De Jure

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Masala, Spice. More Please.

Rajani Associates
simple solutions

Introduction

As Indians, we are known for our masalas and are quite proud of it. Likewise, we were proud when International Finance Corporation issued Rupee bonds and christened them as masala bonds to give them an Indian identity. Here we discuss the advantages of masala bonds and how they can benefit the infrastructure sector.

Masala Bonds

Masala bonds are issued by Indian companies in offshore capital markets. Unlike a 'medium-term note' or a 'floating rate note' or a 'convertible bond' which are dollar (or any other convertible currency) denominated, masala bonds are rupee denominated, i.e., an investor will pay dollars to purchase masala bonds which will be converted into Indian Rupees and credited to the issuer company. While the bonds are raised in Indian currency, they are considered as part of foreign borrowing and, therefore, governed by the Reserve Bank of India (RBI) regulations and may be converted subject to the foreign direct investment policy prevalent at the time of conversion.

Masala bonds could prove to be a viable source of corporate finance as they shift the exchange rate risk to investors and also serve the RBI's policy objectives of integration of the Indian economy into the global economic system and internationalisation of the Indian Rupee. They also serve as a good instrument to diversify the investor base for entities whose balance sheets are largely rupee-oriented, such as small- and mid-sized banks and non-banking financial companies (NBFCs).

Why Masala Bonds?

The first advantage is interest rates which are higher than that in other countries and, therefore, attractive to overseas investors who otherwise earn a meagre 1% to 3% interest on their deposits. Compared to that, masala bonds offer an interest rate of up to 12% on investment. The other advantage is that an investor is allowed to hedge his investment through currency and credit derivatives, so as to minimise the fluctuation risk. Investors are relieved from insecurity hovering around credit rating since these bonds are issued by accredited financial institutions recognised in foreign markets. Another advantage is that India is a fast-growing large economy and presents many opportunities.

Masala bonds are also a good source to raise funds for issuer companies. Unlike the external commercial borrowing (ECB) guidelines, which restrict various types of entities from borrowing ECBs or raising money through foreign currency convertible bonds, RBI has permitted all corporates or body corporates, NBFCs, Securities and Exchange Board of India (Sebi)-registered real estate investment trusts (REITs) and infrastructure investment trusts (InvITs) to issue masala bonds. This provides an opportunity to all Indian corporates to avail rupee denominated debt and ensure stability in future debt servicing. The issuer company is also at liberty to determine the all-in-cost ceiling, since there is no cap on all-in-cost for issue of masala bonds and the same is calculated on the basis of prevailing market conditions.

Masala bonds are preferable over ECB as masala bonds are rupee denominated and the exchange rate risk does not lie on the issuer company. The cost of hedging the currency risk in ECBs can be significant and if unhedged, adverse exchange rate movements can come back to bite the issuer company. But in the case of masala bonds, the cost of borrowing can work out to be much lower.

Masala bonds and the infrastructure sector

In September 2015, RBI allowed corporates, body corporates, REITs and InvITs to issue Masala bonds, with no end-use restrictions, other than the usual, real estate, capital market and on-lending (negative list).In August 2016, RBI allowed banks to issue masala bonds to meet their capital needs and to finance infrastructure projects. Thus, while a corporate may use the proceeds of masala bonds for any purpose, except for the negative list, banks are only allowed to use the proceeds of masala bonds to meet their capital needs and to finance infrastructure projects.

Why this special carve out for infrastructure sector? Infrastructure is a key driver for the Indian economy. Increased spending in this sector has a multiplier effect on overall economic growth as it necessitates industrial growth and manufacturing which in turn boosts aggregate demand by improving living conditions. The wide-ranging sector when developed will help raise the country's economic productivity which has led to the Indian government promoting investing in infrastructure, providing benefits such as easing of tax restrictions and multiple financing alternatives. Such a focus on investment to boost gross domestic product has led to RBI permitting banks to issue masala bonds to finance infrastructure projects.

Forging relationships with private and foreign investors has additionally introduced long-term sustainability and global best practices in the infrastructure industry. Furthermore, important government initiatives to ensure policy stability, ease of financing, transparency, and various legal and regulatory reforms projects a healthy outlook for investing in the sector. With allowing banks to issue masala bonds to finance infrastructure projects, the infrastructure sector will receive an additional boost, which will in turn improve economic growth.

Masala bonds and statute relaxations

To promote masala bonds, the Indian government has clarified that the chapter on prospectus and allotment of securities in the Companies Act, which deals with public offer and detailed prospectus, will not apply to masala bonds, since they are technically foreign currency bonds. In addition to the above relaxation, the government has also waived compliance with conditions to issue debentures. Separately, Sebi has clarified that investments in rupee denominated bonds will not be treated as foreign portfolio investments (FPI) and, therefore, not fall within the regime that otherwise apply to FPI.

The finance ministry has also contributed to the promotion and has cut withholding tax (a tax deducted at source on residents outside the country) on interest income of such bonds to 5% (earlier 20%), making it attractive for investors. Another advantage of investing in masala bonds is capital gains on rupee appreciation are exempted from tax.

Success of masala bonds

The critical factors for the success of masala bonds are coupon rate, liquidity of Indian currency and liquidity in trading in masala bonds. India is rated BBB- by global ratings agencies—a notch above junk rating. Sovereign rating will substantially influence pricing of these bonds. The success of masala bonds would demonstrate overseas investors' confidence in Indian currency. In other words, successful issue of these bonds by Indian corporate would imply faith on India's macroeconomic fundamentals and the central bank's role in currency management.

However, too much reliance on external debt can weigh heavily on our rating by global agencies and affect the marketability of masala bonds. Masala bonds are a good idea to shield corporate balance sheets from exchange rate risks, but they are best used in moderation. It's necessary that India has a stable exchange rate and there is improvement in sovereign rating and currency derivatives market. An absence of any of these factors will make the masala hot, spicy and unbearable.

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