Update

Masala Bonds - Recent Restrictions Imposed by the RBI

21 June 2017

The much-anticipated Masala Bonds have recently been put under stringent restrictions by the RBI. This could limit the appeal of such bonds for investors and douse expectations of internationalising the Indian bond market.

Background

After much deliberation and discussion, the Reserve Bank of India (RBI) in September 2015, introduced Rupee denominated bonds or Masala Bonds (as they are colloquially called), payable in foreign currency (mostly USD). Given market conditions at the time, it was soon apparent that it would be too costly for a subscriber of these bonds to hedge the currency risk. However lately, with the Indian rupee finally showing strength, the product started taking off and various issuers such as HDFC, NHAI and NTPC successfully raised funds through Masala Bond issuances.

On 7 June 2017, the RBI introduced certain additional requirements for Masala Bond issuances to harmonise the Masala Bonds framework with the external commercial borrowings (ECB) guidelines (June 2017 Amendments). The original Masala Bond regime was refreshingly unrestricted and in line with similar products available in international markets. However, the June 2017 Amendments could adversely impact the growing popularity of this product.

June 2017 Amendments and their Impact

The additional requirements stipulated by the RBI under the June 2017 Amendments and their impact are briefly summarised below:

(a) Approval Requirement

All Masala Bond issuances are to be approved by the RBI's Foreign Exchange Department. Since the RBI has not provided any indicative timeframe for approving proposals, this approval requirement will impact timelines for any future issuance of Masala Bonds. Issuers will no longer have clarity on the timing of an issue, resulting in pricing uncertainty.

(b) Maturity Requirement

Minimum maturity period stipulations have been introduced for Masala Bond issuances as follows:
<table>
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<tr>
<th>Issue Size (in USD)</th>
<th>Minimum Maturity Period</th>
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<tbody>
<tr>
<td>Upto 50 million</td>
<td>3 years</td>
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<tr>
<td>Above 50 million</td>
<td>5 years</td>
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Since Masala Bonds cannot have any optionality clause for prepayment before completing the applicable maturity period, this minimum maturity requirement will impact the flexibility of issuers to decide the tenure of their obligations.

(c) **Pricing Restrictions**

The June 2017 Amendments stipulate an all-in-cost ceiling of 300 basis points over the prevailing yield of government securities of corresponding maturity (which is approximately 6.5-6.7% at present).

Though it isn’t immediately clear whether the pricing restriction will have a dampening effect on the market for these bonds, it is a new restriction that wasn’t applicable earlier and is antithetical to the principle of ongoing liberalisation.

(d) **Related Party Exclusion**

Entities which are classified as related party within the meaning of Indian Accounting Standards- 24, will no longer be eligible to invest in Masala Bonds. This will impact companies looking to raise funds for their operations from related overseas entities.

It appears that the RBI has introduced this related party exclusion to prevent round-tripping of funds. However, the restriction is not aligned with the larger ECB framework since foreign equity holders are permitted to advance foreign currency loans to Indian corporates in compliance with certain conditions under the ECB guidelines. Further, since all Masala Bonds are now subject to RBI approval it is unclear why this additional restriction is required.

The June 2017 Amendments introduce significant changes to the landscape of Masala Bonds that could impede the rapid growth of this market. While the RBI’s intent seems to be to harmonize Masala Bonds issuances with the ECB guidelines, the amendments significantly reduce the flexibility that issuers enjoyed so far in issuing these bonds.

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