

Debt Funding in India Series

November 05, 2020

OFFSHORE FUNDING ROUTE: FOREIGN PORTFOLIO INVESTORS

One of the most widely used avenue for debt investment into India is the foreign portfolio investor ("FPI") regime. This regime was introduced in 2014, when SEBI permitted FPIs to invest into listed or to-be-listed debt instruments (defined to mean to be listed within 15 days of issuance) under the FPI route. Subsequently, unlisted debt instruments were also included as permissible instruments for FPIs. The government and the central bank, the Reserve Bank of India ("RBI") has prescribed aggregate investments by FPIs under this regime, and these limits were exhausted multiple times.

In 2015, the securities market regulator, i.e. the Securities and Exchange Board of India ("SEBI") and the RBI introduced certain concentration norms for FPIs investing into debt instruments, resulting in a substantial reduction of debt investments by FPIs. The broad features of the FPI regime for investment into NCDs are provided in [Annexure A](#).

In March 2019, the RBI, with the intent to 'attract long term and stable FPI investments into debt markets', introduced a new regime referred to as the 'voluntary retention route' ("VRR") for investments by FPIs into debt to provide them an additional avenue for investment into the Indian debt market. The broad features of the VRR regime for investment into NCDs are provided in [Annexure B](#).

Since the introduction of VRR, there have been increased debt investments under this route by investors who have a long-term outlook for their investments in India because of the relaxations granted under this route and the additional flexibility to shift investments to another debt investment in order to comply with the committed portfolio size (CPS) requirements (*covered in detail below*).

We have listed down a few FAQs which will help understand the debt investments in India via the FPI investments into NCDs route better.

1. What is an NCD issued to an FPI?

An NCD issued to an FPI is any rupee denominated NCD issued by an Indian company. The same tranche of NCDs may be subscribed to by residents and FPIs.

2. How does security creation work in case of FPIs? How are FPI investors protected?

Security for NCDs is created in favor of a resident debenture trustee. The security may be in the form of mortgage of immovable properties, pledge of securities, hypothecation of receivables or floating charge over the assets of the borrower. In addition, escrow mechanisms are also entered into for protection of the FPI investors. In most of these cases, the rights are exercised by the debenture trustee on the instructions of the debenture holders.

3. When investing in NCDs of an Indian company, which FPI option should one prefer – the usual FPI route, or the VRR?

Investments into Indian debt markets can be made, as explained above, either by the simple FPI route (referred to as the "Simple FPI Route" for convenience), or under the VRR. Both options have their pros and cons, and these are pertinent considerations when determining which route to invest through.

- **Tenure of investment:** Under the Simple FPI Route, the minimum residual maturity of an NCD is 1 year (reduced from an earlier imposed 3 years). Accordingly, any NCD with a residual maturity of 1 year at the time of investment by the FPI is permitted under the Simple FPI Route. On the other hand, while the NCD is not required to have any minimum residual maturity under the VRR, 75% of the investment under the VRR (see [Annexure B](#) for further details) are locked-in for a period of 3 years. Thereby, while the amounts can be redeemed by the investee company in India, the funds cannot be repatriated by the FPI prior to 3 years.

Accordingly, the VRR is a more plausible alternative from a tenure perspective when the investment is expected to be a long term investment, or when the FPI invests regularly, and can effectively deploy the funds without repatriating, if received prior to the 3 year period.

- **Investment entity:** Under the Simple FPI Route, an FPI cannot acquire more than 50% of the tranche of the NCDs being issued. The intent was to develop a more liquid debt market. However, the outcome of such a regulation is that for any negotiated / structured deal, the investee company needs to find at least 2 FPIs (not related to each other), or other investors to acquire at least 50% of the issuance. This has also led to setting up on onshore vehicles by offshore investors, since onshore vehicles are not restricted by the 50% requirement. In addition, some investors have also preferred a co-investment approach with an offshore and a captive onshore vehicle (such as AIFs or NBFCs) to ensure they comply with the regulations, while exercising relevant control through the offshore FPI vehicle.

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In case of investment by VRR, the 50% restrictions do not apply, and hence a single FPI can invest in the entire issuance by the Indian corporate.

Accordingly, in cases where multiple FPIs / other domestic entities are not available for investment, the VRR may be a better option when compared to the Simple FPI Route. However, where there are multiple entities available, such that the investment by a single FPI need not exceed 50%, the Simple FPI Route may be preferred since the funds can be repatriated.

