Regulatory Hotline

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A NEW ERA OF DEBT-RAISING! – RBI ANNOUNCES LIBERALIZED FRAMEWORK FOR RUPEE DENOMINATED OVERSEAS BORROWING

- Revised ECB framework a significant alternative to other forms of overseas borrowing.
- Larger pool of borrowers and investors permitted to participate in issuance of Rupee Bonds.
- All-in-cost is flexible, commensurate with prevailing market conditions.
- No end-use restrictions, except for a minimal negative list.

In a move that encourages India Inc. to consider overseas borrowing as an important source of debt funding, the Reserve Bank of India ("**RBI**") has liberalized the External Commercial Borrowings ("**ECB**") framework vide its circular dated September 29, 2015 ("**Revised Policy**"),[1] permitting Indian corporates to avail overseas rupee denominated debt ("**Rupee Bonds**") with extremely minimal restrictions. The key changes in the Revised Policy include a widened pool of investors and borrowers, a market determined all-in-cost ceiling instead of a fixed one, and very limited end-use restrictions. Considering the advantages of the Revised Policy (which is explained below), corporates in certain sectors may view issuance of Rupee Bonds as a significant substitute for raising overseas debt through other conventional means, i.e., issuance of listed non-convertible debentures ("**Listed NCDs**") to foreign portfolio investors and foreign currency denominated borrowing as per the existing ECB policy ("**Existing Policy**").

BACKGROUND

Under the Existing Policy, Indian body corporates are permitted to avail overseas foreign currency denominated debt under the automatic route upto certain limits. However, the extant policy prescribes stringent stipulations in order to obtain the afore-said overseas borrowing, including the following: (i) only companies (excluding financial intermediaries such as NBFCs), micro-finance institutions and non-governmental organization are permitted to obtain overseas borrowing; (ii) apart from international banks, multilateral financial institutions, foreign equity holders holding minimum of 25% equity shares and supplier of equipment, other entities are not permitted to lend under the Existing Policy; (iii) the borrowed funds carry strict end-use restrictions, and such funds generally cannot be utilized towards working capital and general corporate purposes; and (iv) a maximum all-in-cost ceiling is prescribed,[2] which generally restricts the total cost of borrowing to less than 8 – 10%. In 2014, RBI for the first time permitted a multilateral financial institution to issue rupee denominated dollar settled global bonds in 2014 and based on the demand for such rupee bonds, the RBI has decided to liberalize the legislative framework governing issuance of rupee bonds.

KEY CHANGES AND ANALYSIS

The key changes introduced by the Revised Policy and the comparative advantages of the Revised Policy vis-a-vis the Existing Policy/ Listed NCDs (wherever applicable) has been highlighted below:

- **Broader definition of 'eligible borrower':** The Revised Policy permits (under the automatic route) all body corporates, real estate investment trusts and infrastructure investment trusts to opt for issuance of Rupee Bonds, as against the limited entities permitted under the Existing Policy. Hence, this should provide Indian corporates a significant additional option of debt funding. Further, entities such as LLPs that cannot raise debt through issuance of Listed NCDs can now opt for issuance of Rupee Bonds. However, 'trusts' may not be able to take benefit of the Revised Policy since they cannot be categorized as 'body corporates'; as a result, entities such as Alternative Investment Funds set up as trusts will not be able to issue Rupee Bonds.

- **Larger group of 'investors':** Unlike the Existing Policy, the Revised Policy permits all kinds of investors who enter from an FATF compliant jurisdiction to invest in Rupee Bonds.[3] This expanded definition of 'investors' should assist Indian corporates in accessing a considerably larger pool of debt capital. This change also allows for a wider range of foreign investors to invest in Rupee Bonds without being regulated/ registered by an Indian regulator (eg: Mandatory FPI registration) and hence, non-FPI investors who would not be permitted to invest in Listed NCDs should find Rupee Bonds as a significant alternative. Further, innovative pooling structures should also be encouraged in light of there being no mandatory registration requirement for investors.

- **No fixed 'all-in-cost' ceiling:** In sharp contrast to the Existing Policy, the Revised Policy does not place any fixed cost restriction; instead, it mentions that the 'all-in-cost' ceiling should be commensurate with the prevailing market conditions. At a principle level, this change seems to indicate that RBI does not intend to exercise strict control on the amount coupon paid to overseas investors so long as market conditions justify such payment. However, since the term 'prevailing market conditions' does not have a fixed standard or range, this significant change seems slightly ambiguous. Admittedly, interest rates for domestic lending in India are determined based on numerous

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factors, including the nature of lending entities, business of the borrower entities etc. (for eg: typically, NBFCs lend at substantially higher rates when compared to commercial banks). Further, since there is no guidance on how to ascertain 'prevailing market conditions', whether the interest rates offered by a willing borrower can be considered as 'prevailing market condition' or should there by a market study conducted is unclear. Nonetheless, the spirit of this change seems to be positive and with a little more clarity, the intended objective should stand achieved.

