asifma

Growing Asia's Markets

India's Debt Markets

The Way Forward

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ASIFMA is an independent, regional trade association with over 100 member firms comprising a diverse range of leading financial institutions from both the buy and sell side including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative and competitive Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the US and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

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A. Executive Summary

Ever since India ushered in a burst of economic reforms starting in the early nineties, there has been a metamorphosis in the Indian capital markets, which has posted impressive growth across several dimensions. Even so, there is scope for improvement across a number of are ranging from the more visible physical infrastructural constraints to the less visible institutional, social, legal, regulatory and governance deficits have collectively impeded the further development of the Indian markets – so much so that even though growth rates and the progress witnessed in Indian capital markets in absolute terms might appear to be impressive, these have been outpaced by even faster capital market developments – particularly in the fixed income space – in the other regional emerging markets, China in particular. ASIFMA (together with our co-authors) have endeavoured to take stock of recent developments (since the publication of ASIFMA's last India bond markets roadmap in 2013) and to lay down some clear markers for the future evolution of the Indian fixed income markets.

For a long period of time post-independence in 1947, India has had a relatively closed capital account, which the Indian regulatory authorities have only begun to open gradually. Since the dawn of the economic reform era in the early 1990s, the domestic Indian markets (both debt and equity) have shown substantial growth. Turning to some specific numbers, net cumulative foreign investment in equities has grown from nothing in 1992 to USD 128.5bn as of end-2016, while the comparable figures for debt stands at USD 42.1bn. These figures account for about 6.4% of the total Indian equity market capitalization and approximately 3.0% of the combined value of the Indian debt markets (source: Business Standard). While the overall growth figures over the last 25 years have been impressive, these figures are still relatively low compared to the other, more open capital markets globally.

Across other metrics too, there are several areas in which the Indian fixed income markets could see structural changes for the better, despite stand-alone growth rates being relatively impressive – for instance, while Indian corporate debt as a percentage of GDP has grown from less than 5% to about 15% of GDP over a five-year period starting in 2012, this figure is considerably less than even a smaller ASEAN market such as Malaysia, where corporate debt penetration is around 40% of GDP. Thus, there is considerable room for growth in corporates accessing the capital markets (as opposed to the more traditional loan markets), more so in an environment where bank non-performing loans (NPLs) have weighed heavily on Indian bank profitability and capital ratios in recent years.

A mix of restrictive rules regarding issuance, high public sector borrowing requirements, uncertainties around tax policy and the propensity of the Indian regulatory authorities to implement frequent rule changes without sufficient market consultation, shortcomings (at least till recently) in areas such as bankruptcy, resolution and netting, the lack of benchmark yield curves, illiquidity in the secondary markets except in a limited number of on-the-run benchmark instruments, the lack of a trading culture among several classes of institutional investors, the lack of well-developed fund management and insurance industries and the low rate of capital formation coupled with the low level of private sector savings, have all weighed on the development of the fixed income markets.

We have attempted to address all these issues in the course of this document and have organized our discussion along the following lines:

1. Evolution of the Indian Bond Markets

In this section, we have reviewed some of the key points and the various recommendations we made in the "2013 India Bond Market roadmap" and have outlined how both the Indian cash bond and derivatives markets (particularly the government bond markets) have developed, with the key role played by the Clearing Corporation of India Limited (CCIL), in the areas of trading and clearing. Even though a great deal of progress has occurred, some of our recommendations have yet to be met – particularly with respect to the lack of liquidity in anything but the on-the-run issues and the adoption of a "mark-to-market" (as opposed to a hold-to-maturity) mindset among several market participants.

We then review the growth in the corporate bond markets, the different types of instruments, the volumes traded, the holding pattern of securities among various classes of investors, the development of the repo markets and the need for a "classic repo" market and the progressively wider participation in the Indian bond markets among a wider range of Foreign Portfolio Investors (FPIs). We also assess the growth and development of Indian mutual fund investments in the debt markets.

Finally, we look at developments in the Indian securitization markets, the granting of access to FPIs in recent months and the rationalization/removal of certain tax barriers to investment in Indian securitization structures. We also evaluate the Indian credit markets infrastructure, particularly the creation of ratings agencies and the increasingly key role they play in the Indian ratings space. While foreign ratings agencies have a presence in India (both direct and indirect), more needs to be done to align the local Indian scale of ratings to international norms. Additionally, while trading, clearing and settlement infrastructures have developed, linkages of Indian securities depositories with International Central Securities Depositories (ICSDs) would prove especially beneficial for collateral mobility internationally.

