

Masala Bonds:

Regulatory, Structuring and Execution Considerations

JOLO.

C L I F F O R D C H A N C E

Introduction

The issue of A.P. (DIR Series) Circular No.17¹ by the Reserve Bank of India (the "**RBI**"), increasingly referred to as the "Rupee Bond Guidelines", has paved the way for Indian issuers to quickly and efficiently issue Indian Rupee-denominated bonds in the international debt capital markets pursuant to the RBI's overarching Master Circular on External Commercial Borrowings and Trade Credits (the "**ECB Guidelines**"), together with the External Commercial Borrowing Policy – Revised Framework dated 30 November 2015 (the "**Revised ECB Framework**"), without prior approval from the RBI.²

The Rupee Bond Guidelines have relaxed a number of the requirements for Indian credits to access foreign funding and, in the process, have opened up a potentially flexible form of funding for Indian companies through the issuance of so-called 'Masala bonds', which are bonds denominated in Indian Rupees but settled in a foreign currency (for example, U.S. dollars).³ This synthetic settlement feature of Masala bonds will mean that issuers will enjoy the benefits of raising capital in their home currency, with currency fluctuation risk shifting to investors, while at the same giving them an opportunity to tap an international investor base. Similarly, the Rupee Bond Guidelines present foreign fixed income investors with the first real opportunity to gain portfolio exposure to the Indian Rupee – a currency that has enjoyed significantly lower implied volatility compared to its Asian peers and other emerging market currencies in the wake of the RBI's inflation targeting policies.⁴

This document seeks to examine some of the regulatory considerations arising from the Rupee Bond Guidelines that need to be taken into account in the structuring of a Masala bond offering, as well as certain issues that may arise in bringing a Masala bond to the international debt capital markets successfully.



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The Regulations

The Rupee Bond Guidelines are set out in the Annex to the RBI circular⁵ and provide a framework for the issuance of Masala bonds by setting out certain parameters that must be complied with in order for Masala bonds to be validly issued under the so-called 'automatic route' (i.e. without prior approval from the RBI).6 Working closely with Indian and international counsel early in the execution process in order to identify the manner in which these parameters are likely to influence the structure, execution, marketing and distribution of a Masala bond should play a significant role in the ultimate success of an offering.

Based on discussions with market participants and Indian counsel active in the debt capital markets in India, set out below is a brief summary of our understanding of certain features of these parameters.

Which issuers are eligible and what can the proceeds be used for?

The Rupee Bond Guidelines have expanded the universe of potential issuers, with any corporate or body corporate being eligible to issue Rupee-denominated bonds overseas, and specifically includes real estate investment trusts (or **"REITs**") and infrastructure investment trusts (or **"InvITs**") that are subject to the regulatory jurisdiction of the Securities and Exchange Board of India.⁷

While the revised ECB Guidelines published on 30 November 2015 appear to liberalise the restrictions on the "end-uses" (or use of proceeds) of external commercial borrowings denominated in foreign currencies, the restrictions on the "end-uses" of Masala bonds still appear to be comparatively less restrictive. Our understanding is that Masala bond proceeds can be used for all purposes except real estate activities (other than for the development of integrated townships and/or affordable housing projects); investing in capital markets and using the proceeds for domestic Indian equity investment; activities otherwise prohibited under the existing Indian Foreign Direct Investment (or "FDI") guidelines; on-lending to other entities for any of the preceding restricted uses and the purchase of land. Such broader end-use requirements could mean that raising capital through a Masala bond issue becomes a legitimate and flexible source of funding for general corporate purposes, refinancing existing Indian Rupee debt and financing working capital requirements. In addition, the Revised ECB Framework has liberalised the restrictions on the enduse of external commercial borrowings in a similar manner. We believe that this liberalisation of the end-use restrictions for external commercial borrowings generally, and for Masala bonds in particular, will be a fundamental and favourable consideration for potential issuers of Masala bonds.

What types of bonds may be issued?

