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FOREIGN PORTFOLIO INVESTMENT IN DEBT SECURITIES: SWEEPING CHANGES IN LEGAL FRAMEWORK

7 May 2018

Amidst growing investor appetite for Indian debt securities and increased government and corporate debt needs, the Foreign Portfolio Investment (FPI) route has been a dominant source of foreign funding. Liberalisation of the FPI route to allow investment in unlisted debt securities had further bolstered investments through this route. However, the Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI) have issued various circulars over the last couple of weeks, which have introduced extensive changes in the legal framework governing FPIs which will impact investment through this route, being:

(a) A.P. (DIR Series) Circular No. 22 dated 6 April 2018 (6 April Circular) – revises the debt limits applicable to FPIs in various debt securities and eased the requirement of purchasing the limits through the auction process.

(b) A.P. (DIR Series) Circular No. 24 dated 27 April 2018 (27 April Circular) and a subsequent clarificatory circular no. A.P (DIR Series) Circular No. 26 dated 1 May 2018 (1 May Circular) - revises minimum maturity requirements and introduces concentration limits and investor-wise limits for FPI investments.

Further, SEBI has introduced Know Your Client Requirements for FPIs by way of a circular dated 10 April 2018 (SEBI Circular) which we have detailed in a separate update dated 17 April 2018.

6 April Circular – Key Changes

- *Single limit for corporate bonds:* The overall limit for FPI investment in corporate bonds has been fixed at 9%. The FPI limit in corporate bonds would hence go up to Rs 2660 billion in the first half of fiscal 2018 from Rs 2440 billion currently, and further increase to Rs 2890 billion in the second half of 2018-19. Further, existing sub-categories under corporate bonds (i.e. credit enhanced bonds, unlisted corporate debt securities and long-term investor category) have been discontinued and replaced with a single limit for FPI investment for all types of corporate bonds.

- *Two stage increase for Government Securities (G-Secs) limits:* The limit for FPI investment in G-Secs is sought to be increased in two tranches by 0.5% each year for the next two years; i.e., from 5% to 5.5% of the outstanding stock of securities in the financial year 2018-2019 and to 6% in the financial year 2019-2020 (based on half yearly financials).

- *Re-investment of coupon in G-Secs*: Earlier, re-investment of coupon by FPIs in G-Secs was not accounted for within the investment limit - this has now been brought within the G-Secs investment limits.

- *Limit for State Development Loans (SDLs)*: No fresh allocation of limits has been made for SDLs. Further, out of the existing limit of Rs 136 billion for long-term SDLs, Rs 65 billion have been transferred to the G-Secs category.

- The revised limits on FPI investment is as illustrated in the table below:

In Rupees crore

	G-Sec-General	G-Sec-Long Term	SDL - General	SDL-Long Term	Corporate Bonds	Total Debt
Current Limit	191,300	65,100	31,500	13,600	244,323	545,823
Revised Limit for the HY Apr-Sep, 2018	207,300*	78,700	34,800	7,100	266,700	594,600
Revised Limit for the HY Oct 2018-March, 2019	223,300*	92,300	38,100	7,100	289,100	649,900
* Includes ₹ 4,760 crore one-time addition to limit to provide for inclusion of coupon investment amount in utilization.						

Table 1: Revised limits on foreign portfolio investor investments for the financial year 2018-2019

Key Features of the 27 April Circular and 1 May Circular

- *Minimum residual maturity reduced to one year*:

  - *Corporate Bonds*: Under the extant framework, FPIs were permitted to invest in corporate bonds with a minimum residual maturity of 3 years, which has now been reduced to 1 year under the 27 April Circular. The 1 May Circular further clarifies that FPI investments in corporate bonds with residual maturity below 1 year shall not exceed, at any point in time, 20% of the total investment of that FPI in corporate bonds. Accordingly, at any point in time, all securities with residual maturity of less than one year will be reckoned for the 20% limit, regardless of the maturity at the time of purchase by the FPI. In the event that securities with residual maturity of less than 1 year as on 2 May 2018 exceeds 20% of the total investment in any category, the FPI shall ensure that it is brought down to 20% or lower of the total investment within 6 months from the date of the 1 May Circular, i.e., 31 October 2018. Further, the FPI investor shall ensure that no further additions are made to such portfolio of securities, either by fresh purchases or roll-down of investments with current tenor exceeding 1 year.

  - *G-Secs*: The minimum residual maturity for FPI investments in G-Secs as well as SDLs stands reduced from 3 years to 1 year. Further, FPI investment in such securities for a period less than 1 year is capped at 20% of the total investment of that FPI in either category.

- *Treasury Bills*: FPIs are also permitted to invest in treasury bills issued by the Central Government.