2. Legal & Regulatory Framework (Bankruptcy & Resolution, Netting)

In this section, we discuss the overall domestic legal and regulatory framework governing the Indian fixed income markets, in particular, the division of oversight responsibilities between the Reserve Bank of India (RBI) and the Securities & Exchange Board of India (SEBI). We also discuss some of the newer fixed income products introduced into the domestic bond markets (and the regulations governing such instruments) such as municipal bonds and gold sovereign bonds.

Next, we consider the linkages between the cash markets and derivatives/hedging instruments such as swaps and futures and the evolution of the repo markets in India. While several positive developments have occurred in the swaps market (such as the setting up of bilateral margining, central clearing and the mandating of "Legal Entity Identifiers" (LEIs), much more needs to be done. Turning to the repo markets, there has been progress here as well, but has been relatively limited. While re-repo is permitted under certain conditions in the government securities markets, this has not been allowed for corporate bonds. As for other steps, central clearing and reporting of repos and more recently, the legalization of a tri-party repo framework have all been taken. That said, a true "classic repo" framework remains some distance away in India.

Additionally, issues related to the adoption of close-out netting, the new bankruptcy & insolvency regime (which is expected to provide an impetus to close-out netting) and the "Financial Resolution & Deposit Insurance Bill" (FRDI), all of which align the Indian markets more closely with international standards, are also discussed. Finally, specific measures for investor protection and the granting of increased access to FPIs are covered in this section. Specific proposals made by the Indian regulatory authorities to further develop the bond markets, such as rules governing the re-issuance of bonds and the adoption of the Electronic Book Provider ("EBP") mechanism are explored in greater detail.

3. Settlement and Operations – Issues and Suggested Steps for Resolution

In this section, specific issues related to the settlement and operations infrastructure with respect to the Indian fixed income markets are highlighted and specific solutions are proposed for their resolution. Specifically, the lack of a uniform settlement cycle, undue complexity in managing FPI limits and the need to consolidate the multiple circulars pertaining to guidelines for FPI investments in the Indian bond markets are discussed.

4. Offshore Issuance by Indian Issuers – Structures and Legal Framework

This section focuses on the external/international component of the Indian bond markets and focuses specifically on some of the innovative High Yield (HY) deal structures employed in accessing these markets. A brief overview of how these structures can be compared and contrasted with HY issuance from other jurisdictions such as China (with a focus on covenant packages and credit support mechanisms) is explored in detail in this section.

In terms of specific instruments, the newly introduced Masala bond market's overarching regulatory framework, together with some of the more recent (in our view, counterproductive) restrictions that have been imposed are discussed in some detail. Finally, rules governing Indian Medium Term Note (MTN) programmes and the fast-developing green bond market are also covered.

5. Access Channels and the Taxation of Debt Instruments

The final section of the document provides exhaustive coverage around the "access channels" available for all FPIs for investment in a whole range of Indian debt instruments – ranging from dated government securities, to zero-coupon bonds, non-convertible debentures, perpetuals, Masala bonds, debt-oriented mutual funds, securitized instruments, infrastructure investments and Real Estate Investment Trusts (REITs), among others.

The paragraphs following the discussion of FPI access channels provide a detailed overview of the complex Indian tax framework – specific topics discussed include the latest developments with regard to the revision of Indian tax treaties with a number of countries, the General Anti-Avoidance Rules (GAAR), rules related to "Base Erosion and Profit Sharing" (BEPS), Thin Capitalization Rules, Income Computation and Disclosure Standards (ICDS) and "Overseas Transfer Provisions".

Additionally, this section also discusses the "Safe Harbour Provisions" for international investors in the Indian capital markets and the newly established framework for the establishment of International Financial Services Centres ("IFSCs") with the Gujarat International Finance Tech City ("GIFT City") being the first such IFSC. Tax exemptions and incentives for investment in IFSCs are also alluded to in this section.

The remaining sections are all Annexures/Appendices, which complement and add round out the discussions centred on the topics above.