Only "plain vanilla bonds", issued in a Financial Action Task Force ("**FATF**") compliant financial centre, are eligible for issuance under the Rupee Bond Guidelines.⁸

The term "plain vanilla bonds" is not defined in either the ECB Guidelines or the Rupee Bond Guidelines, and we understand from market participants and Indian counsel that no other specific clarification or direction is available at this time as to what may constitute "plain vanilla bonds", but it would appear that typical senior unsecured or secured⁹ and fixed or floating rate notes will constitute "plain vanilla bonds" for the purposes of the Rupee Bond Guidelines.

Further, the specific parameter on leverage¹⁰ would suggest that the issuance of Masala bonds by Indian financial institutions (such as non-bank financial companies, or "**NBFCs**") and banks is permitted, provided they remain in compliance with Indian prudential norms and regulations.

What pricing parameters apply?

In order to qualify under the Rupee Bond Guidelines, a Masala bond will need to meet the following essential pricing parameters:

- A minimum maturity of five (5) years¹¹ – this is in contrast to the "average maturity requirement" under the ECB Guidelines, which has the effect of limiting the redemption features of a Masala bond to bullet redemption. In addition, the Rupee Bond Guidelines explicitly exclude put and call options exercisable prior to the initial five year period, which may have significant implications in relation to any future change in tax treatment of Masala bonds (see "Withholding tax treatment", below).
- A maximum principal amount of US\$750 million¹² to qualify for automatic issuance – any amount in excess of US\$750 million will be subject to prior RBI approval.

A major feature of the Rupee Bond Guidelines, compared with the ECB Guidelines under which Indian issuers currently access international debt funding, is the effective removal of the all-in cost ceiling,¹³ which is to be welcomed as it is likely to open the international debt markets to a wider range of smaller Indian 'mid-cap' and SME issuers. The all-in cost of borrowing through the issuance of Masala bonds must be commensurate with prevailing market conditions (in the same way as any other international bond issue). However, the Rupee Bond Guidelines do also indicate that the all-in cost requirement "will be subject to review based on experience gained", which would suggest that, dependent on the success of the first few Masala bond offerings, the RBI may revisit the imposition of an all-in cost ceiling in the future, once the Masala bond market achieves some degree of critical mass. While not a major concern in the short-term, this is an issue to be considered in light of the longer-term growth of the Masala bond market: current market speculation indicates that the cost of capital attending Masala bonds is likely to be higher than what could be achieved in the domestic Indian Rupee market, given that investors are likely to "price-in" the currency risks they will bear given the inherent exposure to the Rupee attaching to Masala bonds (and given that the currency conversion rate needs to be fixed on issuance, with a minimum maturity of five years - see below). Accordingly, if the Indian Rupee depreciates in future, economic policy considerations prevailing at the time may force the RBI to review the imposition of allin cost ceilings for Masala bonds on the basis of "experience gained". The Revised ECB Framework is indicative of how this may evolve: under the new framework, the all-incost ceiling for external commercial borrowings with a shorter maturity has been reduced, which we believe indicates a less-favourable policy view being taken by regulators for such types of borrowings.

Similar to the all-in cost parameter, the rate of conversion that will apply as between the Indian Rupee and the foreign currency in which the Masala bonds will settle and trade will be the market rate on the date of settlement "for the purpose of transactions undertaken for issue and servicing of the bonds".14 While this is a similarly positive development (in the context of making the currency conversion rate subject to market forces), it is clear that investors will be locked into a fixed conversion rate for the life of the bonds, meaning that they will bear currency risk to the Indian Rupee over a minimum period of five years. While this may prove to be attractive to currency speculators, as mentioned above, the fixed rate of conversion is very likely to lead to potentially significant pricing consequences as investors price this risk into their initial investment.

Marketing and distribution restrictions based on FATF status

Masala bonds can only be issued in a FATF compliant financial centre, and only investors from FATF compliant jurisdictions¹⁵ are "recognised investors" for the purposes of the Rupee Bond Guidelines.¹⁶

In the primary market, this requirement is likely to be met by ensuring that all marketing material (in particular, the offering document by which the Masala bonds are offered), and the distribution thereof by the issuer's investment banking advisors, is sufficiently "legended" and restricted only to FATFcompliant jurisdictions. However, how this can effectively be policed in the secondary market remains to be seen





(though, at a minimum, sufficient risk disclosure as to potential restrictions on trading in the secondary market for the Masala bonds should be included in the offering document). Nevertheless, given that the majority of likely investors are based in FATF-member countries, this is perhaps a risk that is of less significant practical importance.