The above mentioned are the main differences from a commercial perspective for investment into India via the FPI route. The other aspects, such as investment in Rupee denominated NCDs and the tax treatment remains agnostic across both routes.

4. Are any cash returns permitted during the lock-in of 1 year (in case of the Simple FPI Route) or 3 years (in case of the VRR)?

All scheduled coupon and interest payouts are permitted during the lock-in periods. The primary challenge arises in relation to the permitted principal payout. Debt instruments usually have payout schedules for the principal amounts as well. While the regulations do not provide for any guidance with respect to such payouts, it seems that the same may be permitted subject to certain restrictions. In case of VRR, the redemption may be permitted, as long as the balance of the face value post such part redemption exceeds 75% of the committed portfolio size (see [Annexure B](#)). On the other hand, the regulation around the Simple FPI Route is more complicated, and the view seems to be that as long as the weighted average maturity of the NCD is more than 1 year, the redemption should be permitted.

5. Can the investee company issuing NCDs redeem NCDs prior to 1 year period (in case of the Simple FPI Route) or 3 years (in case of the VRR)?

In case of VRR, the regulations are clear and state that the NCDs can be redeemed prior to the 3 year period as well. The restriction is an FPI-level restriction, i.e. the FPI is not permitted to repatriate the funds from India. The intent is to encourage long term investment into bonds.

The situation is slightly more nuanced in case of the Simple FPI Route. The restriction is imposed on the FPI as an acquirer, as well as the NCDs to have a minimum residual maturity. However, it seems that as long as there is no obligation on the borrower to redeem the NCDs prior to the 1 year period (including any call or put options), the redemption should generally be permitted. This is developed over time to ensure that the investment into the NCD by the FPI should not restrict the ability of the borrower to prepay the NCDs, if it is able to do so. However, any form of obligation on the borrower would not be permitted, and redemption prior to the 1 year period, whether in part or full, may be challenging. Potential incentivization structures for borrowers to redeem prior to the 1 year period, without imposing an obligation can be evaluated depending on commercial considerations.

6. As an FPI, what are the exit options available prior to the 3 year (for VRR) and 1 year (Simple FPI Route), if for any reason (such as fund life ending), the FPI has to exit the investment?

For investments under the Simple FPI Route, the FPI can exit by way of transfer of the NCDs to another FPI or domestic investors. In case the transfer is contemplated to another FPI, the NCD must have at least 1 year of residual maturity at the time of transfer. There is no such minimum residual maturity in case of transfer to domestic investors in any case.

In case of VRR investments, an FPI may exit by transferring their investments to other FPIs only, where the transferee FPI agrees to be bound by the restrictions of the transferring FPI. Transfer to a resident, while not restricted would not serve any purpose, since the funds would be locked-in at the India level.

7. Aside from the varying lock-in and the 50% restriction, is there any other distinction between investment under the VRR and the Simple FPI Route?

From a procedural aspect, there are some distinctions between both the routes. Any investment can be made only upon the limits being available to the FPI. For this purpose, an auction is conducted and the FPI is required to bid for the limits. In addition, for investment under VRR, the FPI is required to have a separate cash account with its custodian in India.

A major restriction imposed on investments under the Simple FPI Route is that the FPI cannot invest more than 30% of its entire investment in corporate bonds in short term investments, defined as investments with residual maturity of up to 1 year. This residual maturity is considered on a daily basis. This poses major concerns for FPIs, since any NCD which has an extended tenure may also be considered a short-term investment with the passage of time.

8. With respect to investment into NCDs, can FPIs invest in both listed and unlisted NCDs? What are the distinction between the same?

FPIs have been permitted from 2017 to invest in unlisted NCDs as well. Hitherto, investment was only permitted into listed or to-be-listed NCDs. With respect to unlisted NCDs, the exchange control regulations require that the end use proceeds of the issuance of unlisted NCDs cannot be utilized for real estate business, capital market and purchase of land.

The end use restrictions aside, borrowers issuing listed NCDs have some additional conditions to fulfil as opposed to an unlisted NCD. However, debenture trustees in case of listed NCDs have the benefit of enforcing security under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, which is a pro-creditor legislation. Trustees with respect to unlisted NCDs do not enjoy the same benefit, this becomes an important determinant at times.

With the benefits of NCD investment, investments into NCDs by FPIs has traditionally been a highly preferred mode of investment. The recent regulatory regimes may have made this route slightly onerous, but continue to be effective and used extensively.

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