6. Annexure A – The Overview of Taxability in India

This annexure is a comprehensive overview of how tax is determined, assessed and administered on income streams and capital gains, based on various criteria – the residency of the taxpayer and the characterization/accrual of income. The imposition of various specific taxes – such as withholding taxes and Minimum Alternative Tax (MAT) is discussed, along with the applicability of the various tax treaties with reference to specific situations.

7. Annexure B - Tax and Regulatory Overview of Different Instruments

This annexure is an instrument by instrument description of each of the various classes of debt securities covered in "Section F" – Access Channels – above, with respect to the conditions that regulate FPI investment in and taxation of each of these securities. Specific details are provided on the types of investors, investment conditions, investment limits, taxes on income and capital gains and withholding taxes (if applicable), pertaining to each class of fixed income instrument, among other relevant details.

8. Annexure C – Recommendations

An exhaustive set of recommendations, based on our discussion/analysis of the various issues highlighted in each of the sections above – is contained in this final annexure. These recommendations range from general/broad suggestions at a macro level, to very specific ones – dealing with suggestions that are pertinent to certain micro aspects of the Indian fixed income markets – such as settlement timelines, to give one example.

B. Evolution of the Bond Markets in India

1. Introduction

Over the last five years, India has been considered a key growth economy in Asia and one of the "markets to be in" for foreign investors, as the country consistently recorded annual GDP growth rates in excess of 7% (till the most recent post-demonetization period), making it the fastest growing G-20 economy for a period of time. In short, India is now considered an emerging success story, more so after the new government signalled its intent to carry out (and has implemented) several reforms, many of them centred on the ease of doing business.

However, there are some economic and financial infrastructure bottlenecks that need to be eased to further encouraging foreign investments. Weak corporate balance sheets, need for further tax and labour reforms, high NPLs and low credit growth in an uncertain global economic environment, have taken some of the shine off the India growth story. The implementation of a consistent and coordinated policy to further develop the Indian financial markets would confer great benefits to India and its citizens. A more structured approach would enable a much safer and more appealing market for issuers and investors and ultimately result in a stronger economy for India.

At a more micro level, we do note that the Indian authorities have recognized that a robust bond market is critical for growth of any country and India is no different. A developed bond market significantly increases the depth of the financial markets as it helps in serving the needs of both the private and public spheres better. This assumes a role of even greater significance given the context that bank balance sheets are now extremely weak, thus impeding loan growth, but some of that growth has now shifted to the bond markets, whose development (particularly in the corporate bond area) has accelerated over the last few years. Hence, it comes as no surprise that the Indian regulatory and monetary authorities recognize this and have been taking continuous steps to deepen the fixed income market in India.

In consequence, the total domestic bond market has grown from around USD 1.0tn at the end of 2012 to approximately USD 1.5tn by March 2017, with government securities (both Central and State) accounting for USD 1.06tn (Source: Livemint data and ASIFMA estimates). More significantly, corporate bonds as a percentage of GDP have grown from around 5.0% in 2012 to around 14% in 2016 (Source: ASIFMA and Livemint), although this level of penetration is still considerably lower than that of Malaysia, where the corporate bonds to GDP ratio is in excess of 40%. At a greater level of detail, the following are the types of bonds that are issued in the Indian domestic bond markets:

1. Government bonds and Treasury Bills (T-Bills): issued directly by the government of India, the so called G-Secs; T-Bills are shorter-dated securities, up to one-year in duration;
2. Borrowing by state governments: State Development Loans (SDLs), which are dated securities issued by single states within India for meeting their market borrowing needs;
3. Corporate bonds (including Public Sector Unit (PSU) bonds – issued by sovereign/quasi-sovereign entities and bonds issued by banks/financial institutions): this market has room to

develop further. While the value of corporate bonds outstanding has expanded from single digit to double digit percentages as a proportion of GDP, there is a long way to go;

4. Masala bonds – these are INR-denominated bonds issued offshore and are a form of offshore borrowing – this is a product that has been legalized relatively recently;
5. Securitised Debt Instruments: These are issued either in the form of debentures or Pass-Through Certificates – Foreign investors have recently been given access to this market and moreover, tax treatment of these instruments has been made more advantageous.
6. Municipal bonds: these are bonds issued by Urban Local Bodies (ULBs) for financing specific projects, typically linked to infrastructure; the framework for the issuance of these instruments was recently announced by SEBI and the first issuance was done recently.
7. Gold Sovereign Bonds: This is again a product introduced relatively recently, to help make India's large gold holdings in private hands, more liquid besides being put to more productive uses.
8. Green bonds: The framework for green bonds issuance was introduced in India in 2016 and a few transactions, mostly by financial institutions, have been completed.