Withholding tax treatment

An important point which the Rupee Bond Guidelines does not address, but which remains of significant interest to potential offshore investors, is the treatment of Masala bonds for withholding tax and capital gains tax purposes. To this end, the Indian Ministry of Finance (the "MoF") issued a press release on 29 October 2015, pursuant to which it has indicated an intention to provide concessional tax treatment for income and capital gains arising from Masala bonds held by foreign investors. As such, and similar to current bond issues by Indian issuers under the ECB Guidelines, we understand that a withholding tax rate of 5 per cent (compared to the usually applicable 20 per cent rate) should be applied to interest income, and a capital gains tax exemption would be available in respect of any appreciation of the rupee between the date of the issue of Masala bonds and the date of their redemption. We further understand that this tax treatment of Masala bonds will need to be finalised by way of amendments to India's existing income tax legislation, but it is not yet clear when this will take place.

Assuming that the legislative amendments to India's tax regime will reflect the reduced rate of withholding tax for Masala bonds set out in the MoF's press release, the following important factors will need to be carefully considered in the structuring,

marketing and distribution of a Masala bond offering:

- We understand that the 5 per cent. rate of withholding tax is subject to expiration, under a statutory "sunset provision", on 30 June 2017. If not extended thereafter, and in light of the fact that the minimum maturity of Masala bonds is five years, there is some uncertainty as to the future tax treatment of Masala bonds.
- Although any changes in the tax regime in India are likely to be made subject to a typical 'eurobondstyle' tax gross-up condition in the terms and conditions of the Masala bonds, issuers will not be able to include the usual call option allowing them to redeem the bonds for taxation reasons prior to the expiry of the stipulated five year minimum maturity period (see "What pricing parameters apply?" above), meaning that issuers will bear the risk of a change in tax treatment for the duration of the tenor of their Masala bonds.

The issues identified above, in addition to other tax considerations that may apply, make it essential to ensure that Indian tax counsel are retained to advise issuers and their investment banking advisers on the application of Indian tax law both during the initial execution and documentation stage, as well as in respect of the tax consequences that may apply over the duration of the Masala bonds. Equally, investors in Masala bonds should ensure that they seek appropriate advice from Indian tax counsel in assessing the financial implications of prevailing Indian tax laws on their investment in Masala bonds, both in the primary and secondary markets.



Documentation and Execution

It is important to bear in mind that, owing to prevailing capital and currency controls in India, Masala bonds are effectively Indian Rupee-linked notes and, as such, will not settle and clear in Indian Rupees, but in other international currencies. Accordingly, it is anticipated that Masala bonds will be marketed and distributed to an offshore investor base (i.e. outside of India), and therefore remain subject to the same execution process in relation to documentation and due diligence as other "G3" currency bond offerings made under the ECB Guidelines by Indian issuers.¹⁷ In addition, the governing law of Masala bond documentation is likely to be driven by the same factors prevailing in the Eurobond markets, with English law likely to be the law of choice for investors in the Regulation S-only market, and New York state law for offerings aimed at a high yield investor base in the United States. Similarly in alternative currency markets, for example, Singapore, Singapore law is likely to remain the governing law for Singapore dollar-denominated Masala bond offerings.

However, there are additional considerations that will apply to Masala bonds, depending on how they are intended to settle and where the issuer intends to list the bonds.

Payment and settlement mechanics

In order to achieve the link between the Indian Rupee denomination of a Masala bond and the currency in which it will settle and clear, specific provisions will need to be included in the payment conditions of the bonds and agency agreement (in the case of Masala bonds constituted by a trust deed under English or Singapore law), or the description of notes and indenture (in the case of Masala bonds constituted by an indenture under New York state law).

