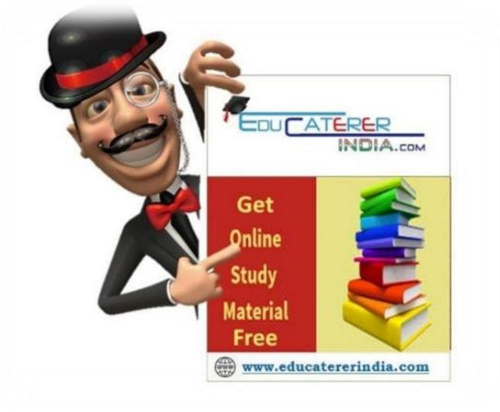
Masala Bonds - All You Need to Know



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SEBI (Securities and Exchange Board of India) is an apex institution for investment in India. Let's know about functions of SEBI :

Functions of SEBI:

We can classify the functions of SEBI into three categories:-

1. Protective functions
2. Developmental functions
3. Regulatory functions

1. Protective Functions:

As the name suggests, the main focus of this function of SEBI is to protect the interest of investor and security of their investment

As protective functions SEBI performs following functions:

(i) SEBI checks Price Rigging:

Price Rigging means some people manipulate the prices of securities for inflation or depressing the market price of securities. SEBI prohibits such practice to avoid fraud and cheating which can happen to any investor.

(ii) SEBI prohibits Insider trading:

Any person which is connected with a company such as directors, promoters, workers etc is called Insiders. Due to working in the company they have sensitive information which affects the prices of the securities.Such information is not available to people at large but Insider gets this key full knowledge by working in such company. Insider can use this information for their personal benefits or make a profit from it, such process is known as Insider Trading.

For Example - Managers or Directors of a company may know that company will issue Bonus shares to its shareholders at a particular time and they purchase shares from market to make a profit with bonus issue.

SEBI always restricts these types of practices when Insiders are buying securities of the company and take strict action to avoid this in future.

(iii) SEBI prohibits fraudulent and Unfair Trade Practices:

SEBI always restricts the companies which make misleading statements which are likely to induce the sale or purchase of securities by any other person.

(iv) SEBI sometimes educate the investors so that become able to evaluate the securities and always invest in profitable securities.

(v) SEBI issues guidelines to protect the interest of debenture holders.

(vi) SEBI is empowered to investigate cases of insider trading and has provision for stiff fine and imprisonment.

(vii) SEBI has stopped the practice of allotment of preferential shares unrelated to market prices.

(vii) SEBI has stopped the practice of making a preferential allotment of shares unrelated to market prices.

2. Developmental Functions:

Under developmental categories following functions are performed by SEBI:

(i) SEBI promotes training of intermediaries of the securities market.

(ii) SEBI tries to promote activities of stock exchange by adopting a flexible and adaptable approach in following way:

(a) SEBI has permitted **internet trading** through **registered stock brokers**.

(b) SEBI has made underwriting optional to reduce the cost of issue.

(c) An Even initial public offer of primary market is permitted through the stock exchange.

3. Regulatory Functions:

These functions are performed by SEBI to regulate the business in stock exchange. To regulate the activities of stock exchange following functions are performed:

(i) SEBI has framed rules and regulations and a code of conduct to regulate the intermediaries such as merchant bankers, brokers, underwriters, etc.

(ii) These intermediaries have been brought under the regulatory purview and private placement has been made more restrictive.

(iii) SEBI registers and regulates the working of stock brokers, sub-brokers, share transfer agents, trustees, merchant bankers and all those who are associated with stock exchange in any manner.

(iv) SEBI registers and regulates the working of mutual funds etc.

(v) SEBI regulates takeover of the companies.

(vi) SEBI conducts inquiries and audit of stock exchanges.

Other Functions

1. Registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to issue, trustees of the trust deed, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment adviser and such other intermediaries who may be associated with securities markets in any manner.

2. SEBI also perform the function of registering and regulating the working of depositories, custodians of securities. Foreign Institutional Investors, credit rating agencies etc.