The ultimate objective of RBI has been to ensure complete transparency and increasing liquidity across the curve, thereby helping in better discovery of prices for both government and corporate bonds. Clearly articulated steps have been taken by RBI over the course of last three to four years to ensure this is achieved. Further, to make the market more vibrant, RBI has also been introducing new products and encouraging more types of investors to actively contribute to the bond market. That said, more needs to be done to bring the Indian fixed income markets on par with the more developed regional bond markets. In the following sections, we will outline how bond markets have evolved in India in last few years and set out recommendations on how this market could be further improved.

2. Government Securities

Since the last report on the Indian bond markets published in 2013, there has been considerable progress that the Indian government securities markets have recorded. We outlined several areas pertaining to the Indian government securities market where there was/is room for improvement and articulated specific advocacy points, which we urged the Indian authorities to consider adopting. While it is fair to say that many of the suggested changes/improvements to the Indian government securities framework have been passed, there is room for more improvement.

Specifically, we urged the development of benchmark yield curves across the maturity spectrum and the need for greater liquidity in the secondary markets (through the adoption of more of a trading mentality among market participants, a move away from "held-to-maturity" portfolios to the adoption of a "mark-to-market/held-for-trading" approach, which in turn would be facilitated by a reduction in the Statutory Liquidity Ratio (SLR), encouraging the development of a broader and more active domestic and foreign investor base, including pension funds, mutual funds, insurance companies and other real money investors, besides developing a variety of hedging tools including repo and derivatives). Over the last half decade, while a great deal of forward movement has occurred, progress in at least a few of the areas has been decidedly mixed.

The volumes traded in the government bonds market have increased as the borrowing program of the government has increased over the years. In terms of secondary market activity in government bonds, the volumes traded across the yield curve since the last few years have seen a change in distribution. The benchmark 10y has been the most traded security (with the highest percentage of volumes being traded in the 7y-10y bucket). However, since 2014-15 we have seen a pickup in volumes traded in the 5y and 5y-7y bucket which has led to better discovery of the bond curve in less than 7y tenors. The 10y-15y bucket which is the second most traded bucket has seen a decline in share in total volumes traded.

The longer end of the curve which is > 15y maturity however continues to be less traded accounting for 1-3% of volumes. This is because the most active participants in this segment are investors like pension funds and insurance firms who are long only investors and undertake less trading activity in this segment. Thus, one of our goals, the suggested encouragement of traders to trade across the maturity spectrum has not yet been met. That said, the authorities are conscious of the need for longer dated benchmarks and in order to make the longer end more relevant for investors like Employee Provident Fund Organizations (EPFOs) and insurance companies a 40 year bond was issued for the first time in 2015.

