Masala bonds - A taste of things to come?

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Background

Borrowing by Indian companies from the overseas market or 'External Commercial Borrowings' (commonly referred to as ECBS), is regulated by the Reserve Bank of India (RBI) and is governed by the various rules specified by the RBI.

Until recently, the ability of Indian companies to borrow from the overseas markets was predominantly limited to foreign currencies.

The Reserve Bank of India issued its A.P. (DIR Series) Circular No.17 on 29 September 2015 (the 'Rupee Bond Guidelines') which allowed Indian companies to raise funding through the issuance of Rupee-denominated debt instruments – which are now widely referred to as ‘Masala Bonds’.

The Rupee Bond Guidelines have increased the ability of Indian issuers to access the international debt capital markets and thereby have potentially opened up another avenue for Indian issuers to seek competitively priced funding from the international markets. Similarly, the Rupee Bonds Guidelines have allowed foreign fixed income investors with the first real opportunity to have exposure to the Indian Rupee, which has been enjoying a lower volatility lately compared to other Asian currencies.

Some of the key features of Masala Bonds

Issuers

The Rupee Bond Guidelines allows a greater universe of issuers to issue Masala Bonds. In addition to companies (as was the case), any ‘body corporate’, non-bank financial company, real estate investment trust and infrastructure investment trust which is subject to the regulatory oversight of the Securities and Exchange Board of India is also eligible to issue Masala Bonds.

Use of proceeds

The proceeds of a Masala Bond issue can be utilised by the issuer for all purposes except for:

- real estate activities (including acquisition of land) except development of integrated townships or affordable housing projects
- investment in capital markets (including domestic Indian equity investments)
- activities otherwise prohibited under the existing ‘foreign direct investment’ regulatory framework, and
- on-lending to other entities for the purposes of any of the preceding restricted uses.
**Issuer and investors**

Masala Bonds can only be issued in a jurisdiction which is a Financial Action Task Force (FATF) Compliant Centre, and only investors from a FATF-compliant jurisdiction are eligible to invest in accordance with the Rupee Bond Guidelines. They should also be 'plain vanilla bonds'. What does not constitute 'plain vanilla bonds' is not clear at present, as the term is not defined in the Rupee Bond Guidelines.

**Pricing parameters**

The Rupee Bond Guidelines prescribe a minimum maturity of three years with prepayment (whether voluntary or mandatory) possible only after the three years from the date of issuance. Masala Bonds can only be issued in a maximum size of US$750 million. Any increase in the issue size beyond US$750 million will require the prior approval of the RBI. In relation to the pricing of Masala Bonds the Rupee Bond Guidelines provides that the 'all-in costs' of an issuance should be commensurate to the 'prevailing market conditions'. There is a lack of clarity as to what this means. In any event, it is expected that once a market develops for Masala Bonds, the RBI may revisit this all-in cost ceiling.

In addition to the all-in cost ceiling, the rate of conversion that will apply between the Indian Rupee and the foreign currency in which the Masala Bond will settle and trade will be the prevailing rate at the time any payment is being made on the bonds – thereby shifting the currency risk onto the investors. This feature will have consequences on pricing as investors will want to factor a currency volatility into the price of Masala Bonds.

Consistent with the tax treatment of bonds issued by Indian issuers, a withholding tax of 5% is exigible on interest income.

**Outlook**

The publication of the Rupee Bonds Guidelines certainly provides an avenue for a vast variety of issuers to raise capital from the international debt markets. Provided that the cost of borrower onshore is higher that the pricing of the Masala Bonds, it would certainly be of interest to Indian companies who wish to raise financing at a lower cost. Equally, given the relatively high cost of borrowing onshore in India, especially for smaller mid-cap companies, there is the expectation that even an aggressively priced bond may appear palatable to both investors and issuer alike. There is also the need for fund raising to address India’s infrastructure needs, which Masala Bonds may address if a robust market develops for these bonds. Also for Indian non-bank finance companies, funding remains a main weakness, given the regulatory restrictions which limit their ability to accept deposits. It is expected that these NBFCs may look towards the international debt capital markets to address this funding requirement.

To conclude, the advent of Masala Bonds may herald a new phase in investor appetite to participate in one of the world’s fastest growing economies.

**Indian Rupee Bonds on the Main Market of the London Stock Exchange**

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Issue Date</th>
<th>Size</th>
<th>Tenor</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFC 7.1% 21/03/2031</td>
<td>21-Mar-16</td>
<td>£20.9m</td>
<td>15 yrs</td>
</tr>
<tr>
<td>EBRD 6.4% 03/04/2016</td>
<td>04-Mar-16</td>
<td>£52.5m</td>
<td>3 yrs</td>
</tr>
<tr>
<td>IFC 6.45% 30/10/2018</td>
<td>10-Aug-15</td>
<td>£30.8m</td>
<td>5 yrs</td>
</tr>
<tr>
<td>EBRD 5.1% 02/02/17</td>
<td>24-Jun-15</td>
<td>£18.9m</td>
<td>1 yr</td>
</tr>
<tr>
<td>IFC 6.45% 30/10/2018</td>
<td>30-Apr-15</td>
<td>£164m</td>
<td>3.5 yrs</td>
</tr>
<tr>
<td>EBRD 5.1% 02/02/17</td>
<td>02-Feb-15</td>
<td>£33.7m</td>
<td>2 yrs</td>
</tr>
<tr>
<td>IFC 6.3% 25/11/24</td>
<td>18-Nov-14</td>
<td>£103.5m</td>
<td>10 yrs</td>
</tr>
<tr>
<td>EBRD 5.625% 15/03/17</td>
<td>28-Oct-14</td>
<td>£33.3m</td>
<td>2.4 yrs</td>
</tr>
<tr>
<td>EBRD 5.75% 19/03/18</td>
<td>19-Sep-14</td>
<td>£15.3m</td>
<td>3.5 yrs</td>
</tr>
<tr>
<td>IDB 6% 05/09/17</td>
<td>05-Sep-14</td>
<td>£78m</td>
<td>3 yrs</td>
</tr>
</tbody>
</table>
IDB 6.1% 02/09/16 02-Sep-14 £40.2m 2 yrs
IDB 8.25% 15/05/17 15-May-07 £18.4m 10 yrs

Disclaimer: Please note that Indian regulations do not permit foreign law firms to advise on Indian law. This article is based on our discussions with Indian counsel, our understanding of Indian regulations, and our experience of working on Indian-related transactions.

1 The Rupee Bond guidelines for the purposes of this article also include the update to the Rupee Bond Guidelines issued by the RBI on 13 April 2016
2 The Companies Act 2013 includes a cooperative society within the definition of ‘body corporate’
3 Source: London Stock Exchange Factsheet on Indian Rupee Bonds

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