3. Registering and regulating the working of Venture Capital Funds and collective investments schemes including mutual funds.

4. Promoting and regulating self - regulatory organizations.

5. Calling for information form, undertaking inspection, conducting inquiries and audits of the stock exchange, mutual funds and intermediaries and self - regulatory organizations in the securities market.

6. Calling for information and record from any bank or any other authority or boars or corporation established or constituted by or under any Central, State or Provincial Act in respect of any transaction in securities which are under investigation or inquiry by the Board.

7. Conduct research on any matter described if any.

8. Calling information from any agency, institution, banks etc.

During his visit to the UK last week, Prime Minister Narendra Modi spoke about the Indian Railways issuing bonds and listing them on the London Stock Exchange.

What are Bonds?

Bonds are debt instruments which allow the companies or govt. to raise funds only by incurring debt and lender is guaranteed of a fixed repayment (Principle and Interest).

What are instrument available with Company to raise funds?

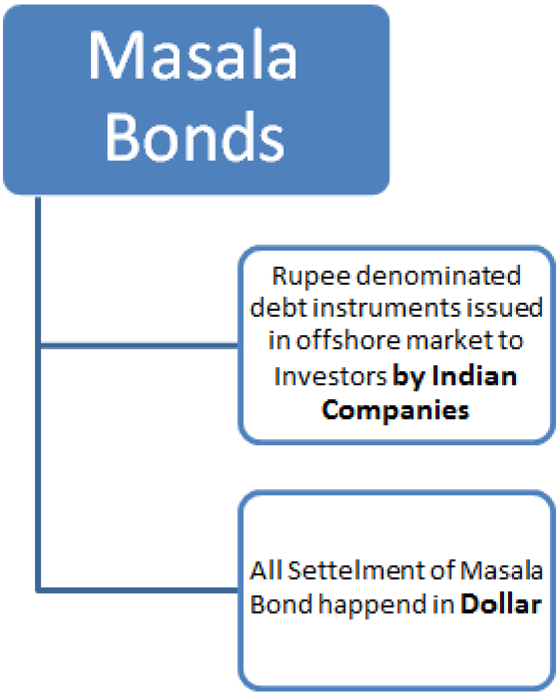
1. Issue Bonds – Companies will have to pay the fixed amount when the bond matures.
2. Issue Shares – Companies would like to raise money but don't want it as a debt so the company will issue shares.

How the bonds are more secure than the shares?

In case of **liquidation** of the company, the bond holders get their claim before the share holders.

Masala Bond is nothing but a bond in Indian rupee denominated bonds issued in offshore capital markets.

Introduction of Masala Bonds



The bonds listed on the London Stock Exchange (LSE) is termed as Masala Bonds. These bonds are offered and settled in US dollar to hike Indian Rupee in International market. These bonds help to raise Indian rupees from International investors for infrastructural development in India. International Financial Corporation (IFC) converts bond from dollars into rupees and uses the rupees to finance private sector investment in India. The term Masala bond was coined by IFC and it recognized globally.

'Masala' refers to spices and it evokes the culture and cuisines of India. These bonds can be issued by Indian corporates only. No bank is allowed to issue Masala bonds Some of the corporates like HDFC, Indian Railway Finance Corporation and NTPC are willing to raise funds abroad.

The major component of Masala Bond is its hedging costs. The rupee-dollar equation plays an important role and the stability of this equation gives assurance and confidence to invest. IFC issues Masala bond in the offshore market. The price of a bond is denominated in Indian currency and not in the US dollars, but it is paid in dollars after maturing.

Why Masala Bond?

