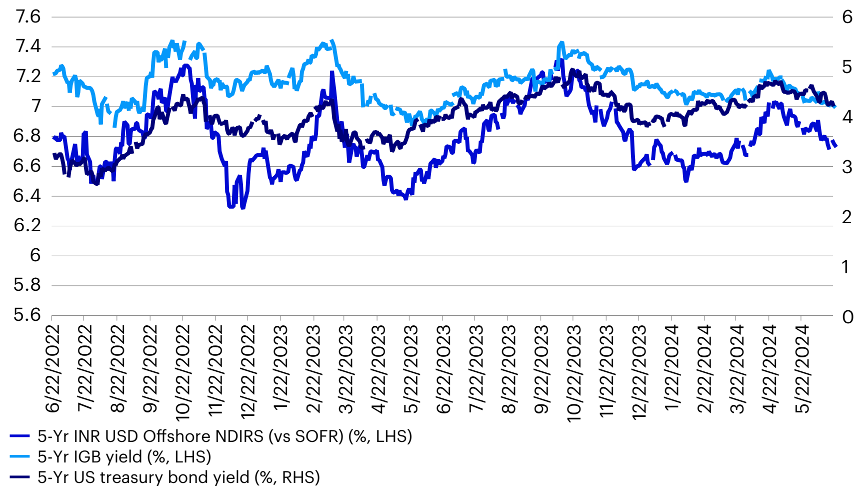
July 2024

INR-USD cross currency swaps have historically been a strong indicator of offshore INR liquidity conditions. Figure 5 illustrates how over the past two years, INR-USD cross currency swaps have been positively correlated with both onshore conditions (indicated by IGB yields) and overall global conditions (indicated by the US treasury bond yields).

Figure 5 – INR-USD cross currency swap relative to IGB yields and US treasury bond yields



Source: Bloomberg, Invesco. Data as of 20 Jun 2024. Note: NDIRS refers to Non-Deliverable Interest Rate Swap. SOFR refers to the Secured Overnight Financing Rate.

Given the aforementioned factors, we believe current market conditions provide a good entry point for INR bonds issued by high credit quality supras in the offshore market. First, many supra-issued INR bonds are now offering similar if not higher yields compared to the IGBs with the same maturity profiles. Second, offshore liquidity conditions are improving, and the market has started to price in more Fed rate cuts in 2024 and 2025 as inflationary pressures reduce in the US. However, it is worth pointing out that investors considering these bonds will look to hold their positions for the medium-to-long term as frequently trading them will incur higher transaction costs.

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What's driving demand for INR-denominated supranational bonds?

July 2024

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