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RBI implements tighter rules on short-term bonds

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India is preparing to implement a new set of guidelines on short-term non-convertible debentures that will allow the central bank to tighten its grip on that market.
The latest directives from the Reserve Bank of India on short-term NCDs, which come into effect on August 2, will prohibit the issuance of bonds with a maturity of less than 90 days. The move is designed to close a loophole in the system and make it harder for weak companies to sell bonds.
“These RBI directives are not to be seen as a mere measure to increase the liquidity option availability with the company [issuers],”said R Vaidhyanadhan, senior associate in the capital markets team of Nishith Desai Associates, a law firm.
“It is a directive which seeks to regulate the issuances of short term NCDs to ensure soundness of such instruments and avoid unnecessary shocks in the financial markets, he added.
The Reserve Bank of India was prompted to bring in the legislation after a number of examples of misuse of the instruments came to light. Some borrowers were found to be issuing one-year bonds with put and call options that made the life of these instruments considerably shorter, even less than three months.
Investors preferred the security offered by NCDs over other short-term debt instruments like commercial paper. Moreover, the growing use of low-cost NCDs with put/call options was beginning to have an impact on money market rates.
Mutual funds — often with banks among their investors — had also become big buyers of short-term corporate NCDs, allowing companies to access funding at rates below the usual bank lending levels. Companies could then use that money to repay bank loans, freeing up banks to invest more in mutual funds via their treasury operations.
This re-routing of money was snapped with a parallel move by the capital markets regulator, the Securities and Exchange Board of India in the last quarter of 2009 to ban liquid funds from investing in bonds of more than 91 days.
The RBI’s move will restrict corporate issuers from selling bonds with a maturity of less than 90 days. It also requires NCDs to be rated, with a minimum rating capped at P-2 of Crisil or equivalent. Issuers will be required to disclose their financial position, even for a private placement of NCDs, and have a tangible net worth of US$870,000 equivalent. That may encourage CP