Rupee denominated bonds: A major shift with potential

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Quite without warning, the Reserve Bank of India (RBI) notified the framework for issuance of rupee denominated bonds under the overall external commercial borrowing (ECB) framework on 29 September. Unlike other surprises from the RBI, this was a pleasant one, particularly because the framework's provisions were more liberal than its draft form, which had left much to be desired.

The issuance of the framework follows the submission of a report to the Ministry of Finance by the Committee to Review the Framework of Access to Domestic and Overseas Capital Markets, in February this year. The report included a recommendation that the market for local currency denominated bonds should be encouraged as it provides an alternative source of debt financing for private and public sector borrowers which does not expose them to currency fluctuation risk. By reducing currency mismatches and lengthening the duration of debt, such bonds could also augment financial stability. To encourage the development of the Indian bond market, the committee also recommended the removal of quantitative restrictions on foreign investment in the Indian bond market.

In view of the interest of investors in subscribing to rupee denominated bonds issued by the International Finance Corporation, the RBI, in its bi-monthly monetary policy statement of 7 April, said it intended allow Indian bodies corporate to raise ECBs through rupee denominated bonds. It then released the draft framework for issue of rupee denominated bonds on 9 June for public comments.

The draft framework received a lukewarm reception, particularly because it proposed to retain many features of the prevailing ECB policy such as its end-use restrictions and requirements that the amount and maturity of the bonds be in accordance with the policy. The draft framework also provided that only Indian bodies corporate that were eligible to raise ECBs could issue rupee denominated bonds, and that coupon payments would be restricted to a maximum of 500 basis points above the yield of corresponding government of India securities.

In marked contrast to the draft version, the notified framework allows all bodies corporate including real estate investment trusts and infrastructure investment trusts to raise debt under the ECB policy by issuing rupee denominated bonds. The only end-use restrictions in the notified framework are that funds raised cannot be used for real estate activities (other than for development of integrated township/affordable housing projects), capital market and domestic equity investment, activities prohibited under the foreign direct investment policy, on-lending for any of the above, and the purchase of land. Further, the only all-in-cost restriction is that the all-in-cost should be "commensurate with prevailing market conditions".

Unlike the ECB policy, which prescribes eligibility criteria for entities that can provide debt, the notified framework allows any investor from a Financial Action Task Force compliant jurisdiction to invest in bonds issued under the framework. Rupee linked bonds can be issued under the notified framework under the automatic route for an aggregate amount of US$750 million per year; any issuance beyond this will require RBI approval.

The notified framework prescribes that only plain vanilla bonds can be issued, and that all bonds must be issued for a minimum maturity of five years. A put or call option cannot be exercised before five years have elapsed.

While the draft framework contemplated currency conversion at the RBI's reference rate as at the date of issue of the bonds, the notified framework allows currency conversion at the market rate prevailing on the date of settlement. This, in particular, will be perceived as a market-friendly move. All other provisions of the ECB policy such as obtaining a loan registration number, monthly reporting, requirements and restrictions on providing of security and guarantee to secure the bonds, and parking of funds overseas until needed for use will continue to apply.

The notified framework uses the term "broad contours" to describe the provisions for issuance of rupee linked bonds under the overall ECB policy. From a regulatory philosophy perspective, this marks the next in a series of progressive steps by the RBI in changing its approach from overly detailed prescriptive rule making to a combination of principle-based and prescriptive regulatory rule making. The advantages of the changed approach are that it provides flexibility to both the regulator and the "regulated" to achieve their goals within the overall financial regulatory framework, while at the same time presenting a suitable alternative to the "light touch" regulatory practice that is often blamed for the global financial crisis of 2007-08.

Apart from the liberalization of end-use restrictions and eligibility requirements for issuers and investors, the clearest advantage of the notified framework is that it reduces the currency risk that the issuer is exposed to because the bonds are denominated in Indian rupees. To encourage raising of debt under this route, the government should also consider introducing a withholding tax exemption similar to that available for foreign portfolio investors.

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