The payment clauses in the Masala bond documentation would, in essence, need to provide:

- that all amounts due under the Masala bonds and the trust deed or indenture are expressed to be payable in a defined "settlement amount";
- for the "settlement amount" to be defined as the Indian Rupee amount converted into the settlement currency (for example, U.S. dollars) using a defined and agreed spot rate on a specific rate calculation date;
- for the spot rate to be expressed to be a rate reflecting the amount of Indian Rupees per one unit of the settlement currency, as reported by the central bank controlling that currency and reflected on a financial news service screen (such as Bloomberg or Reuters) at a specified time on the rate calculation date (which, in turn, would need to be a day on which investment banks in the financial centres of the settlement currency are open for business, at least one or two days prior to the due date for payment under the Masala bonds); and
- for appropriate "fallback" provisions for the calculation of the spot rate (such as by reference to a defined set of foreign exchange dealers, or an independent investment bank) where the financial news service screen is not available

at the specified time on the rate calculation date.

It is likely that, in addition to the usual paying agents, the issuer of Masala bonds would need to appoint a calculation agent in order to undertake and perform the calculations required for the conversion and payment mechanics summarised above.

In addition, Masala bonds will need to be expressed to be in minimum denominations of a given amount of Indian Rupees (and integral multiples thereof), and in such amounts as to ensure that the bonds fall within the relevant wholesale exemptions in the markets in which they are initially distributed and sold. Furthermore, given than the bonds are settled in foreign currencies, the rules and procedures of the relevant settlement systems (for example, the Depository Trust Company in New York, Clearstream Banking S.A. and Euroclear S.A./N.V. in Europe and the Central Depository (Pte) Limited in Singapore) will need to be taken into account when formulating the relevant denomination and payment provisions of the Masala bond conditions.

Listing considerations

There are no particular additional issues or considerations that arise or need to be taken into account when listing Masala bonds on The Singapore Exchange Securities Trading Limited (the **"SGX**") or The Stock Exchange of Hong Kong Limited (the **"HKEx**").

However, to the extent Indian issuers seek to access European Union investors by listing Masala bonds on stock exchanges in Europe, the following considerations will apply:

Which market?

European Union stock exchanges are either regulated markets for the purposes of the Markets in Financial Instruments Directive¹⁸, or markets that are subject to being regulated by the rules of the exchanges on which they list.

For example, the Main Market of the London Stock Exchange is an EU regulated market, and is subject to regulation under the Prospectus Directive,¹⁹ Prospectus Regulation²⁰ and Transparency Directive²¹ at the EU level, and the Financial Services and Markets Act 2000 and the Financial Conduct Authority's (the "FCA") Listing Rules and Prospectus Rules (which give national effect to the EU level legislation) at the national level in the United Kingdom. The exchange regulated market in the United Kingdom is the Professional Securities Market (the "PSM"), and is subject only to the FCA's Listing Rules and the London Stock Exchange's Admission and Disclosure Standards.

Accordingly, listing bonds on the PSM is subject to compliance with fewer EU and United Kingdom laws and regulations than a listing on the Main Market, even though the latter market provides an arguably higher profile for issuers. As bonds are traded in the over-the-counter market, issues of secondary market liquidity are not a factor to be considered in choosing the market for listing.

Financial statement requirements

A fundamental distinction between EU regulated markets and exchange regulated markets lies in the requirements relating to financial information disclosure.

As a general matter, for non-EU issuers seeking a Main Market listing of debt securities (such as Indian issuers seeking a listing of Masala bonds), historical financial statements must be prepared in accordance with International Financial Reporting Standards ("IFRS") or an equivalent third country GAAP, which currently includes Indian GAAP until 31 March 2016. However, this transitional relief from the requirement to produce financial statements under IFRS for Indian issuers expires on 31 March 2016 and, if a Main Market listing is sought thereafter, an issuer of Masala bonds would need to consider restating its Indian GAAP financials in accordance with IFRS or providing a narrative difference between IFRS and Indian GAAP, all of which may have unfeasible cost and timing consequences in

the context of the transaction in question.

