Corpsec Hotline

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DEATH KNELL FOR FOREIGN INVESTORS IN INDIAN CORPORATE DEBT MARKETS?

- Minimum residual maturity reduced from 3 years to 1 year
- Credit Concentration norms for FPI investments included
- Maximum subscription by a FPI of a single issuance introduced

BACKGROUND

In 2008, SEBI introduced the SEBI (Issue and Listing of Debt Securities), Regulations 2008, which paved the way for companies to issue their debt securities, primarily, non-convertible debentures ("**NCD**") to investors. Subsequently, the Foreign Exchange Management (Transfer and Issue of Securities to Persons Resident outside India) Regulations, 2000 ("**TISPRO 2000**") was amended to permit foreign institutional investors (and later Foreign Portfolio Investors ("**FPI**")) to invest in listed NCDs, and subsequently in to-be-listed NCDs.

In February 2015, the Reserve Bank of India ("**RBI**") and the Securities Exchange Board of India ("**SEBI**") further amended TISPRO 2000 and the SEBI (Foreign Portfolio Investors), Regulations 2014 ("**FPI Regulations**") stipulating a minimum residual maturity for NCDs which FPIs could invest in. This was considered as a major impediment to foreign investment, since this restricted raising short term financing through NCDs.

Despite the introduction of a minimum residual maturity, issuance of NCDs by Indian corporates were at an all-time high. This was evident in the fact that the prescribed overall limits for corporate debt had been exhausted, and limits were thereafter, available only under auction.

In light of the issues faced by the market participants, the RBI has introduced 2 circulars, Circular No. 24 dated April 27, 2018 ("**Circular 1**") and Circular No. 26 dated May 1, 2018 ("**Circular 2**") to introduce certain changes.

CHANGES AND ANALYSIS

1. Minimum residual maturity:

Background

In February 2015, the RBI and SEBI amended relevant regulations to provide for a minimum residual maturity of 3 years. This minimum maturity applied to primary subscriptions, as well as secondary acquisition of NCDs by FPIs. By way of a press release, RBI also clarified that optionality clauses enforceable prior to the minimum residual maturity of 3 years was not permitted. This was considered a major concern since, pre-payment was also considered as optionality rights which the borrower had. Further, the regulations also restricted pre-payments even in default cases where the lender could seek pre-payments.

Changes

By Circular 1, RBI has now reduced the minimum maturity from 3 years to 1 year.

Analysis

This is a welcome move since it was felt that the restriction of a minimum maturity of 3 years was too onerous, and impacted fund raising by Indian corporates. In the absence of a similar restriction on resident NCD holders, companies intending to pre-pay NCDs were facing substantial challenges, if even a single NCD was held by a FPI. Further, this regulatory arbitrage led to a situation where FPIs would transfer the NCDs to an Indian entity to provide for the redemption prior to the 3 year period. While NCDs having residual maturity of less than 3 years were not permitted to be redeemed prior to the expiry of the 3 year period, FPIs were permitted to transfer the NCDs to a resident entity prior to expiry of the 3 year period.

The change would now permit resident Indian NCD holders and FPIs to be treated at par with respect to repayments / redemptions, without FPIs being required to restructure their holdings in case of a pre-payment (such as the warehousing structure mentioned above). Further, the 1 year restriction would not impact NCD issuances substantially, since RBI regulates issuance of NCDs with less than 1 year maturity separately, and the NCDs issued by corporates to such FPIs are generally for a period greater than 1 year.

Another important consideration is that the changes are prospective in nature, i.e. the changes do not impact NCDs issued prior to the notification of the changes.

2. Single issuance concentration norms

Background

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NCDs have been used by corporates as an effective mechanism to raise debt from offshore, especially from FPIs. This was a preferred route for corporates, since the NCD holders were not subject to strict regulatory compliances otherwise applicable to banks, provided substantial flexibility with respect to structuring returns and was tax efficient for the holders and the issuers. This made the NCD-FPI route attractive and a large number of corporates raised debt from a single FPI investor by issuing NCDs to them, especially since the FPIs were permitted to hold 100% of the NCDs issued by a borrower (as opposed to limits prescribed on the equity investments by FPIs). The limits prescribed apply to an FPI along with all related FPIs.

Changes

- By Circular 1, RBI has introduced limits on the extent of an issuance that FPIs can subscribe to. Under Circular 1, RBI has prescribed that the investment by an FPI shall not exceed 50% of the issuance of NCDs by a corporate. In cases, where this limit has been breached, the FPI shall not be permitted to make any further investments till the exposure of the FPI in such issuance has met the 50% condition.
- Circular 2 has clarified that 'related FPIs' means all FPIs registered by a non-resident entity.

Analysis

The imposition of a limit of 50% of a bond issuance that can be subscribed to by an FPI is expected to have major implications on the viability of the NCD route as a mode for raising funds. Currently, a single FPI can subscribe to the entire issuance of NCDs by a company. However, with this new restriction, a minimum of 2 FPIs would be required for any corporate to undertake an issuance. This is unnecessarily onerous in the current framework, where a borrower generally negotiates the terms with an FPI and issues NCDs to such FPI.