- **Limited end-use restrictions:** In addition to the above, the Revised Policy does not carry forward the end-use restrictions placed under the Existing Policy. Instead, it permits eligible borrowers to utilize funds raised by issuance of Rupee Bonds for any purpose, except a small negative list of activities. The negative list includes the following:
  - Purchase of land, and undertaking real estate activities (other than for development of integrated township/ affordable housing projects). Since the term 'integrated township' is not defined, it should probably have the same meaning as under the Existing Policy[4] which requires a minimum of 100 acres to be developed; and
  - Investing in capital markets or for equity investment domestically. In our view, this provision does not seem to place a blanket restriction on investing in equity shares. Instead, the objective is to prohibit raising money through Rupee Bonds only for the purpose of investing in capital markets/ equity shares domestically. However, the government should clarify the scope of this provision.

  Nevertheless, this change comes as a major departure from the approach adopted by the government in the Existing Policy, which prescribes strict end-use restrictions in order to track the utilization of overseas debt. Further, the minimal end-use restrictions should also provide the much required flexibility for Indian borrowers to deploy funds raised through Rupee Bonds for working capital/ general corporate purposes.

- **Nature of Instrument, Maturity and Free Transferability:** The Revised Policy permits issuance of vanilla bonds, which may be either be privately placed or listed on stock exchanges. The likely objective is to facilitate increased trading of the rupee denominated debt instruments. Further, unlike the considerably onerous compliances (such as continuous disclosures, credit rating etc.) to be followed by a company issuing Listed NCDs, compliances to be undertaken by a company issuing privately placed Rupee Bonds should be very limited.

  Further, the Revised Policy states that the Rupee Bonds must have a 'minimum maturity' of 5 years, and any call or put option can be given effect only after 5 years. Interestingly, the term 'minimum maturity' is adopted in the Revised Policy, instead of 'minimum average maturity' which is used in the Existing Policy. The aforesaid wording seems to indicate that amortization/ part repayment of Rupee Bonds within 5 years of issuance would not be possible. As regards transferability of Rupee Bonds, it is also important to note that Rupee Bonds are freely transferable at any stage to any non-resident entity. This may again be a comparative advantage of Rupee Bonds as against Listed NCDs, since Listed NCDs which do not have a residual maturity of 3 years cannot be transferred to a non-resident entity.

- **Hedging permitted:** Overseas investors are also permitted to hedge their rupee exposure arising as a result of their lending. This should be an added advantage for investors to enter through the Rupee Bonds route with limited currency fluctuation risk.

- **Other provisions:** In addition to the above, all other provisions of the Existing Policy relating to security creation, parking of proceeds, conversion into equity etc. will be applicable to the Revised Policy as well. However, the requirement to undertake a currency swap has been done away with.

CONCLUSION AND RECOMMENDATIONS

The Revised Policy certainly seems to be a step in the right direction, which should usher a new era of raising debt by Indian corporates. In fact, in light of the comparative advantages between Rupee Bonds vis-a-vis Listed NCDs/ Existing Policy, the Revised Policy seems to thrown open a completely new avenue of debt funding for Indian corporates. The Revised Policy also facilitates a new pool of borrowers, i.e., start-ups, to raise overseas debt in a hassle free manner. However, in order for the Revised Policy to achieve its intended objective, a few aspects (mentioned below) either require clarity or need to be realigned with the objective:

1. First, while the end-use restrictions have been substantially relaxed, it is not clear as to why borrowers from sectors such as real estate are not permitted to issue Rupee Bonds, especially when such borrowers are permitted to raise debt through issuance of Listed NCDs under the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("**TISPRO Regulations**"). Further, as mentioned above, there should be clarity on the restriction from investing in equity shares domestically. Net-net, the government should ensure that end-use restrictions for Rupee Bonds are very minimal and akin to those restrictions prescribed under the TISPRO Regulations.
2. Second, as mentioned above, the Revised Policy provides for a 'minimum maturity' period 5 years. As a result, the flexibility to partly redeem/ repay the Rupee Bonds within 5 years of issuance has been taken away. Hence, it may be appropriate to clarify the wording of the Revised Policy to state that the term 'minimum maturity' should include 'minimum average maturity' in case of amortizing bonds. Further, the Revised Policy also prohibits exercise of any call/ put options during the 5 maturity year period. While such restriction is understandable in case of put options, the borrower should be allowed to have a 'call' option on such Rupee Bonds allowing it to repay/ redeem the Rupee Bonds prior to completion of maturity in order to mitigate excessive interest outflow.
3. Third, in order to afford more clarity, it would be helpful if a process is set-out for assisting the borrowers/ investors to ascertain whether a proposed coupon payment is in line with 'prevailing market conditions' or not.
4. Lastly, since there is no concessional tax withholding rate for Rupee Bonds in general, withholding at the rate of 40% or such other lower rate as per the tax treaty should be applicable. Hence, investors may have to enter from certain specific jurisdictions (Eg: Singapore) in order to obtain the benefit of lower tax withholding which the relevant tax treaty may provide. However, in order to incentivize investment in Rupee Bonds, it would be meaningful if the government introduces a lower withholding rate for payments on Rupee Bonds.

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– Shreyas Bhushan, Ruchir Sinha & Vaibhav Parikh
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[1] Please refer https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10049&Mode=0.

[2] The all-in-cost ceiling cannot exceed 5% more than the six-month LIBOR rate.

[3] Please visit the following website to identify the list of FATF compliant countries

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