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Regulatory Alert

Delivering Clarity

RBI notifies the Voluntary Retention Route for FPI investments in debt securities

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Background

The Reserve Bank of India (RBI), through a press release dated 5 October 2018, had proposed an additional investment route - Voluntary Retention Route or VRR - for FPIs to invest in Indian debt securities and had invited public feedback on the proposed framework.

Pursuant to the feedback received and consultations held with stakeholders, RBI has notified the final VRR guidelines vide its circular dated 1 March 2019. The investment limits prescribed under VRR are in addition to the existing limits prescribed for FPI investments in debt securities (hereinafter referred to as general investment framework). Further, the investments made under VRR will not be subject to the regulatory restrictions currently applicable to FPI investments in debt securities, viz. residual maturity conditions, concentration limits or single / group investor-wise limits.

Key features

The key features of the VRR framework are as follows:

Eligible investors

Any FPI registered with SEBI can invest under the VRR.

Eligible Instruments

- Investments can be made in all debt securities permitted for FPIs, e.g. central government securities, Treasury Bills, State Development Loans, Bonds, Non-convertible debentures, Commercial Papers etc.
- FPIs can also undertake repo and reverse repo transactions provided the amount borrowed or lent under repo transactions does not exceed 10 percent of the investment under VRR.

Minimum retention period

- Investments made under VRR would be subject to a minimum retention period of **3 years** from the date of allotment, or such other period as decided by RBI for each allotment.
- An exit mechanism has been provided within the retention period whereby an FPI can sell off its investments to another (eligible) FPI within the retention period. The buyer FPI in such case would need to abide by all terms and conditions on which the initial investment was made by the selling FPI.

Investment limits and mode of investment

- Investments under VRR (by all FPIs taken together) would be capped at INR 400 billion for government securities and INR 350 billion for corporate debt securities. These caps can be increased by RBI from time to time.
- For making investments under the VRR, an FPI would need to be allocated a specific investment amount. The allocation could be on tap or through an auction mechanism, as decided by the RBI for each allotment.

- The mode of allocation, the amounts available for investments and the minimum retention period shall be announced by RBI, ahead of each allotment tranche.
- RBI shall make the allocation of investment amounts based on applications / bids submitted by an FPI. The primary criteria for allocation of investment amounts would be the retention period, i.e. applications / bids with highest retention period would be accorded priority.
- Once the investment amounts are allocated to an FPI, it would need to invest at least 25 percent of the allocated amount (committed portfolio size or CPS) within one month and the remaining amount within three months of the date or allotment.
- Throughout the retention period, an FPI would need to be invested in the debt securities for at least 75 percent of the CPS. For this purpose, the cash balance maintained by the FPI in its bank account in India (opened specifically for VRR) would also be considered as "investment".
- At the end of retention period, the FPI would have an option to roll-over the investments for the identical retention period without having to apply / bid for the investment amount. Also, the FPI can shift investment made under VRR to the general investment framework subject to availability of investment limits.
- Interest income arising to an FPI from investments made under the VRR can be re-invested by FPI in excess of the CPS.
- An FPI investing under VRR can participate in any currency or interest rate derivative instrument to hedge their interest rate or currency risk. The derivative contract can be executed on the stock exchange or OTC with an Authorised Dealer (banks) in India.

Operational aspects

- An FPI would need to open one or more INR accounts with its designated bank (typically custodian bank) in India and all investments under VRR would need to be routed through such bank account(s). An FPI would need to open a separate security account to hold securities invested under the VRR.
- Custodian should have appropriate legal documentation with FPIs to enable them to ensure that FPIs adhere to VRR conditions.
- Both FPI and its designated custodian in India would be responsible for utilisation of limits and adherence to other requirements under the VRR. In case a repatriation instruction requested by FPI could result in FPI investments falling below 75 percent of the CPS during the retention period, the custodian shall reject such repatriation request.
- Any violations by FPI under VRR would be subjected to regulatory action by SEBI. However, minor violations (in the opinion of the custodian) can be regularised by the FPI within five working days of the violation.

Our comments

The VRR offers an additional avenue for FPIs to invest in Indian debt securities. Though there would be a minimum retention period of three years (or other period as RBI may decide for each allotment), an exit route has been facilitated where an FPI can sell its investments to another FPI before three years which is indeed welcome. Also, non-

applicability of residual maturity conditions and the single exposure limits (as applicable to general investment limits) will make this route attractive. The VRR also offers a good alternative to the External Commercial Borrowing route considering that there are no end-use restrictions, no caps on interest rates, relatively lower reporting and compliance requirements under the VRR.

However, certain requirements under the VRR could pose practical challenges and there may be a need for clarity / re-consideration by the RBI. These include the need to open additional bank and security account under VRR, custodian's discretion on what constitutes minor violations by FPIs, adherence to minimum investment (75 percent of CPS) on a day-end basis, through the retention period etc.

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