- *Concentration limits for FPI investments for all Debt Investments*: FPI investment in all three categories of debt, i.e., G-secs, SDLs and corporate debt securities are now subject to concentration limits:

  - In case of long-term FPIs, the concentration limit is 15% of the prevailing investment limit for that category.

  - In case of other FPIs, the concentration limit shall be 10% of the prevailing investment limit for that category.

  - The following new formulae have been specified in the event that FPI investments exceed the prescribed concentration limits as on the effective date[1]:

	Abbreviation
Investment by FPI on the effective date	INV_0
Investment by FPI at a given point in time	INV_t
Investment Limit	IL
Concentration Limit on the effective date	CL

If $\text{INV}_0 > \text{CL}$, then the following relaxations shall apply, subject to the overall limit as applicable:

1. Additional investments at any point in time should represent

   $\text{INV}_t </= \text{INV}_0 + 2.5\%$ of IL

2. If $\text{INV}_t < \text{CL}$, then investments may be made upto the applicable concentration limit.

3. If $\text{INV}_0 </= \text{CL}$ but $\text{INV}_0 > 7.5\%$ of IL,

then investments may be made upto the point when the total investments reflect $\text{INV}_t </= \text{INV}_0 + 2.5\%$ of IL

  - *Investment-wise limits for corporate bonds*: All investments by FPIs (including investments by 'related' FPIs) shall not exceed 50% of any corporate bond issue. If the investment has exceeded 50%, then the FPI shall not make further investments in that issue until such stipulation is met. Further, an FPI cannot have an exposure exceeding 20% of its corporate bond portfolio with respect to a single corporate entity, and in case such exposure exceeds 20%, it cannot incur further exposure to such entity until such stipulation is met. Newly registered FPIs have been provided a period of 6 months (from the date of commencement of their investments) to adhere to these stipulations.

[1] As per the 27 April Circular, the 'effective date' shall mean the date on which these concentration limits come into existence

The 1 May Circular defines the following terms in context of the investment limits:

(a) *'related entities'* shall have the meaning as defined in section 2 (76) of the Companies Act, 2013 e.g. this would cover any holding, subsidiary or associate company or a common subsidiary of the same holding company;

(b) *"related FPIs"* shall refer to all FPIs registered by a non-resident entity. Illustratively, if a non-resident entity has set up five funds, each registered as an FPI for investment in debt, total investment by the five FPIs will be considered for application of concentration and other limits.

(c) *"newly registered FPI"* shall mean an FPI registered after 27 April 2018.

- Partly paid instruments: FPIs cannot invest in partly paid instruments.
- Revision of security-wise limits for G-Secs: The aggregate cap on FPI investments in G-Secs has been revised to 30% of the outstanding stock from the earlier 20% cap.
- Shift from auction mechanism to an online monitoring system for G-Secs only: Under the earlier framework, when FPI investment in G Secs reached 90% of the allowed limit utilisation, it triggered the requirement for an auction mechanism for allocation of the remaining 10% of the limit. This auction mechanism has been discontinued to pave way for online monitoring of G-Secs by the Clearing Corporation of India with effect from 1 June 2018.

Comment

The raising of limits on FPI investment along with relaxation of minimum residual maturity from 3 years to 1 year is a welcome move and comes with a clear agenda to enhance demand for debt securities in the domestic market, given the encouraging demand for FPI debt amidst rising stability of the Indian rupee and as a cost-efficient tool for hedging investments. The changes encourage foreign investors to remain invested and cool of bond yields as mark to market losses will be lower in shorter tenor bonds. Further, the dispensation of the sub-categories in the corporate bond segment is likely to trigger increased FPI debt flow. The total utilisation of the FPI limits was close to 100% at the end of March and with the current changes, it is now closer to 80-85% and is an encouraging change for foreign investors. However, the potential impact of the exposure and concentration limits on acquisition funding structures remains to be seen.

- *Manisha Shroff (Partner), Madhuparna Dasgupta (Associate Partner) and Meenakshi Kurpad (Associate)*

For any queries please contact: editors@khaitanco.com

Mumbai
One Indiabulls Centre, 13th Floor
Tower 1 841, Senapati Bapat Marg
Mumbai 400 013, India

T: +91 22 6636 5000
E: mumbai@khaitanco.com

New Delhi
Ashoka Estate, 12th Floor
24 Barakhamba Road
New Delhi 110 001, India

T: +91 11 4151 5454
E: delhi@khaitanco.com

Bengaluru
Simal, 2nd Floor
7/1, Ulsoor Road
Bengaluru 560 042, India

T: +91 80 4339 7000
E: bengaluru@khaitanco.com

Kolkata
Emerald House
1 B Old Post Office Street
Kolkata 700 001, India

T: +91 33 2248 7000
E: kolkata@khaitanco.com