2. Foreign Participation In G-Secs - Economy

The Government of India has introduced tax exemptions and investment-related reforms for Foreign Institutional Investors (FIIs) and Foreign Portfolio Investors (FPIs) investing in Government Securities (G-Secs).

1. These reforms mark a significant shift in India's capital markets policy aimed at deepening the bond market and attracting stable long-term foreign capital.
2. The changes apply to income arising on or after 1 April 2026 under the Income-tax (Amendment) Ordinance, 2026.

1.Understanding FIIs and FPIs

Foreign Institutional Investment (FII)

1. Foreign Institutional Investment is a category of FPI that refers specifically to investments made by foreign institutional investors such as mutual funds, pension funds, insurance companies, and hedge funds.
2. These institutions invest pooled funds in financial markets and typically play more active roles in investment research and decision-making compared to individual investors.
3. FIIs represent substantial capital inflows given their large fund sizes and sophisticated investment strategies.

Foreign Portfolio Investment (FPI)

1. Foreign Portfolio Investment refers to investments made by foreign individuals, institutional investors, or funds in financial instruments including stocks, bonds, mutual funds, and government securities.
2. FPIs do not participate in the management or decision-making of companies where they invest and are generally considered passive investors focused on portfolio returns.
3. FPIs provide essential liquidity to financial markets without requiring operational involvement.

Government Securities (G-Secs) - Nature and Classification

Definition and Characteristics

1. Government Securities (G-Secs) are tradable debt instruments issued by Central or State Governments to borrow funds and meet expenditure requirements.
2. They represent the government's debt obligation and are generally considered risk-free as they carry a sovereign guarantee protecting investors against default risk.
3. G-Secs form the backbone of government financing and monetary policy implementation.

Classification of G-Secs

1. Treasury Bills (T-Bills) are short-term securities with maturity of less than one year enabling short-term borrowing and liquidity management.
2. Government Bonds/Dated Securities are long-term securities with maturity of one year or more providing long-term financing for developmental projects.
3. State Development Loans (SDLs) are long-term securities issued by State Governments for their financing needs.
4. The Central Government issues both Treasury Bills and Government Bonds while State Governments issue State Development Loans.

2.Tax Reforms - Previous vs. New Regime

Previous Tax Treatment

1. Prior to the latest reform, Foreign Institutional Investors (FIIs), including SEBI-registered FPIs, were taxed under Section 210 of the Income-tax Act.
2. Interest income earned on G-Secs was taxed at 20% for FIIs/FPIs reducing effective returns.
3. Short-term capital gains from sale of G-Secs were taxed at 30% depending on transaction nature.
4. Long-term capital gains were taxed at 12.5%.
5. A significant portion of returns earned by foreign investors from holding or trading G-Secs was payable as tax in India reducing attractiveness.

New Tax Exemption Regime

1. Under the new regime, FPIs/FIIs will be completely exempt from interest income earned from G-Secs.
2. Capital gains arising from sale, transfer, exchange, or redemption of G-Secs will also be tax-exempt.
3. The exemption applies to income arising on or after 1 April 2026 providing clarity and certainty for new investment decisions.
4. Zero tax liability on G-Sec's income makes Indian government securities significantly more attractive to foreign investors.

3.Significance of the Reforms

Attracting Long-Term Foreign Capital

1. Experts estimate that the measures could bring $45-50 billion in additional foreign inflows over the next two years representing substantial capital influx.
2. Tax-exempt status makes Indian G-Secs highly competitive with international debt instruments attracting global institutional investors.

Deepening Bond Market Development

1. As of May 2026, FPIs held Government Securities worth about ₹3.75 lakh crore, accounting for 3.34% of total outstanding G-Sec stock.
2. Greater participation can improve market liquidity enabling easier trading at better prices, enhance price discovery reflecting true market values, and increase trading activity deepening the market.
3. Deeper markets attract more sophisticated trading strategies and investment approaches.

Lowering Government Borrowing Costs

1. Increased demand for Government Securities can reduce yields on new issuances lowering borrowing costs for the government.
2. Lower borrowing costs reduce fiscal burden allowing reallocation of resources toward development spending.

Supporting Infrastructure and Development Financing

1. Additional capital from foreign sources can support infrastructure, manufacturing, renewable energy, and urban development projects requiring substantial investment.
2. Development financing enables faster implementation of government initiatives.

Strengthening External Sector Stability

1. Higher foreign inflows can support the Balance of Payments (BoP) improving current account positions.
2. Increased inflows strengthen foreign exchange reserves reducing pressure on the rupee from external imbalances.

4.Potential Challenges

Volatility of Portfolio Flows

1. Unlike Foreign Direct Investment (FDI), FPI investments are highly sensitive to global interest rates, geopolitical tensions, and risk sentiment.
2. A rise in US interest rates or global financial uncertainty can trigger sudden withdrawals from emerging markets including India.

Risk of Capital Flight

1. While increased foreign participation can deepen the bond market, sudden outflows may lead to sharp movements in bond yields and exchange rates.
2. Sharp yield movements increase borrowing costs and rupee depreciation pressures.

Limited Impact on Structural Issues

1. Tax exemptions may improve attractiveness of Indian Government Securities but may not fully address currency volatility concerns, fiscal deficits, or broader investor confidence issues.

5.Way Forward

1. **Maintain Fiscal Discipline** - Ensure government deficits remain manageable preventing large-scale borrowing pressures even with lower costs.
2. **Build Foreign Investor Base Diversity** - Attract investors from multiple countries and institutions reducing dependence on any single source.
3. **Strengthen Currency Management** - Maintain stable monetary policy and forex management reducing currency volatility concerns for foreign investors.
4. **Improve Market Infrastructure** - Continue enhancing trading platforms, settlement systems, and regulatory frameworks for international investors.

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