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NEWSALERT

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REVISED NORMS FOR INVESTMENT IN DEBT INSTRUMENTS BY FOREIGN PORTFOLIO INVESTORS

1. INTRODUCTION

The Reserve Bank of India (the "**RBI**") has undertaken a detailed review of the current regulations governing debt investment by Foreign Portfolio Investors ("**FPIs**") with the objective of simplifying the process of investments into debt instruments by FPIs in India.

In this context, the RBI in consultation with the Securities Exchange Board of India ("**SEBI**") revised the limits of debt investments by FPIs at the end of April 2018, by issuing 2 (two) notifications on April 27, 2018[1] ("**Circular 1**") and on May 1, 2018[2] ("**Circular 2**" and together with Circular 1, the "**Circulars**").

These Circulars notified the following key changes which will affect operational aspects of FPI investments in to debt, broadly: (a) revising of minimum residual maturity requirement; (b) increasing the limit for investment in central government securities; (c) discontinuing the auction mechanism; (d) introducting concentration and investor-wise limits for particular subscriptions; and (e) clarifying the type of instruments that FPIs can invest in.

2. IMPACT OF THE CIRCULARS

2.1 Revision of minimum residual maturity requirements

Currently, FPIs are required to invest in to debt with a minimum residual maturity of 3 (three) years. In order to bring consistency across debt categories, the RBI has now withdrawn this requirement for investment in all categories of debt, central government securities, state development loans and corporate bonds.

This relaxation is permitted subject to the condition that investment in securities by an FPI, in either of these categories, where the residual maturity is less than 1 (one) year, will not exceed 20% (twenty percent) of the total investment of that FPI at any point in that category, on a continuous basis.

Further, the RBI has clarified that all securities with residual maturity of less than 1 (one) year will be reckoned for the 20% (twenty percent) limit, regardless of the maturity of the security at the time of purchase and if investments in securities with less than 1 (one) year residual maturity, as on May 2, 2018,

[1] RBI/2017-18/168 A.P. (DIR Series) Circular No. 24 available at https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NT16864DC2602F2834E29A64D4ADF6D41EA80.PDF

[2] RBI/2017-18/170 A.P. (DIR Series) Circular No. 26 available at https://rbidocs.rbi.org.in/rdocs/notification/PDFs/170FPI85A621943FC94443AB5B7373E1F34667.PDF

is more than 20% (twenty percent) of total investment in any category, then FPIs will bring such share below 20% (twenty percent) within a period of 6 (six) months from the date of Circular 2.

In this regard, FPIs will ensure that no further additions are made to the portfolio of securities either through fresh purchases or through roll-down of investments with current tenor of more than 1 (one) year, until the share of such portfolio of securities falls below 20% (twenty percent) of the total investment in that category.

2.2 **Increase in limit for investment in central government securities**

In October 2015,[3] the aggregate FPI investments in any central government security was capped at 20% (twenty percent) of the outstanding stock of that security. FPIs are now permitted to invest in central government securities for up to 30% (thirty percent) of the outstanding stock of that security.

2.3 **Discontinuation of auction mechanism**

The Clearing Corporation of India Limited has commenced online monitoring of the utilisation of central government securities utilisation limits and henceforth, the RBI has decided to discontinue the auction mechanism with effect from June 1, 2018.

2.4 **Concentration and investor-wise limits**

In addition to the relaxation of the minimum residual maturity requirements, it shoud be noted that investment by any FPI, including investments by related FPIs (being all FPIs registered by a non-resident entity), will not exceed 50% (fifty percent) in a single corporate bond (or entites related to that single corporate). Further, an FPI will not permit exposure of more than 20% (twenty percent) of its corporate bond portfolio in a single corporate (or a related entity).

If the current investment exceeds these limits, Circular 1 stipulates that no further investments will be permitted in that particular corporate, until these stipulations are met.

Moreover, any new FPI which is registered after April 27, 2018, will be required to adhere to these conditions within 6 (six) months from the commencement of its investments.

Furthermore, concentration limits for investment by FPIs (including related FPIs) in debt have been prescribed, where the limit for long term FPIs is 15% (fifteen percent) of the prevailing investment limit for that particular category of debt; and that for other FPIs is 10% (ten percent) of the prevailing investment limit for that particular category of debt.

The RBI has additionally relaxed these limits by proposing one-time measures for investments currently exceeding the newly prescribed concentration limit.

[3] Available at https://rbidocs.rbi.org.in/rdocs/notification/PDFs/FP92CFEDEED4B24242B65E44C749A4CA87.PDF

2.5 **Type of instruments**

Lastly, it should be noted that the RBI has clarified that FPIs are permitted to invest in treasury bills issued by the central government but are restricted from investing in partly paid instruments.

INDUSLAW VIEW

The increase in limits on FPI investments along with the easing of minimum residual maturity from 3 (three) years to 1 (one) year is a welcome move and should stimulate FPI investment into India's corporate debt markets, assuming stability of the Rupee or the ability to effectively hedge at commercially acceptable rates.

However, the potential impact of the exposure and concentration limits on the bond market, which is struggling with lower demand and rising yields remains to be seen. Issuer's of corpoate debt will now presumbably have to have at least 2 (two) subscribers for any debt issue, in order to meet the new requirement, limiting a single FPI to no more than 50% (fifty percent) of any single corporate debt issue. How these revisions will affect funding structures by particular FPIs (such as the multi-lateral funding agencies and the foreign development banks) using these instruments to fund particular project development, remains to be seen.

Furthermore, introducing exposure limits could potentially impact the ability of new FPI entrants into the market, as a cap on 20% (twenty percent) exposure to a particular corporate issuer would necessarily mean that the FPI would have to have at least 5 (five) investments in play? This might not be practical or achievable for certain FPI entrants in the short term, and it remains to be seen how existing FPIs will have to re-balance their portfolios in order to achieve this requirement.

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