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Regulatory Alert

Delivering Clarity

RBI revises regulatory framework for FPI investments in debt securities

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In this issue:

Background

The Reserve Bank of India (RBI) (through its circulars dated 28 April 2018 and 1 May 2018) had revised the regulatory framework concerning investment by foreign portfolio investors (FPIs) in Indian debt securities. In the revised framework, RBI had relaxed minimum residual maturity conditions in bonds but introduced several new restrictions.

Some of the newly-added restrictions posed significant practical challenges for FPIs as well as custodians. Given the challenges, representations were made to RBI to reconsider certain restrictions and to provide some lead time for implementation of the circulars. Reacting to the representations, RBI issued a circular on 15 June 2018 to provide operational flexibility as well as a transitionary path for implementation of the newly-introduced restrictions.

The Securities and Exchange Board of India (SEBI) has also issued its circular on 15 June 2018, in line with the RBI circular of the same date. Accordingly, the revised framework is applicable with immediate effect.

Key changes

The key changes brought in by the recent RBI and SEBI circulars are as follows:

Security Receipts (SRs) not to be subject to new restrictions

- Single / group investor-wise limit (20% limit on exposure to a single corporate and 50% limit in a single issue of corporate bond) would not apply to SRs.
- Residual maturity restrictions (i.e. FPI investments in bonds with residual maturity of one year not to exceed 20% of FPI's total investments in such category of bonds) would not apply to SRs.

Note: It is important to note that SRs continue to be part of the overall corporate debt limits.

Residual maturity restriction not applicable to existing investments

- The newly-introduced residual maturity restriction (i.e. FPI investments in bonds with residual maturity of one year, not to exceed 20% of FPI's total investments in each category) would not apply to investments made by FPIs on or before 27 April 2018. However, this relaxation is available only if an FPI's portfolio of bonds with maturity of one year or less, comprises of investments made on or before 27 April 2018.

Note: It is important to note that the moment a new bond (acquired by an FPI post 27 April 2018) in FPI's portfolio falls within the one-year maturity period, the grandfathering benefit on investments made on or before 27 April 2018, would also go away.

Relaxation in single corporate exposure limits

- The newly-introduced restriction of 20% single corporate exposure limit (i.e. FPI's exposure to bonds of a single company shall not exceed 20% of such FPI's total corporate bond portfolio) would not apply to investments made by existing FPIs (registered before 27 April 2018) between 28 April 2018 to 31 March 2019, provided the FPI is not already in breach of this 20% limit in such company as on 27 April 2018.

Note: It is important to note that the exemption is available only up to 31 March 2019, and therefore starting 01 April 2019, the FPI would need to ensure it does not have more than 20% exposure (of its total bond portfolio) to bonds of a single corporate (or related entities of such corporate).

- Newly-registered FPIs (registered after 27 April 2018) can comply with the single corporate exposure limits by 31 March 2019 or within 6 months of its date of registration in India, **whichever is later**.

Pipeline investments in corporate bonds

- Corporate debt investment by FPIs which were in process (but not materialized) as on 27 April 2018, would not be subject to the following newly-added restrictions:
  - Investment by an FPI along with other FPIs in the same investor group shall not exceed 50% of a single issue of a corporate bond
  - An FPI shall not have exposure of more than 20% of its corporate bond portfolio to a single corporate or related entities of such corporate

Note: The above relaxation to pipeline investments would apply provided certain conditions (related to the proposed investment) mentioned in the circular are met and the concerned Indian custodian satisfies itself to that effect.

Rationalization of definitions

- Related FPIs (for the purpose of single corporate exposure limits) have been accorded same definition as Investor group in Securities and Exchange Board of India (Foreign Portfolio Investor) Regulations 2014.
- Entities related to the corporate (for the purpose of single corporate exposure limits) would include following entities:
  - a holding, subsidiary or an associate company of such company
  - a subsidiary of a holding company to which it is also a subsidiary

Note: Ascertaining list of entities related to the corporate (in which FPI would invest) would be a practical challenge as there is no ready database available for such information.

