Masala Bonds

1. Background

1.1. Newspaper reports have indicated that Indian companies have raised about ₹.6000 crore through Masala Bonds during the last one year. It may be recalled that the International Finance Corporation (IFC), the investment arm of the World Bank, in November 2014, issued a ₹1,000 crore bond to fund infrastructure projects in India. These bonds were listed on the London Stock Exchange (LSE). IFC then named them Masala Bonds to give an Indian identity[1].

1.2. During the Prime Minister’s visit to the UK in November 2015, organisations such as Housing Development Finance Corp., Yes Bank, and the Railways had announced they were going to raise funds through Masala Bonds from the London market. Ratings agency S&P expected that the issuance of Masala Bonds would touch US $5 billion annually over the next two to three years.

2. What are Masala Bonds?

2.1. Bonds are instruments of debt - typically used by corporates to raise money from investors. Masala Bonds are the rupee-denominated bonds issued to overseas buyers for raising money by the Indian corporates. The price of the bond is denominated in Indian currency. However, at issuance of Masala Bonds, investors pay USD amount equivalent to INR principal determined at the market exchange rate on the date of transactions undertaken for issue and servicing of the bonds. Exchange rate is fixed on T-2 based on RBI reference exchange rate. At coupon and on maturity, issuers pay INR amount which is converted to USD for the investors by the Authorised Dealer. Exchange rate applied again is the market rate on the date of settlement and is fixed on T-2 based on RBI reference exchange rate. Coupon amount is paid as a percentage of INR principal at issuance.

2.2. Earlier, for raising money from abroad, Indian corporates relied on avenues such as external commercial borrowings (ECBs). The challenge with arrangements like ECBs is that corporates have to bear the burden of currency risks. As against this, in Masala Bonds, the currency risks have to be borne by the investors. For example, a corporate could issue ₹.10 billion worth of Masala Bonds with the promise of paying back ₹.11 billion in one year. The investors will lend the dollar equivalent of the ₹.10 billion. After one year, the Indian corporate needs to pay back the dollar equivalent of ₹.11 billion. As against this, in the case of ECBs,

[1] *Bonds have earlier been named similarly. For example, IFC's Chinese yuan-denominated Dim-sum bonds or bonds issued by others like Yankee bonds (issued by a foreign entity in the US), Bulldog bonds (sterling bonds issued by foreign borrowers in the UK market), Samurai Bonds (Japanese yen denominated bonds issued in Japan by non-Japanese companies)*

the issuer had to pay interest and principal repayments in US dollars (Refer ***Annex Table 1*** for difference between Masala Bonds and ECBs).

3. Masala Bond Regulations

3.1. The Reserve Bank of India issued guidelines on September 29, 2015 allowing Indian companies, non-banking finance companies (HDFC, India Bulls Housing Finance are examples of such companies) and infrastructure investment trusts and real investment trusts (investment vehicles that pool money from various investors and invest in infrastructure and real estate sectors) to issue rupee-denominated bond overseas. Accordingly,

- any corporate or body corporate is eligible to issue Rupee denominated bonds overseas. Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) coming under the regulatory jurisdiction of the Securities and Exchange Board of India are also eligible.

- Only plain vanilla bonds would be issued in a Financial Action Task Force (FATF) compliant financial centres; either placed privately or listed on exchanges as per host country regulations, (Refer ***Annexure Table 2*** for FATF Compliant Countries).

- Any investor from a FATF compliant jurisdiction would be eligible to invest. Initially it was regulated that Banks incorporated in India would not have access to these bonds in any manner whatsoever, but can act as arranger and underwriter. In case of underwriting, holding of Indian banks cannot be more than 5 per cent of the issue size after 6 months of issue. Further, such holding shall be subject to applicable prudential norms. However, in a recently announced measures on August 25, 2016 RBI has permitted Indian banks also to raise Masala Bonds.

- Minimum maturity period would be 5 years. The call and put option, if any, shall not be exercisable prior to completion of minimum maturity. Later in April 2016, in a circular RBI has decided to reduce the minimum maturity period for Masala Bonds to 3 years in order to align with the maturity prescription regarding foreign investment in corporate bonds through the foreign portfolio investment route.

- The all-in-cost[2] of Masala Bonds should be commensurate with prevailing market conditions. This will be subject to review based on the experience gained.

- The bond proceeds can be used for all purposes except for the following:

  a) Real estate activities other than for development of integrated township / affordable housing projects;
  b) Investing in capital market and using the proceeds for equity investment domestically;
  c) Activities prohibited as per the foreign direct investment (FDI) guidelines;
  d) On-lending to other entities for any of the above objectives; and

[2] *All-in cost refers to every cost involved in a financial transaction, that includes total fees and interest involved in a financial transaction.*

e) Purchase of land.