G-Sec Volumes

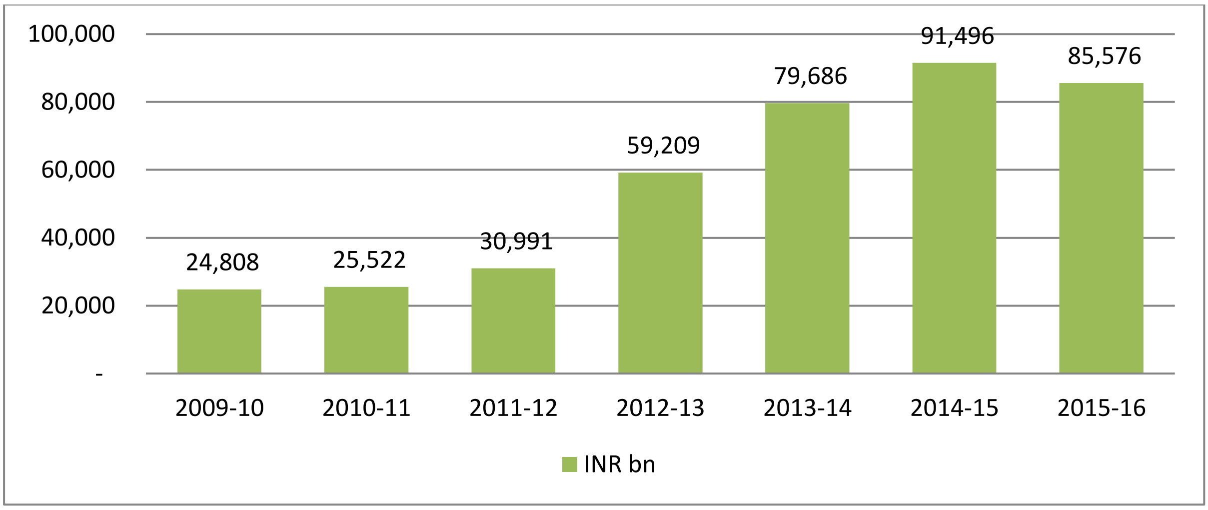


Table 1: G-Sec traded volumes
Source: CCIL

In terms of structural developments in connection with the market's trading infrastructure, cash bond trading in the government securities market has evolved in a unique direction. The Negotiated Dealing System – Order Matching (NDS-OM) framework of the CCIL effectively acts as a "Central Limit Order Book" on which the bulk of government bonds trade (and is also the CCP – Central Counterparty – for all secondary market trades in the government bond market, which have to be mandatorily cleared/settled through CCIL). This represents a marked difference from most other markets, where government bonds are generally traded OTC, or on a Request for Quote (RFQ) basis.

In the context of CCIL playing a central role in both the government bond (and repo) markets, the recognition of CCIL as a CCP equivalent to a European CCP by ESMA in March 2017, ahead of the effective start date of MIFID II in January 2018, is a welcome development. ASIFMA has long advocated that Asian CCPs (including and especially CCIL) obtain equivalence (with both the US and European CCPs), to ensure a smooth transition to the new regulatory regimes (MIFID II in the case of Europe).

The benchmark on the run bonds continue to be the most liquid securities that are traded on the NDS-OM screen and the broker market. Yet another initiative with a view to ensure more liquidity in illiquid bonds is the market making program for Primary Dealers (PDs), where PDs offer two way quotes on the screen on selected securities. This will lead to more trading activity in illiquid securities and correspondingly better discovery of the yield curve.

Tenor-wise Issuance of Government Bonds (INR billion)

	Up to 5Y	5-7Y	8-10Y	11-15Y	16-20Y	21-40Y
2013-14	110	1,160	1,230	1,190	930	950
2014-15	-	810	1,610	1,470	930	1,100
2015-16	-	200	1,970	1,430	1,120	1,130
2016-17	-	730	1,750	1,630	820	890

Table 2: Tenor-wise Issuance of Bonds
Source: CCIL

Tenor-wise Distribution of Traded Volumes (INR crores)

	<5y	%	>5-7y	%	>7-10y	%	>10-15y	%	15-20y	%	>20-40y	%
2014-15Q4	304,205	13	31,884	1	980,226	43	881,529	39	25,071	1	62,113	3
2015-16Q1	386,973	17	34,724	2	1,139,598	50	638,305	28	33,830	1	47,317	2
2015-16Q2	246,532	11	54,214	3	1,435,526	67	345,300	16	27,631	1	44,999	2
2015-16Q3	283,526	15	253,748	13	797,313	41	504,134	26	50,128	3	43,143	2
2015-16Q4	554,152	25	206,045	9	693,755	32	663,532	30	36,132	2	37,109	2
2016-17Q1	578,125	20	303,138	11	903,690	32	964,381	34	37,005	1	41,477	1
2016-17Q2	517,385	10	455,477	9	1,908,203	37	2,202,993	42	59,825	1	61,470	1
2016-17Q3	342,109	7	379,778	8	2,089,302	45	1,658,342	36	59,807	1	63,528	1
2016-17Q4	317,374	12	165,704	6	1,370,790	53	646,997	25	26,937	1	44,635	2

Table 3: Tenor-wise Distribution of traded volumes
Source: CCIL

3. State Developmental Loans

The amount of SDLs traded, as a percentage of total volumes, have also increased over the last few years as states have increased reliance on market borrowings from 69.7% of outstanding liabilities in March 2015 to 74.7% by end March 2017. Over the years we have seen a steep increase in SDL issuances. From a gross borrowing figure of INR 1182bn in 2009-10 it has increased to INR 3820bn in 2016-17.

