Foreign Portfolio Investors – Voluntary Retention Route

Background

The regulatory framework for Foreign Portfolio Investors ('FPI') investment in government securities and debt securities of an Indian Companies ('debt securities') has evolved over the years, influenced by various factors. However, measures undertaken in recent times have had a significant impact on FPI investment in corporate debt. Prior to 27 April 2018, FPIs were permitted to invest in debt securities subject to certain conditions such as minimum residual maturity, end-use restrictions etc. The Reserve Bank of India ('RBI') vide circular[1] dated 27 April 2018 followed by a clarificatory circular in May 2018 and a superseding circular in June 2018[2], made certain radical changes to existing conditions relating to investment in debt securities by an FPI and also introduced certain additional restrictions such as concentration limits on investments in one Indian Company. Some of the key restrictions ('Exposure Norms') are as under:

- Investment by an FPI (including investment by related FPIs) should not exceed 50% of any issue of a corporate bond; and
- Exposure to a single corporate (including related parties as per the Companies Act, 2013) should not exceed 20% of the FPI's corporate bond portfolio.

The above changes coupled with other macro-economic factors such as increasing bond yields negatively impacted the investments by FPI in corporate debt with investment declining to INR 2.01 trillion at end-September 2018 from INR 2.24 trillion at end-March 2018. Consequently, FPI's utilisation of the approved limit for investment in corporate bonds declined sharply to 75.5 per cent at end-September 2018 from 91.9 per cent at end-March 2018. Interestingly, resource mobilisation through issuances of corporate bonds in the primary

[1] RBI/2017-18/168 A.P. (DIR Series) Circular No. 24
[2] RBI/2017-18/170 A.P. (DIR Series) Circular No. 26 dated 1 May 2018 and RBI/2017-18/199 A.P. (DIR Series) Circular No. 31 dated 15 June 2018

market also declined by 31.3 per cent to INR 1,906 billion during April-August 2018 from INR 2,773 billion during the corresponding period of the previous year[3].

Given the negative cues, in a meeting chaired by the honourable Prime Minister Shri Narendra Modi on 14 September 2018, proposed a review of Exposure Norms as one of the five measures to contain the Current Account Deficit and check the Rupee fall.

With this backdrop, on 5 October 2018, RBI rolled out a discussion paper proposing a new investment channel for FPIs called the 'Voluntary Retention Route ('VRR') which aims to provide FPIs with more operational flexibility in terms of instrument choices as well as exemptions from Exposure Norms. RBI has invited comments on the discussion paper from market participants and other interested parties by 19 October 2018.

Key features of VRR:

- **Eligible securities:**
  - Government securities (Central Government securities as well as State Development Loans) including T-bills ('VRR-Govt'); and
  - Corporate debt instruments, including commercial papers ('VRR-Corp').
- **Maximum amount of investment:**
  - RBI from time to time will decide the total amount of investment basis the macro-prudential considerations and assessment of investment demand; and
  - Separate investment limit will be prescribed for investment in VRR-Govt and VRR-Corp.
- **Over and above the general investment limit:**
  - Investments through the VRR shall be voluntary and in addition to the FPI investment limits (General Investment Limit) under the MediumTerm Framework[4].
- **Auction Process:**
  - Investment limits in the VRR-Govt and VRR-Corp will be allocated to FPIs through an auction process;
  - No FPI (including its related FPIs) shall bid for an amount greater than 50% of the auction amount;
  - Criterion for allocation of investment amount to each FPI ('Committed Portfolio Size' or 'CPS') shall be the retention period proposed by the FPI and the amount it proposes to invest therein;
  - Minimum retention period shall be three years or as decided by RBI for each auction;
  - Bids will be accepted in the descending order of retention period (until the accepted bids is equal to the auctioned amounts); and

[3] Source: Monetary Policy Report – October 2018
[4] As per A.P. (DIR Series) Circular No. 22 dated 6 April 2018, as modified from time to time

- RBI will have the full discretion to accept or reject any or all bids, either wholly or partially, without assigning any reason.

- **Investment during Retention Period:**
  - FPIs will be required to invest a minimum of 67% of the CPS within the one-month from the date of auction results. The retention period will commence from the end of the one-month period;
  - After allocation, FPIs shall remain invested in debt instruments at all times during the retention period, subject to the following relaxations:
    - Minimum investment (other than cash or deposits) of an FPI during the retention period shall be 67% of the CPS on an end-of-day basis; and
    - FPIs can modulate investments between 67%-100% of CPS to adjust their portfolio size as per their investment philosophy.
  - Amounts of investment shall be in terms of the face value of securities; and
  - One month prior to the end of the committed retention period, an FPI will exercise its choice to continue investments under VRR by opting for an additional identical retention period.
- **Exemption from Exposure Norms etc:**
  - Investments through the VRR shall be exempt from minimum residual maturity requirement, concentration limits and Single/Group investor-wise limits in corporate bonds (i.e. Exposure Norms) as mentioned in the A.P. (DIR Series) Circular No. 31 dated 15 June 2018; and
  - Income from investments through the VRR may be reinvested at the discretion of FPIs and will be permitted beyond the CPS.
- **Exit Conditions:**
  - FPIs can opt out of the VRR at the end of the retention period by liquidating its portfolio and exit or shift its investments to the 'General Investment Limit', subject to availability of limit under the 'General Investment Limit'; and
  - FPIs under exceptional circumstances (which involves the FPI exiting from all its activities in India), can liquidate their investments under the VRR prior to the end of the retention period by selling their investments to other FPIs. However, FPIs buying such investment shall abide by all the terms and conditions applicable to the seller under the VRR.
- **De-registration:**
  - FPI that violates any of its commitments under VRR shall be deregistered by SEBI.
- **Access to other facilities and other operational aspects:**
  - FPIs investing through the VRR will be eligible to participate in repos for liquidity management, provided that the amount borrowed or lent under repo shall not exceed

10% of their investment under VRR. Securities sold under repo shall not bring the holdings below 67% of the CPS. Securities bought under repos shall not be reckoned for maintenance of the minimum 67% of CPS;

- FPIs will be allowed to participate in any currency and interest rate derivative instrument, OTC or exchange traded, to hedge their interest rate or currency risk;
- FPIs shall open a separate Special Non-Resident Rupee (SNRR) account for investment through the VRR. All fund flows relating to investment through the VRR shall reflect in this account;
- FPIs shall open a separate securities account for holding debt securities under the VRR; and
- FPIs already registered with SEBI are not required to undertake fresh KYC for investment through this Route.

Dhruva comments

The proposed VRR in all likelihood should revive/ deepen the FPI investments in corporate debt market and restore the FPI-NCD route as an investment avenue for financial investors as well as corporate groups. RBI would finalise the VRR regulations after seeking comments of all stakeholders (stakeholders can provide their suggestions and comments to RBI till 19 October 2018).

Separately, given that the minimum retention period is proposed at 3 years, and the tax concessions are currently available only till end of June 2020[5], VRR would be further augmented if the said tax concessions are extended throughout the Retention Period.

[5] Interest payable before the 1st day of July 2020 in respect of investment made by an FPI in rupee denominated bond of an Indian company is eligible for a lower rate of taxation of 5% (plus applicable cess and surcharge) subject to certain conditions.

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