Masala bonds have a quite significant for the Indian economy. Indian Issuers face less risk in Masala bond as compared to bond markets. The currency risk is entirely borne by the foreign Investors. Masala Bonds are issued to foreign investors and settled in US dollars. Unlike external commercial borrowings (ECBs), where Indian companies raise money in foreign currency loans, the currency risk lies with the investor and not the issuer, Masala bonds are similar to external commercial borrowings (ECBs), in which Indian companies raise funds in foreign currency and are exposed to rupee-dollar fluctuations. If ECBs (External Commercial Borrowings) help companies to take advantage of the lower interest rates in international markets, the cost of hedging the currency risk is significant, but If unhedged, adverse exchange rate movements bite the borrower. Inversely in the case of Masala bonds, the cost of borrowing can work out much low. Overseas investors will be eligible to hedge their exposure in rupee through permitted derivative products with banks in India to hedge the riskes. It helps Indian companies to diversify their bond portfolio. Earlier, companies used to issue only corporate bonds. Masala bonds are an addition to their bond portfolio. It helps the Indian companies to reduce the cost. Bonds issued in Indian companies carries an interest rate of 7.5%-9.00%, whereas Masala Bonds are issued below 7.00% interest rate outside India. It also helps Indian companies to attract a large number of investors as these bonds are issued in the offshore market. An offshore investor earns better returns by investing in Masala bonds rather than by investing in his home country. If the rupee appreciates at the time of maturity, then An investor will benefit from his investment in Masala bonds.

Facts Rules of Masala Bonds –

- As per RBI guidelines, not only corporates but also Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) are eligible to issue these bonds.
- These bonds can be privately placed or listed on exchanges as per host country regulations.
- These bonds will be issued for a minimum maturity period of 5-years.

What's new in the Masala Bonds?

Basically, **overseas rupee bonds** are known as Masala bonds.

- Indian firms have earlier raised money abroad through bonds and other forms of borrowings, but always in **foreign currency**, mainly via ECBs (External commercial borrowings).
- However, the **first overseas rupee bonds** were issued in 2013 by the International Finance Corporation, the World Bank's private sector investment arm.
- To raise funds for capital expenditure, the **Indian Railway Finance Corporation** will be issuing bonds denominated in rupees.

What are the risks faced by Indian companies associated with foreign currency overseas bond?

- An Indian company issuing an overseas bond (i.e. in other currencies especially dollar) **runs into a risk** on account of **currency fluctuation**.
- If rupee weakens during the period of the bond, then it **adds significantly to costs** at the time of repayment, normally at the end of 5 years.

How Masala Bonds will benefit Indian companies?

- If the issuer, issues bonds in rupees, then he **gets rid of this risk** (currency fluctuation) which passes on to the investor.
- This bond brings a **new and diversified set of investors** for Indian companies and more liquidity in foreign exchanges, apart from bank-funding and the corporate bond market in India.

Does Masala bond offer something to the foreign investors?

- The investor who purchases a bond issued by an Indian entity is betting on India, in a hope that the **currency and inflation would be stable** enough to ensure good returns after hedging for foreign exchange risks.
- With **India's GDP or national income rising** and projected to grow at a reasonably fast clip over the next few years, many overseas investors would like to buy into such bonds to join the party and

to **earn higher returns** compared to the US and Europe where interest rates are still low.

How does Govt. and RBI view Masala Bonds?

- The local currency bond markets can contribute to **financial stability** by **reducing currency mismatches** and extending the duration of debt.
- It will also be a sign of early **acceptance** of the Indian currency in trading and settlement overseas, showing the confidence of investors and can lead to **internationalization** of the currency over the **medium and long term.**
- Foreign investors prefer to hedge their **risks overseas** because there are limited products in the Indian market, especially for longer periods.
- The other worry, if the overseas rupee bond market takes off, will be about the **growth of the Indian corporate bond market** and Indian banks as top companies shift to another market, impacting the growth here.

Was such an approach adopted by any emerging economies in past?

- China's People's Bank of China has previously issued yuan denominated bonds (Dim Sum Bonds) to raise funds at a little over 3%.
- Japan had also floated yen denominated bonds called as 'Samurai'

Let's take into account the differences between India and China!

1. Unlike China, the Indian govt. has **never borrowed abroad** on its own, preferring to push its state owned firms, instead.
2. RBI, unlike the Chinese central bank, **cannot issue debt** with no legal sanction for it.

But these have been borrowings in dollar or other currencies. The Railways bond, on the other hand, will be denominated in rupees.