State government borrowings were unevenly distributed with bunching up of borrowings in the second half of the year. There has been more visibility for the market on issuance of SDLs and state wise issuance calendars are published on a quarterly basis. This has led to an increase in market participation and also the percentage of SDLs traded in the secondary market has increased over the last few years as can be seen from the table below.

SDL Gross Borrowing (INR billion)

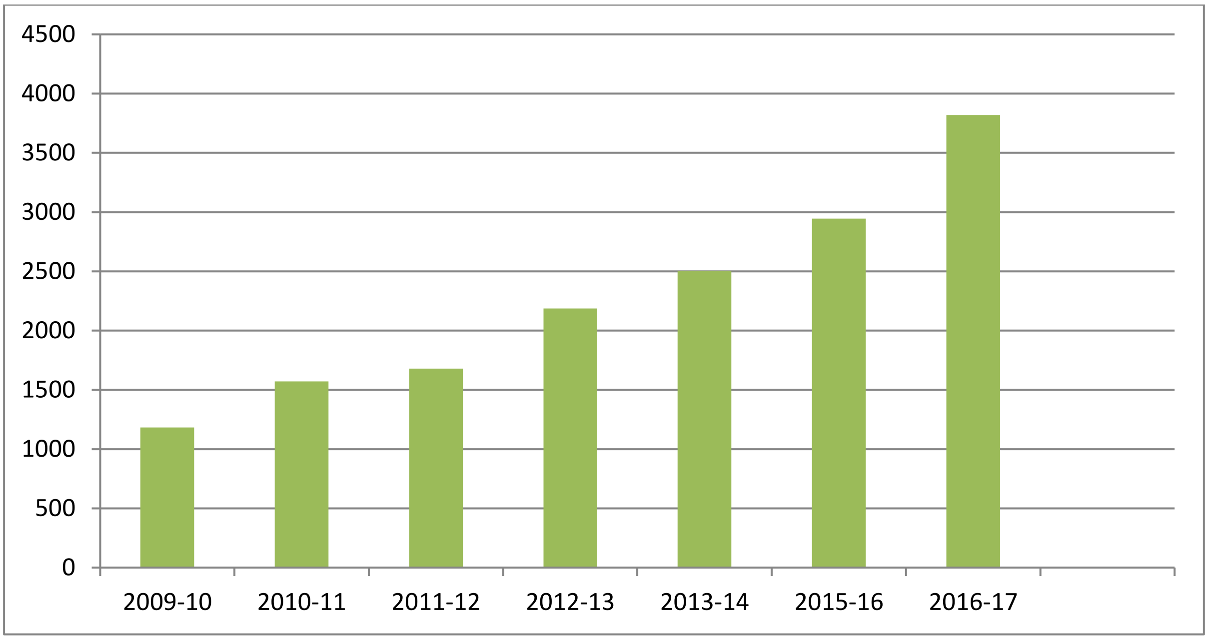


Table 4: SDL Gross Borrowing
Source: RBI

Instrument wise % of Traded Volumes

% of Traded Volumes	G-Secs	SDL	T-Bills
2014-15Q4	90.0	2.5	7.5
2015-16Q1	89.1	2.2	8.7
2015-16Q2	87.6	3.1	9.2
2015-16Q3	86.3	3.9	9.7
2015-16Q4	88.7	3.9	7.4
2016-17Q1	89.1	3.5	7.4
2016-17Q2	91.8	3.3	4.9
2016-17Q3	91.9	2.9	5.3
2016-17Q4	84.8	5.3	9.9

Table 5: Instrument wise % of Traded Volumes
Source: CCIL

4. Introduction and Strengthening of Funding Markets

While the Indian repo market has seen significant changes since 2013, notably the introduction of mandatory trade reporting on the National Dealing System (NDS) of the CCIL, India has still yet to adopt the "classic repo" framework advocated by ASIFMA in our 2013 India bond market roadmap. For more on the legal framework governing the Indian repo market, please see the "Legal & Regulatory" section.

