

Regulatory Hotline

February 10, 2015

GOVERNMENT TIGHTENS NORMS FOR FOREIGN INVESTMENT IN CORPORATE BONDS

- Foreign portfolio investors ("FPIs") restricted from investing in corporate bonds with residual maturity of less than 3 years
- FPIs not subject to any lock-in restrictions on holding of bonds, and are free to sell

In a major blow to foreign investment in bonds issued by corporates in India ("Bonds"), the Reserve Bank of India ("RBI"), by way of a circular dated February 3, 2015 ("RBI Circular") and the Securities Board of India, by way of a circular dated 3, 2015 ("SEBI Circular", and together with RBI Circular, the "Circulars"), has restricted the ability of foreign portfolio investors ("FPI") to invest in Bonds having residual maturity of less than 3 (three) years.

BACKGROUND

FPIs are permitted to invest in government securities ("G-Sec") and Bonds. To encourage more patient capital, the RBI had restricted FPIs from investing in G-Sec having a minimum residual maturity of less than 3 (three) years. No such restriction was previously imposed on Bonds issued by corporates. However, the RBI Governor in the Sixth Bi-Monthly Monetary Policy, dated February 3, 2015, announced that to harmonize the conditionalities, FPIs would henceforth be permitted to invest in Bonds only with a minimum residual maturity of 3 (three) years. The Circulars are introduced in line with the abovementioned policy. This was succeeded by a clarification dated February 6, 2015 ("Clarification") with respect to the investment by FPIs in Bonds.

CHANGES

- FPIs are now permitted to invest in / purchase corporate Bonds only with a minimum residual maturity of 3 (three) years. This applies to for all future investments by FPIs into Bonds;
- FPIs however do not have any lock-in for such investments, and are free to sell it any time; provided however, if less than 3 (three) years is pending to maturity, FPIs can sell the Bonds only to persons resident in India;
- FPIs are now not permitted to invest in liquid and money market mutual fund schemes;
- FPIs cannot invest in Bonds with maturity over 3 (three) years but having optionality clauses exercisable within 3 (three) years.

ANALYSIS

Contractual arrangements difficult: Imposition of 3 year residual maturity requirement would not only impact shorter term loans, it would also restrict various contractual arrangements like call / put option vis-a-vis the issuing company, part redemptions etc. to be exercised prior to the expiry of 3 years. For an issuer company which is contemplating having a prepayment clause in the terms of the Bonds, this may be a major deterrent for them to raise monies from FPIs. Also, in many cases, especially in real estate sector, where payments are linked to agreed distribution waterfall, or where Bonds were structured from a tax perspective in a manner that payments on them are attributed towards principal in the beginning and the premium is back-ended, this new requirement would majorly hinder such structures.

Optionality Clauses: The Clarification has also made it clear that any investment into Bonds, having residual maturity above 3 (three) years, but having optionality clauses exercisable prior to 3 (three) years would also not be permitted for investment by FPIs. This would prevent structuring by FPIs to exercise put option and sell the Bonds. This may be against the intent of RBI to bring in patient lasting capital and accordingly seems to be prohibited.

Default: The Circulars do not clarify whether in case of default, the Bonds can be redeemed prior to 3 years upon enforcement of security. In the absence of such clarification, even redemption upon enforcement prior to 3 years would require regulatory approvals. However, if the application for approval is coupled with court order, regulatory approvals for prior redemption may be granted. Alternatively, the FPI may also transfer the Bonds to a domestic counter-party prior to enforcement, in which case this 3 year condition would not apply.

Grandfathering: The requirement of minimum 3 year residual maturity is only for fresh investments by FPIs. Existing holdings of Bonds by FPIs can continue to have call / put options and be redeemed prior to 3 years.

Possible structures: Considering that principal moratorium of more than 18 months may not be amenable, warehousing in India by FPIs and sale to promoter without any optionality clauses in the terms of the document of the Bond issuance seem to be possible structuring options open to the FPIs. However, each of these options would have their own set of regulatory and tax considerations which may need to be analyzed in detail on a case to case basis.

Research Papers

Compendium of Research Papers

April 11, 2024

Third-Party Funding for Dispute Resolution in India

April 02, 2024

Opportunities in GIFT City

March 18, 2024

Research Articles

Private Client Insights - Sustainable Success: How Family Constitutions can Shape Corporate Governance, Business Succession and Familial Legacy

January 25, 2024

Private Equity and M&A in India: What to Expect in 2024?

January 23, 2024

Emerging Legal Issues with use of Generative AI

October 27, 2023

Audio

IBC allows automatic release of ED attachments: Bombay HC reaffirms

April 15, 2024

The Midnight Clause

February 29, 2024

Enforceability of unstamped or inadequately stamped Arbitration Agreements

January 10, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

Cyber Incident Response Management

February 28, 2024

Webinar : Navigating Advertising

CONCLUSION

The Indian corporate bond market is a highly underdeveloped market in comparison to other countries. It lags behind China (USD 1,651 billion), South Korea (USD 1,014 billion) and Japan (USD 786 billion) at approximately USD 242 billion.¹ In 2013, the government had substantially reduced the withholding tax for corporate NCDs, which seemed to indicate that it intends to encourage foreign debt. However, the introduction of minimum 3 years residual maturity requirement is a major dampener for FPIs and corporates. Though the aggregate limit for all corporate NCDs is USD 51 billion of which 90% is available on-tap basis, still a substantial portion is yet to be utilized. The Circulars and the Clarification do not augur well with the intention of the government to encourage debt.

– **Abhinav Harlalka, Deepak Jodhani & Ruchir Sinha**

You can direct your queries or comments to the authors

¹ <http://www.careratings.com/upload/NewsFiles/Studies/Indian%20Bond%20Market-%20Striking%20a%20Chord%20with%20Asian%20Peers.pdf>

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.