Corpsec Hotline

January 10, 2012

SEBI STRIPS FIIS OF RE-INVESTMENT FACILITY IN DEBT

→ record:tt_news:1104The Securities Exchange Board of India ("**SEBI**") vide Circular No. CIR/IMD/FIIC/1/2012 dated January 3, 2012 ("**Circular**") has done away with the facility of reinvestment of the corporate debt limits available with the foreign institutional investors ("**FIIs**") leaving the FIIs who had acquired debt investment limits high and dry, especially those FIIs who had recently purchased these limits in pursuance of SEBI Circular No. CIR/IMD/FIIC/20/2011 dated November 18, 2011 ("**Circular 20**").

BACKGROUND

For an FII to invest in corporate debt or debt securities, the FII first needs to acquire debt allocation limits to be able to invest in debt securities. These debt limits are issued or auctioned by the SEBI from time to time. Fresh limits aggregating to USD 5 billion were recently auctioned by SEBI on November 30, 2011 vide Circular 20 which has been discussed in detail in our hotline titled "Fresh Debt Allocation to Institutional Investors up for Bid."

Earlier once these investment limits were obtained and utilized by an FII i.e. once the FII had invested into or purchased debt securities within the subscribed limits, the FII had a period of five business days for replacement of disposed off/matured debt instruments, as per Circular No. IMD/FII&C/30/2008 dated July 4, 2008 of SEBI. This period was increased from five business days to fifteen business days by SEBI vide Circular No. CIR/IMD/FIIC/18/2010 dated November 26, 2010. Hence, previously an FII which had acquired or obtained investment limits from SEBI, had the flexibility to reinvest into debt securities after the initial investment had been sold off or had matured, provided the subsequent investment was made within 15 business days of such sale or maturity of the earlier investment.

THE CHANGE

To the disappointment of FIIs that had purchased such debt limits with a long term debt strategy in mind, the Circular has withdrawn the facility of re-investment by the FIIs by providing that the debt limits acquired henceforth by an FII shall expire upon the redemption or sale of debt securities, with certain leeway for FIIs that have already acquired debt limits.

The Circular deals with corporate and infra debt and has brought in the following changes:

In respect of Corporate debt:

Fresh Investments: The debt limits being acquired henceforth by an FII shall expire on sale or maturity of the debt investments and the FII would be required to obtain the limits again through the bidding process or first come first serve basis.

FIIs which already have acquired limits: As per the Circular, the FIIs that have already obtained the debt limits from SEBI and / or invested in debt would continue to have the reinvestment facility i.e. they may re-invest into debt securities within 15 business days of the sale or redemption of the earlier investments, until the occurrence of any of the following conditions:

1. The total sales made by an FII from its debt portfolio reaches twice the value of the entire debt portfolio (i.e. the total of the utilised and utilised limit available with the FII); or
2. A period of two years has elapsed since from the date of issue of the Circular. i.e. on January 2, 2014.

Once any of the above conditions is met, the reinvestment facilities available to the FIIs would cease to exist and the FII would be required to obtain fresh limits to make any further investments into debt. However, it is clarified that if an FII holds certain debt investments acquired prior to the occurrence of any of the above conditions, it is not obligated to sell such investments upon the occurrence of any of the above conditions, and may continue to hold such investments till the sale or redemption thereof.

LONG TERM INFRA DEBT CATEGORY

According to SEBI Circular No. IMD/FII&C/18/2010 dated November 26, 2010, infra debt category is where the FII invests into debt securities of infrastructure companies i.e. the companies engaged in the infrastructure sector as per the external commercial borrowings policy1. The investments made by a FII under infra debt category are subject to either (i) three years lock-in with a residual maturity of minimum three years or (ii) a one year lock–in with a residual maturity of minimum one year, depending upon the nature of the limit obtained by the FII. During such lock-in period,

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an FII can sell its investments only to another FII and not to a domestic entity.

The changes introduced by the Circular for investments in infra debt category is as follows:

- **Fresh Investments :** For all new allocations of debt limit, the limits shall expire upon the redemption of the debt security or any sale after the lock-in period. Unlike the corporate debt category, where the limits are not transferrable, the limit are automatically transferred to the purchasing FII/sub-account if the sale is during the lock-in period.
- **FIIs which already hold debt investments under this category :** FIIs holding investments in long term infra debt category with one year lock-in and residual maturity of one year shall be subject to similar restrictions as applicable to FIIs already holding investments in corporate debt mentioned above. However, if an FII decides to sell its investments (i) during the lock-in period, in a special trading window as provided by the exchange in terms of SEBI circular dated March 31, 2011; or (ii) after the lock-in period but before January 2, 2014; such an FII has the option to sell its investments along with the limits (in which case the purchase would be subject to the abovementioned conditions), or may chose to sell only the investments and retain the limits (in which case the seller would be subject to the abovementioned conditions).

