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EY Regulatory Alert

Reserve Bank of India notifies "Voluntary Retention Route" for investment by Foreign Portfolio Investors in Indian debt securities

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Executive summary

This Regulatory Alert summarizes a recent Press Release and Circular [1] dated 1 March 2019 issued by the Reserve Bank of India (RBI), finalizing the Voluntary Retention Route (VRR) scheme for investments by Foreign Portfolio Investors (FPIs) in Indian debt securities. The investment in VRR shall be open for allotment from 11 March 2019.

[1] Press Release: 2018-2019/2086 and RBI/2018-19/135 A.P. (DIR Series) Circular No. 21

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Background

- Following its announcement in the Fourth Bi-Monthly Monetary Policy Statement dated 5 October 2018, the RBI on 5 October 2018 after consultation with the Government of India and the Securities and Exchange Board of India (SEBI), had released a discussion paper[2] on VRR for investment by FPIs in Indian debt securities. Comments on the discussion paper were invited from market participants by 19 October 2018.

- After considering the comments and views provided by various stakeholders, the RBI on 1 March 2019 issued a Press Release and Circular [1] finalizing a separate scheme called the 'VRR' for investment by FPIs in Indian debt markets.

- Investments through VRR will be free of the macro-prudential and other regulatory norms that are applicable to FPI investments in debt markets, provided FPIs voluntarily commit to retain a required minimum percentage of their VRR investments in India for a prescribed period.

- This alert summarizes the key features of the VRR scheme.

Eligible Investors

- Any FPI registered with SEBI is eligible to participate in the VRR.

- Participation through VRR will be entirely voluntary.

Eligible Instruments

- Under the VRR, FPIs can invest in the following instruments:

  - Government Securities (VRR-Govt);
  - Corporate Debt Instruments (VRR-Corp); and
  - Repo transactions[3] and Reverse repo transactions[4], excluding repo and/ or reverse repo conducted under Liquidity Adjustment Facility and the Marginal Standing Facility.

- VRR-Govt shall include Central Government dated securities (G-Secs), Treasury bills and State Development Loans (SDLs).

- Under VRR-Corp, FPIs may invest in any instrument listed in Schedule 5 of Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017. The same, *inter-alia*, includes the following:

  - Non-convertible Debentures (NCDs)/ bonds issued by an Indian company;
  - Commercial papers issued by an Indian company;
  - Security Receipts (SRs) issued by Asset Reconstruction Companies;
  - Perpetual Debt instruments as prescribed;
  - Rupee denominated bonds/ units issued by Infrastructure Debt Funds;
  - Credit enhanced bonds;
  - Listed non-convertible/ redeemable preference shares or debentures;
  - SRs issued by securitization companies;
  - Securitized debt instruments.

- However, the following securities are excluded from the scope of VRR-Corp:

  - Dated Government securities/ treasury bills; and
  - Units of domestic mutual funds.

Investment Limits

- Investment under the VRR shall be in addition to the General Investment Limit.[5] The current FPI investment limit in debt as per the Medium Term Framework is as under:

Particulars	Amount (INR in billion)
G-Sec (General)	2,233
G-Sec (Long term)	923
State Development Loans (General)	381
State Development Loans (Long term)	71
Corporate Debt	2,891
Total	**6,499**

- The overall investment under VRR shall be capped at:

  - VRR-Govt: INR 400 billion per annum;
  - VRR-Corp: INR 350 billion per annum.

  or such higher amount, as may be decided by RBI from time to time.

- The investment limits shall be released in one or

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[2] Press Release 2018-2019/806 dated 5 October 2018

[3] Repo has been defined under section 45U(c) of the RBI Act, 1934 to mean an instrument for borrowing funds by selling securities with an agreement to repurchase the securities on a mutually agreed future date at an agreed price which includes interest for the funds borrowed.

[4] Reverse Repo has been defined under section 45U(d) of the RBI Act, 1934 to mean an instrument for lending funds by purchasing securities with an agreement to resell the securities on a mutually agreed future date at an agreed price which includes interest for the funds lent.

[5] General Investment Limit for G-secs, SDL or corporate debt instruments has been defined to mean FPI investment limits announced in these categories under the Medium Term Framework in terms of A.P. (DIR Series) Circular No. 22 dated 6 April 2018, as modified from time to time (Medium Term Framework).

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- Allocation of investment amount to FPIs under VRR shall be made on tap or through an auction process.

- The minimum retention period[6] shall be 3 years or as decided by RBI for each allotment by tap or auction.

- The mode of allotment, allocation to VRR-Govt and VRR-Corp categories and the minimum retention period shall be announced by RBI ahead of the allotment.

- No FPI (including its related FPIs[7]) shall be allotted an investment limit greater than 50% of the amount offered for each allotment by tap or auction in case there is a demand for more than 100% of amount offered.

Investment Conditions

- FPIs shall invest the Committed Portfolio Size (CPS) i.e. the amount allotted to the FPI in the relevant debt securities and shall remain invested at all times during the VRR, subject to the following relaxations:

  - To provide flexibility to FPIs to adjust their portfolio size, minimum investment by an FPI during the retention period shall be 75% of the CPS.
  - The required investment amount shall be adhered to on an end-of-day basis. For this purpose, investment shall include cash holdings in the Rupee accounts used for the VRR scheme.
  - Amount of investment shall be reckoned in terms of the face value of securities.