An important point to note is that the restriction has been imposed on the FPI, but not the issuer. It would need to be seen how are FPIs supposed to monitor the same, since it may not have full clarity on the subscribers.

While Circular 1 states that if the FPI holds more than 50% of the issue size, it shall not invest any further funds into the issue till such 50% limit is adhered to. It is unclear in which situation would the FPI exceed the 50% limits prescribed, considering that the FPIs are not permitted to subscribe to more than 50% of the issue. This is also linked to the previous point, on the practicability of the FPI to monitor its investment. As an illustration, if a company intends to issue 100 NCDs (with each NCD having the same face value), an FPI's investment cannot exceed 50 NCDs. However, it is unclear that if the total NCDs issues (due to lack of subscription) is 95, would the issuance to the FPIs be restricted to 47 (instead of 50)? Or would the FPI be issued 50 NCDs, and it would not be permitted to make any further investments in the issuance.

Another important aspect to be considered is what the RBI means by a single 'issuance'. If a borrower issues multiple tranches of NCDs under a single prospectus (termed a 'shelf prospectus'), would each tranche refer to a single issuance, or would all tranches collectively be referred to a single issuance?

While the text is not abundantly clear at this stage, considering that the intent of RBI is to limit an FPI's exposure to 50%, it would be safe to assume that the RBI would want to consider these limits strictly for each issuance.

The definition of 'related FPIs' under Circular 2 seems to be vague, and incoherent with the existing FPI Regulations. Under the definition provided under Circular 2, if a single investor invests through multiple FPIs which are set up by different entities, the investments would not be clubbed. This does not seem to be a logical interpretation of the intent. The RBI / SEBI may refer back to the ultimate beneficial ownership test applicable for FPIs currently, where if an investor has investments through multiple FPIs, the limits would be clubbed for all purposes.

3. Single group concentration norms

Background

Under the current regulatory framework, a single FPI can have only one NCD as its entire debt portfolio, i.e. there is no concentration norms requiring an FPI to spread its investments across portfolios. This provided the FPIs flexibility to invest into NCDs at their discretion, without any requirement for a minimum number of investments.

Changes

- Under Circular 1, RBI has prescribed 20% of the debt portfolio of the FPI as the limit of exposure of a FPI into a single corporate entity, along with related entities.
- If the exposure of a FPI is more than 20% of the debt portfolio of the FPI to a single corporate group, the FPI shall not undertake any fresh exposure in such entity or any related entity, till the 20% limit is met.
- New FPIs (i.e. FPIs registered after April 27, 2018) shall be required to comply with the 20% limit within 6 months from being registered as an FPI.
- Circular 2 clarifies that related entities would have the meaning ascribed to them under the Companies Act, 2013.

Analysis

The requirement for having multiple investments seems to stem from RBI's insistence on diversifying the risk for investors in FPIs. By having a maximum of 20% exposure to a single corporate entity (along with its related entities), FPIs would be mandatorily required to look for more investment opportunities and invest in multiple corporate entities.

The concentration norms as provided for FPIs are similar to those imposed on Alternative Investment Funds in India. However, one notable change in the FPI regime is that new FPIs are required to comply with the 20% concentration norms within a period of 6 months from the date of registration. This would necessarily imply that a newly registered FPI would need to make at least 5 investments of exactly 20% of its debt portfolio, or more than 5 investments, with each investment being lower than 20% of its debt portfolio. Coupled with the concentration norms on single issue concentration norms (covered in 2 above), this may pose a substantial challenge to newly set up FPIs.

Further, existing FPIs have not been given a time frame within which the above provisions would need to be complied with. There seems to be no rationale for the same, considering that the RBI has already restricted any additional exposure by an FPI into a corporate entity if the limits are breached. As an example, if an existing FPI has 3 investments with 33% investment in 3 corporate groups, they are anyway restricted from making any further

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investment in these 3 portfolio companies till the limits are below 20%. In this light, FPIs may benefit from this regulatory arbitrage, unless a time bound obligation is imposed on the existing FPIs.

CONCLUSION

While RBI's intent of Circular 1 and Circular 2 is to encourage companies to mobilize resources through public issuance of NCDs, the concentration norms seems to be unnecessary and excessive, considering the growth of the investor interest in the corporate debt markets. The impact can be observed in the net investment by FPIs in the debt segment being negative in the month of May already (net outflows as of May 22, 2018 in the debt segment is USD 274 million, as opposed to net inflows of USD 320 million as of April 22, 2018 (*as per information available on NSDL's website*)). As mentioned earlier, while the changes seem to bring in diversification and expansion of the debt market, the implications seem to be far excessive and unnecessary.

The concentration norms have been enacted and successfully implemented in other financial services sectors to avoid systemic risk in the financial markets by encouraging diversification among investors, but limits on investment into issuances seems to be far excessive, and may prove to be the death knell for not only the debt segment for FPIs, but an important avenue for fund raising for Indian corporates.

– Abhinav Harlalka & Karan Kalra
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