IMPLICATIONS

- **Expiry upon sales and not redemption :** Unless the expiry of existing debt limits is due to period of two years elapsing from the date of the Circular, i.e. January 2, 2014, per the Circular the existing limits shall expire upon the total 'sales' made by an FII from its debt portfolio reaching twice the value of the entire debt portfolio which includes unutilized debt limits. Therefore, any redemption until January 2, 2014 would not be counted towards the above limit of twice the value of debt portfolio, and after January 2, 2014 the limits would expire on either sale or redemption.
- **Higher costs :** Since the window provided to the FIIs that have already acquired debt limits will expire latest by January 2, 2014, FIIs that were planning to use their existing debt limits over a relatively longer horizon by re-investing now may not be able to do so for long. As a result, such FIIs would have to absorb their entire cost of acquisition of debt in the near future and may not be able to apportion it over a longer tenure as contemplated. As a corollary, since the debt limits can now not be re-used, the price at which future debt limits are auctioned may reduce.
- **Uncertainty :** Earlier, the existing FIIs which had acquired debt limits could keep re-utilising their existing debt limits by re-investing in debt securities. Several FIIs had framed their entire investment strategy around the ability to re-invest and on the perceived surety that the limits could be reutilized. But with the debt limits now expiring latest by January 2, 2014, such long term plans run into uncertainty, as the allocation of fresh debt limits to such FIIs may not be guaranteed.
- **Frequency of future allocation of debt limits :** Since now, the debt limits would expire once the debt is sold or redeemed, the FIIs may not be able to hoard on to the debt limits and hence, auctions for allocation of debt limits could be more frequent. Consequently, this would provide a greater opportunity for new players to enter the market and we may now see more number of players acquiring the debt limits.
- **Call/Put Options :** As the redemption of debt securities would now tantamount to an expiry of the debt limit, there may be reluctance on the part of FIIs to exercise put option or grant a call option on the debt securities to the target company.
- **Different Structures :** Now with the limited life span of the debt limits, alternative structures for debt investments may be seen. With SEBI now mandating expiry of FII debt limits on redemption or sale, the role of NBFCs is likely to enhance as FIIs may park the funds in NBFCs (by way of subscribing to NBFC NCDs) and use such NBFCs in turn for debt deals thereby retaining their debt limits until they exit from the NBFC. A detailed analysis of the debt investments through the NBFC route has been provided in our Realty Check titled "Real Financing – Onshore and Offshore Debt Funding Realty in India (With Special Focus on NBFCs)"

CONCLUSION

Beginning this year, the FIIs have suffered a double blow. On the equity front, the government had recently proposed to allow qualified foreign investors ("QFI") direct access to the Indian equities market as an alternative to the FII route, which as mentioned in our hotline titled "Welcome QFIs: A New Entry Route To Capital Markets For Foreign Investors", could adversely affect the attractiveness of FIIs. And now, with the withdrawal of re-investment facilities, the FIIs have suffered a major setback even on the debt front.

With SEBI changing the rules of the game midway, the FIIs who had already acquired the debt limits and were planning to use it over a relatively longer horizon will now be handicapped to do so. The Circular is likely to be a larger disappointment for FIIs that had very recently acquired their debt limits on November 30, 2011 at a premium as high as 125 basis points based on their ability to invest and reinvest in debt markets over a longer horizon.

Whilst the Circular is likely to be welcomed by a host of FIIs that were unable to procure debt limits in the auctions earlier, the move may not go well with the sentiments of FIIs that had acquired the debt limits at a premium and organized themselves on the premise of a definite long term strategy.

– Ashish Kabra, Deepak Jodhani & Ruchir Sinha
You can direct your queries or comments to the authors

[1] As per paragraph (v)(a) of the Part I of the Master Circular No.9 /2011-12 (Master Circular on External Commercial Borrowings and Trade Credits) dated July 1, 2011, Infrastructure sector is defined as "(i) power, (ii) telecommunication, (iii) railways, (iv) roads including bridges, (v) sea port and airport, (vi) industrial parks, (vii) urban infrastructure (water supply, sanitation and sewage projects), (viii) mining, exploration and refining and (ix) cold storage or cold room facility, including for farm level pre-cooling, for preservation or storage of agricultural and allied produce, marine products and meat."

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