- FPIs are required to invest 25% of their CPS within one month and the remaining amount within three months from the date of allotment.

- The retention period will commence from the date of allotment of limit.

- Income from investments through VRR may be reinvested at the discretion of the FPI. Such investments will be permitted even in excess of the CPS.

- Prior to the end of the committed retention period, an FPI may choose to continue investments under VRR for an additional identical retention period. In such a case, it shall convey this decision to its custodian.

- In case an FPI decides not to continue under VRR at the end of the retention period, it may liquidate its portfolio and exit or shift its investments to the 'General Investment Limit' (subject to availability of limit under the said category).

- Where an FPI decides to liquidate its portfolio prior to the end of the retention period, it may sell its investments to another FPI. The FPI buying such investment shall abide by all the terms and conditions applicable to the selling FPI under VRR.

- Any violation by FPIs shall be subjected to regulatory action as determined by SEBI. FPIs are permitted, with the approval of the custodian, to regularize minor violations[8] immediately upon notice, and in any case, within five working days of the violation.

- Custodians shall report all non-minor violations as well as minor violations that have not been regularised to SEBI.

Relaxations

- The requirement to adhere to minimum residual maturity, concentration limits and limits for single/ group investment in corporate bonds shall not apply to investments made through VRR.

Other Operational Aspects

- To enable FPIs participating in VRR to hedge their interest and exchange rate risk in relation to investments under the said route and to undertake repo/ reverse repo transactions to meet liquidity requirements, amendments have been made to various exchange control regulations.

- Guidelines have also been issued vide Circular[9] dated 1 March 2019 providing for operational guidelines, terms and conditions for hedging the exposure to exchange rate risk on account of investments made under VRR.

- Utilisation of limits and adherence to other requirements of VRR shall be the responsibility of both the FPI and its custodian.

- Custodians shall not permit any repatriation from the cash accounts of an FPI, if the same leads to the FPI's assets falling below the minimum stipulated level of 75% of CPS during the retention period.

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[6] Retention period has been defined to mean the period that an FPI voluntarily commits for retaining the Corporate Portfolio Size (i.e. the amount allotted to the FPI) in India.
[7] Related FPIs has been defined to mean "investor group" as per Regulation 23(3) of SEBI (FPI) Regulations, 2014. As per the said Regulation, in case the same set of ultimate beneficial owners invest through multiple entities, such entities shall be treated as part of same investor group and the investment limits of all such entities shall be clubbed at the investment limit as applicable to a single FPI.
[8] Minor violations has been defined to mean violations that are, in the considered opinion of the custodians, unintentional, temporary in nature or have occurred on account of reasons beyond the control of FPIs, and in any case are corrected within five working days.
[9] A.P. (DIR Series) Circular No 22 dated 1 March 2019.

- FPIs shall open a separate Special Non-Resident Rupee and security account for holding debt securities under VRR.

Auction process

- The key features of the auction process for allotment of investment amounts under VRR shall be as under:
  - An FPI shall bid two variables i.e. the amount it proposes to invest and the retention period of that investment, which shall not be less than the minimum retention period applicable for that auction.
  - FPIs are permitted to place multiple bids.
  - If an FPI has been allotted multiple bids in an auction, the CPS shall be reckoned for each bid separately.
  - The criterion for allocation under each auction shall be the retention period bid in the auction.
  - Bids will be accepted in descending order of retention period, the highest first, until the amounts of accepted bids add up to the auction amount.
  - An FPI which has got CPS allocated under an auction will be eligible to participate in subsequent auction as well.

Current Investment Window

- The current investment window for VRR shall be open for allotment from 11 March 2019 and shall be kept open till the limits are exhausted or 30 April 2019, whichever is earlier.
- The aggregate investment shall be as follows:
  - VRR-Govt: INR 400 billion per annum;
  - VRR-Corp: INR 350 billion per annum.
- Minimum retention period shall be 3 years. During this period, FPIs shall maintain a minimum of 75% of the allocated amount in India.
- Investment limits shall be available on tap and shall be allotted by the Clearing Corporation of India Limited (CCIL) on ‘first come first served’ basis. The application to CCIL should be made by FPIs online through their respective custodians.
- CCIL will separately notify the operational details of application and allotment.

Comments

The VRR is a new channel of investment available to FPIs to encourage them to invest in Indian debt markets, over and above their investments made through the existing route. The objective of VRR is to encourage FPIs to commit long term investments into debt markets while providing them more operational flexibility to manage their portfolio by making the investments under this route free of macro-prudential and other restrictions, otherwise applicable to FPI investments in debt securities.

The RBI has accepted certain suggestions made by the stakeholders (in response to the discussion paper on VRR) such as considering cash balance in Rupee accounts in calculating CPS, extension of period for investing 75% of the CPS to three months and providing custodians with the power to regularize minor violations.

The VRR is subject to conditions relating to minimum retention period, requirement to invest within the time prescribed from the date of allotment and certain restrictions on exit prior to end of the retention period. FPIs may need to consider the merits of VRR prior to participating in this route. For foreign credit funds which have shown significant interest in the Indian debt market following the introduction of a comprehensive bankruptcy law in India in 2016, this route may provide them with one more option for structuring investments into India.

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