Unlike the Main Market, there are no specific requirements to include in the offering document financial statements prepared in accordance with IFRS, or a narrative summary of differences between local GAAP and IFRS, if listing is sought on the PSM. As such, an issuer of Masala bonds is free to include financial statements under Indian GAAP, provided that – as with the Main Market requirements – two years of historical financial information is included.²²

In summary, the Rupee Bond Guidelines provide a long-anticipated framework for Indian issuers to access the international debt capital markets, and for international investors to gain portfolio exposure to the Indian Rupee (as one of the more stable domestic Asian currencies). While some uncertainty might prevail, at this nascent stage of the development of the Masala bond market, as to how the regulations will ultimately be interpreted and applied in future, there appears to be a sufficient degree of clarity and confidence to allow Indian issuers to come to market with "plain vanilla bond" offerings in the near term.

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References

- ¹ RBI/2015-16/193, issued on 29 September 2015 pursuant to Sections 10(4) and 11(1) of the Indian Foreign Exchange Management Act, 1999 (42 of 1999).
- ² The ECB Guidelines are set out in A.P. (DIR Series) Circular No. 5 dated August 1, 2005 which contain the basic framework under which eligible resident entities in India can raise External Commercial Borrowings pursuant to the Indian Foreign Exchange Management Act, 1999 (42 of 1999). These guidelines have been revised from time to time, having regard to macroeconomic developments and the Reserve Bank of India's prevailing economic policies, and serve as a framework to attract foreign capital into India within the boundaries of India's capital account management policies. The ECB Guidelines were most recently revised on 30 November 2015 pursuant to the revised ECB framework in order to allow for three different "tracks" for the raising of ECB dependent on the maturity of the debt.
- ³ This as contrasted with 'Maharaja bonds', which are both denominated and settled in Indian Rupees.
- ⁴ Bloomberg.com
- ⁵ The full text of the Rupee Bond Guidelines can be accessed at <u>https://rbidocs.rbi.org.in/rdocs/notification/PDFs/APDIR17F3216FECE3F0441C8E1107F5E2BA1927.PDF</u>
- ⁶ These parameters are set out in the Annex to the Rupee Bond Guidelines.
- ⁷ Rupee Bond Guidelines Annex 2, Sr. No.1.
- ⁸ Rupee Bond Guidelines Annex 2, Sr. No.2.
- ⁹ In the case of secured bonds, provided that any charge over movable or immovable assets granted in favour of the trustee for bondholders otherwise complies with Indian law (i.e. through obtaining a "no objection" certificate from the issuer's Authorised Dealer Bank).
- ¹⁰ Rupee Bond Guidelines Annex 2, Sr. No.10.
- ¹¹ Rupee Bond Guidelines Annex 2, Sr. No. 4.
- ¹² Rupee Bond Guidelines Annex 2, Sr. No. 7.
- ¹³ The all-in cost ceiling under the ECB Guidelines means that the interest rate and costs of external commercial borrowings (such as a bond or loan) to an issuer or borrower cannot exceed certain ceilings: for track 1 external commercial borrowings with an average maturity of three to five years, the all-in cost ceiling is 6-month LIBOR +350 basis points, and for external commercial borrowings with an average maturity in excess of five years, the all-in cost ceiling is 6-month LIBOR +450 basis points or the applicable benchmark for the relevant currency.
- ¹⁴ Rupee Bond Guidelines Annex 2, Sr. No.8.
- ¹⁵ Which include the United Kingdom, the United States, Singapore, Hong Kong, France, Germany and Japan.
- ¹⁶ Rupee Bond Guidelines Annex 2, Sr. No.3.
- ¹⁷ It is worth noting that the Rupee Bond Guidelines specifically prohibit "banks incorporated in India" from having any "access to these bonds in any manner whatsoever". While Indian banks may act as arrangers and underwriters, where they do underwrite an offering of Masala bonds, their holdings cannot exceed 5 per cent. of the issue size after six months from the issue date, and any such holdings remain subject to applicable prudential norms and regulations in India.
- ¹⁸ Directive 2004/39/EC, as amended.
- ¹⁹ Directive 2003/71/EC, as amended.
- ²⁰ Regulation EC/809/2004, as amended.
- ²¹ Directive 2004/109/EC, as amended.
- ²² For both the Main Market and Regulated Market, if an issuer produces both consolidated and non-consolidated accounts, it must include at least the consolidated accounts in the offering document. In addition, the Listing Rules require that the issuer's most recent year's historical financial information must be presented and prepared in a form consistent with that which will be adopted in the issuer's next published annual financial statements.

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