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Regulatory Alert
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RBI revises regulatory framework for FPI investments in debt securities

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Background

Investments made by foreign portfolio investors (FPIs) in Indian debt instruments are governed by the regulatory framework laid down by the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI).

At present, FPIs are permitted to make investments in government securities as well as corporate debt securities, subject to overall limits prescribed by RBI from time to time. Further, the debt securities in which investments are made should have a residual maturity of at least 3 years, except for investments in securitized debt instruments where the residual maturity condition does not apply.

The debt investment limits were recently revised by RBI in its circular issued on 6 April 2018 as follows:

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		
Earlier Limits	1,913	651	**2,564**	315	136	**451**	2,443.23	5,458.23
Revised limits for Apr 18 - Sept 18	2,073	787	**2,860**	348	71	**419**	2,667	5,946
Revised limits for Oct 18 - Mar 19	2,233	923	**3,156**	381	71	**452**	2,891	6,499

The above-referred RBI circular also indicated that a separate notification would be issued to make certain changes to operational aspects of FPI investments in debt securities. Accordingly, RBI has issued circulars on 27 April 2018 and 1 May 2018 revising the existing framework.

Key changes

The key changes introduced by the RBI in the revised framework are:

Government securities (G-Secs) and State Development Loans (SDLs)

- **No residual maturity condition for investment in government securities:** The existing condition of minimum residual maturity of 3 years has been withdrawn for investments in G-Secs as well as SDLs. **It is also clarified that FPIs can now invest in Treasury bills issued by the central government.** However, a new condition is introduced; investment by an FPI in either G-Secs or SDLs with residual maturity below 1 year shall not exceed, at any point in time, 20% of the total investment by FPI in such categories.

- **Discontinuation of auction mechanism for G-Secs investments and online monitoring:** The existing auction mechanism (which is triggered after aggregate FPI investments reach 90% of the limits) will be discontinued with effect from 1 June 2018, and the limits would henceforth be monitored on an online basis by the Clearing Corporation of India Limited (CCIL).
- **Revision of security-wise limit:** The cap on aggregate FPI investments in a central government security has been increased from 20% of the outstanding stock of that security to 30%.

Corporate bonds

- **Minimum residual maturity for investments in corporate bonds reduced from 3 years to 1 year**: FPIs are now permitted to invest in corporate bonds with minimum residual maturity of more than 1 year instead of 3 years, as was previously allowed. Further, at any point in time, an FPI's investment in corporate bonds with less than 1 year residual maturity, should be less than 20% of its total investments in corporate bonds.
- **Investments by an FPI not to exceed 50% of the issue size**: Investments by a single FPI as well as by all "related FPIs" taken together shall not exceed 50% of any single issue of corporate bond. In case this limit is exceeded, there should be no further investments by such FPI until the investments are less than the 50% limit. The expression "related FPIs" is explained to include all FPIs registered by a non-resident entity for e.g. different funds set up by a non-resident entity and registered in India as FPIs will be considered to be related FPIs. It is pertinent to note that this definition is different from the "investor group" definition provided in SEBI (FPI) Regulations 2014, where FPIs with common beneficial owners are considered to be a part of an investor group.
- **Exposure to a single corporate not to exceed 20% of FPI's corporate bond portfolio**: Investments made by an FPI in corporate bonds of an Indian company as well as related entities of such company (as defined in Indian Companies Act, 2013) shall not exceed 20% of the total corporate bond portfolio of the FPI. In case this limit is exceeded, there should be no further investments by such FPI until the exposure is eventually less than 20%. Further, a newly registered FPI (i.e. registered after 27 April 2018) needs to comply with this condition within 6 months from the commencements of its investments.

Other changes / clarifications

- **Continuous monitoring of 20% limit on securities with less than one year residual maturity**: The newly-introduced 20% restriction discussed above applies to all types of debt securities i.e. G-Secs, SDLs, corporate bonds on a continuous basis. Also, for this purpose, all the debt securities held by the FPIs at any point in time would be considered irrespective of the fact that at the time of original investment, the maturity of a particular bond might have been more than 1 year. In cases where an FPI is in breach of this limit as on 2 May 2018, it should align its portfolio within 6 months to comply with the new 20% restriction. Further, till such time the portfolio is aligned in accordance with this new restriction, the concerned FPI (which is in breach of the 20% limit) is not permitted to: a) purchase new debt securities with less than 1 year residual maturity; b) roll down its existing investments in debt securities with more than 1 year maturity
- **Concentration Limit**: Besides the existing overall limits, a new restriction has been introduced whereby investment by a single FPI as well as related FPIs in shall not exceed following limits:

- **Long term FPIs**: 15% of prevailing overall investment limits in any of the categories i.e. G-Secs, SDLs as well as corporate debt securities. Long term FPIs include Sovereign Wealth Funds, Multilateral Agencies, Endowment funds, Insurance funds, pension funds and Foreign Central banks
- **Other FPIs**: 10% of the prevailing overall investment limits in any of the category i.e. G-Secs, SDLs as well as corporate debt securities

In case the above limits are exceeded by any FPI, any further investments by such FPI in the relevant category would be subject to additional conditions stipulated in the RBI circular dated 27 April 2018.

- **Prohibition on investments in partly paid instruments: FPIs are** specifically prohibited to invest in partly paid instruments. While there is no explanation for "instruments" in the circular, it is understood that this restriction is with respect to debt instruments since the circular is issued to revise the regulatory framework around FPI investments in debt securities.

Source: RBI/2017-18/168 A.P. (DIR Series) Circular No. 24 dated 27 April 2018 and RBI/2017-18.170 A.P.(DIR Series) Circular No. 26 dated 1 May 2018

Our comments

The relaxations for FPI investments in government securities with regard to removing residual maturity condition as well as doing away with auction mechanism, are encouraging. This move would further promote FPI participation in G-Secs as well SDLs and would also bring efficiencies in the investment process. Importantly, FPIs will now invest in Treasury Bills, which were not available for investment by FPIs since July 2014.

As regards changes in the corporate bonds framework, though the reduction in minimum residual maturity from 3 years to 1 year is a welcome step, the other conditions introduced to limit FPI investments in a single issue and the exposure limits for investment in a single Indian company may hamper certain lending structures. Further, there may be challenges in monitoring as well as complying with the new restriction of continuous 20% limit on investments, where the remaining maturity is less than a year.

While the RBI circulars are effective immediately, the revised framework would be implemented once SEBI also notifies these changes.

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Contacts

Ahmedabad
19th Floor, Shapath - V
SG Highway,
Ahmedabad – 380 015.
Tel: + 91 (079) 6682 7300
Fax: + 91 (079) 6682 7400

Bangalore
19th Floor, 46 - Prestige Trade Tower, Palace Road, High Grounds,
Bengaluru,
Karnataka – 560001.
Tel: + 91 (079) 6627 6000
Fax: +91 (080) 6627 6010

Chennai
No.52, Venkatanarayana Road,
7th Floor, ASV N Ramana Tower,
T-Nagar,
Chennai 600 017.
Tel: +91 (044) 6688 5000
Fax: +91 (044) 6688 5050

Coimbatore
Shanmugha Manram
41, Race Course,
Coimbatore
Tamil Nadu - 641018
Tel: + 91 (0422) 439 2801
Fax: +91 (0422) 222 3615

Delhi/Gurgaon
Building 10,
Tower B, 7th Floor,
DLF Cyber City,
Gurgaon 122 002
Tel : +91 (0124) 679 2000
Fax : + 91 (0124) 679 2012

Hyderabad
KRB Towers, Plot No. 1-4,
Survey No. 65 to 67,
1st -3rd Floor
Madhapur, Serilingampally(M),
RR District, Hyderabad.
Tel: +91 (040) 6603 2600
Fax:+91 (040) 6603 2714

Kolkata
13th and 14th Floor,
Building – Omega
Bengal Intelligent Park
Block – EP & GP
Sector V, Salt Lake City,
Kolkata – 700091
Tel : + 91 (033) 6612 1000
Fax : + 91 (033) 6612 1001

Mumbai
Indiabulls Finance Centre,
Tower 3, 28th Floor,
Elphinstone Mill Compound,
Senapati Bapat Marg, Elphinstone (W),
Mumbai – 400013
Tel: + 91 (022) 6185 4000
Fax: + 91 (022) 6185 4101

Pune
706, B-Wing, 7th Floor,
ICC Trade Tower,
Senapati Bapat Road,
Pune – 411 016.
Tel: + 91 (020) 6624 4600
Fax: +91 (020) 6624 4605

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