- Under the automatic route the amount will be equivalent of USD 750 million per annum. Cases beyond this limit will require prior approval of the Reserve Bank.

- The foreign currency - Rupee conversion will be at the market rate on the date of settlement for the purpose of transactions undertaken for issue and servicing of the bonds.

- The overseas investors will be eligible to hedge their exposure in Rupee through permitted derivative products with AD Category - I banks in India. The investors can also access the domestic market through branches / subsidiaries of Indian banks abroad or branches of foreign bank with Indian presence on a back to back basis.

- The leverage ratio for the borrowing by financial institutions will be as per the prudential norms, if any, prescribed by the sectoral regulator concerned.

3.2 Ministry of Finance of India has specified the withholding tax (a tax deducted at source on residents outside the country) on interest income of Masala Bonds at 5 per cent (reduced from 20 per cent to make it attractive for investors)[3]. Also, capital gains from rupee appreciation are exempted from tax.

4 Benefits of Masala Bonds

a) Masala Bonds can help Indian companies to diversify their bond portfolio in addition to corporate bonds and ECBs.
b) Masala Bonds can help Indian companies to cut down cost. If the company issues any bond in India, it carries an interest rate of 7.5%-9.00% whereas, Masala Bonds outside India is issued below 7.00% interest rate.
c) Masala Bonds can help the Indian companies to tap a large number of investors as these bonds are issued in the offshore market.
d) Masala Bonds will help in building up foreign investors' confidence in Indian economy and currency which will strengthen the foreign investments in the country.
e) An offshore investor earns better returns by investing in Masala Bonds rather than by investing in his home country, because the bond yield in his/her home country may be very low (for example bond yield in the US is hardly 2% as against minimum assured Masala Bond yield of 5% to 7%). The investor will also potentially benefit if the rupee appreciates at the time of maturity, but may lose if rupee depreciates.
f) Masala bond will make available more of foreign funds for infrastructural development in India.
g) Masala Bonds will also help enhancing internationalisation of Indian Rupee.

[3] http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/404/Press-Release-Off-shore-Rupee-Denominated-Bonds-29-10-2015.pdf

Annexure Table 1: Differences between ECB and Masala Bonds

	ECB	Masala Bonds
Tenor	• Track I : Upto 50 mn USD: 3 years or more • Trace II: More than 50 mn USD: 5 years or more • Track II: 10 years or more	• Minimum maturity of five years (reduced to 3 years since April 2016) • Call/Put option cannot be exercised prior to minimum maturity
Pricing	• Track I: 3-5 Years: L + 300 bps / More than 5 years: L +450bps • Track II: Maximum L +500bps • Track III: In line with market conditions	• No pricing restrictions. All-in cost should be commensurate with prevailing market conditions
End-use	• End-use restrictions as per RBI guidelines for Tracks I, Track II and Track III	• No end-use restrictions except for a negative list, i.e., real estate including purchase of land, on-lending, stock market operations, FDI prohibited activities
Listing	• No listing requirement for loans	• Can be both listed/unlisted
Quantum	• For all tracks: Upto $750m: Corporates in Infrastructure and Manufacturing Sector / Upto $200m: Software sector / Upto $100m: Micro Finance Entities / Upto $500m: Remaining Entities	• Under automatic route, maximum amount permissible is US$750mn per annum per corporate • For amounts greater than US$750mm, RBI approval is required
Documentation	• Loan agreement between borrower and lender, RBI approval not required. LRN required before drawdown of ECB • Reg S / Reg S 144A documentation applicable for bonds and LRN required	• Reg S / Reg S 144A documentation applicable for bonds and LRN required • Simpler documentation in case of private placement
Hedging	• FCY ECBs - borrower has to hedge onshore • INR ECBs - lender can hedge either onshore or offshore	• Investors can hedge INR exposure with banks both onshore and offshore
Withholding tax	• WHT of 5% on loans issued before April 2017	• WHT of 5%
Regulatory requirement	• Reporting requirements (e.g., LRN), parking of proceeds, etc., as applicable under RBI guidelines	• Reporting requirements (e.g., LRN), parking of proceeds, etc., as applicable under ECB guidelines will continue to apply

Annexure Table 2: FATF Compliant Countries			
Argentina	Finland	Japan	Singapore
Australia	France	Korea	South Africa
Austria	Germany	Luxembourg	Spain
Belgium	Greece	Mexico	Sweden
Brazil	Hong Kong (China)	Netherlands	Switzerland
Canada	Iceland	New Zealand	Turkey
China	India	Norway	United Kingdom
Denmark	Ireland	Portugal	United States