Online monitoring of investment limits in government securities (G-secs) and State Development Loans (SDLs)

- Since the utilization of FPI investments limits in G-Secs and SDLs are not available on an online basis, there should be no breach of the overall G-Sec / SDL limits. In case there is a breach, the investment that resulted in the breach would need to be reversed.
- An FPI selling / redeeming G-Secs or SDLs would be allowed two working days to re-invest the sale / redemption proceeds. Investments made after two working days of sale / redemption would be considered as fresh investments and therefore subject to availability of limits.
- The concerned FPI as well as its custodian in India, are responsible for ensuring compliance with various types of limits applicable on FPI’s investments in G-Secs and SDLs.

- The various limits and caps for FPI investments in G-Secs and SDLs would also be monitored as well as operationalized by Clearing Corporation of India Limited.

Source: RBI/2017-18/199 A.P. (DIR Series) Circular No. 24 dated 15 June 2018

Our comments

Although the recent circular provides certain flexibility and a transitionary roadmap for the newly-introduced restrictions, certain practical challenges still remain:

- **20% limit on FPI investments in bonds maturing within 1 year**: It will be a significant challenge to ensure that **at the end of every day**, an FPI's portfolio in bonds with residual maturity of one year or less shall not exceed 20% of such FPI's total investment in the respective category of bonds. Due to this restriction, an FPI may be forced to either dispose of bonds maturing within one year or buy more bonds which have residual maturity of more than one year and these actions may not be feasible from commercial perspective.

- **Single corporate exposure limit of 20%**: Once the transition period (available up to 31 March 2019 for existing / new FPIs and / or 6 months from registration for new FPIs) is over, any new corporate bond investments made by an FPI would be subject to the single corporate exposure limit of 20%. To illustrate the practical challenge, an existing FPI, which wishes to make its first investment in corporate bonds on 1 April 2019, would need to invest in corporate bonds of at least 5 unrelated companies at the same time.

Overall framework

Pursuant to the recent circular, the salient features of the overall regulatory framework applicable for FPI investment in debt securities is summarized as follows:

- FPI investments in debt securities are subject to availability of debt limits. There are separate limits notified for investments in G-Secs, SDLs and corporate bonds. The overall limits are further divided between Long term FPIs and other FPIs. Long term FPIs include Sovereign Wealth Funds, Multilateral Agencies, Endowment funds, Insurance funds, Pension funds and foreign central banks.

- FPIs can invest in G-Secs (including Treasury Bills) and SDLs without any residual maturity condition.

- FPIs can invest in those corporate bonds which have a minimum residual maturity of above one year.

- On an ongoing basis, an FPI's investment in bonds with residual maturity of one or less, shall not exceed 20% of total investment by such FPI in the respective category of bonds.

- Investment by long term FPI / other FPI in either of the debt securities (G-Secs / SDLs / corporate bonds) shall not exceed 15% / 10% of the overall investment limit in the respective category of bonds.

- Investment by FPIs in corporate bonds shall be subject to following additional restrictions:
  - Investment by an FPI (along with FPIs in the same investor group) shall not exceed 50% of a single issue of a corporate bond
  - Investment by an FPI in bonds issued by a single corporate or related entities of such corporate, shall not exceed 20% of the FPI's total corporate bond portfolio

  These additional restrictions are not applicable to FPI investments in SRs and investments made by Multilateral Financial Institutions in which Government of India is a member.

- FPIs are not permitted to invest in partly paid debt instruments.

- The current overall debt limits and the utilization status are tabulated below:

INR billion

	Central government securities			State development loans			Corporate bonds	Aggregate
	General category FPIs	Long Term FPIs	Total	General category FPIs	Long Term FPIs	Total		
Current limits	2025.4	787	**2,812.4**	348	71	**419**	2,667	**5,898.4**
Current Investments	1545.1	532.9	**2078**	38.43	0	**38.43**	2,022.51	**4138.94**
% limit utilized	76.29%	67.71%	**73.88%**	11.04%	0%	**9.17%**	75.83%	**-**

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