Turning to the evolution of the repo markets themselves, the liquidity operations by RBI have moved to a term repo framework post October 2013. Earlier the banking system was entirely dependent on the fixed rate LAF window where liquidity at a fixed rate (repo rate) was provided by RBI and excess liquidity was taken out through the use of fixed rate (reverse repo). In October 2013 term repos were announced for the first time wherein 7day and 14day term repos were announced through a variable rate auction mechanism. Over the last three years we have seen increased use of variable rate of term repo and term reverse repo facilities across tenors from 2d-128d for managing banking system liquidity. According to RBI's annual report with the institution of the revised liquidity management framework, the role of term repo auctions under the liquidity adjustment facility (LAF) has become significant. Normal 14-day and fine tuning term repos of varying tenors ranging from 2 to 56-day accounted for about 90 per cent of the average net liquidity injection under the LAF during the year.

Liquidity Management: Various Instruments

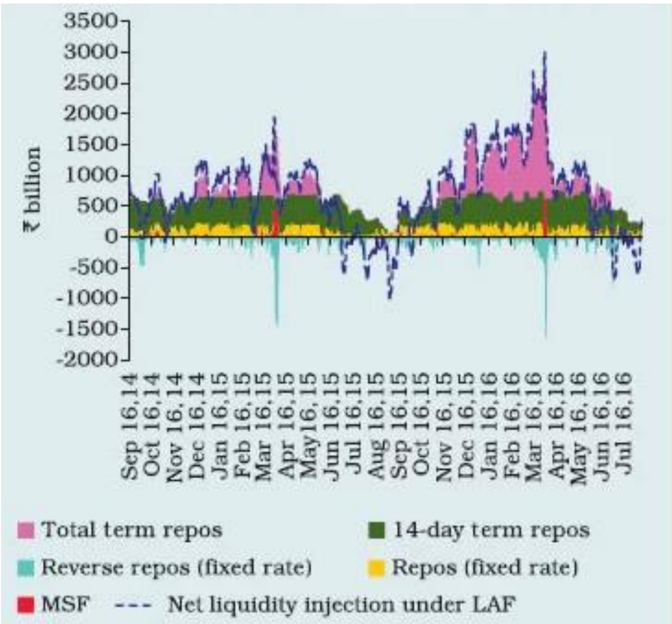


Table 6: Liquidity Management: Various Instruments
Source: RBI Annual Report 2015-16

As the term repo and reverse repo markets have evolved, the reliance of inter-bank community on call money markets has declined. There has been a decline in call money volumes in the last quarter of 2016-17 as the banking system has been parking its entire excess liquidity with RBI.

Percentage of Traded Volumes in CBLO, Repo and Call Market

% of Volumes	CBLO	Repo	Call
2014-15Q4	60.8	27.2	12
2015-16Q1	60.7	28.1	11.2
2015-16Q2	62.8	25.8	11.3
2015-16Q3	57.5	30	12.5
2015-16Q4	53	31.7	15.3
2016-17Q1	54.9	31.9	13.2
2016-17Q2	56.3	32.9	10.8
2016-17Q3	59.1	29.8	11.1
2016-17Q4	62.8	28.4	8.8

Table 7: Percentage of Traded Volumes in CBLO, Repo and Call Market
Source: CCIL

5. Widening of the Market

FPI Participation

The participation of FPIs have increased over the last three years as RBI provided a calendar for opening up limits in government bond markets and SDLs on a quarterly basis. The RBI in its monetary policy statement in September 2015 laid down a medium term framework for FPI limits in consultation with the government. The limits would be increased in phases to 5% of the outstanding stock by March 2018. For more details on FPI participation in the Indian bond markets, see the section of FPI access channels below.

Year Wise FPI Investments in Debt (INR billion)

FPI Investments	G-Secs	Corporate Bonds	SDL
Mar-14	847	840	0
Jun-14	1052	915	0
Sep-14	1396	116	0
Dec-14	1503	1438	0
Mar-15	1529	1890	0
Jun-15	1516	191	0
Sep-15	1528	1869	0
Dec-15	1617	1793	36
Mar-16	1657	1689	45
Jun-16	1645	1613	39
Sep-16	1804	1704	15
Dec-16	1508	1621	11

Table 8: Year Wise FPI Investments in Debt
Source: NSDL

FPI % Holdings in G-Sec

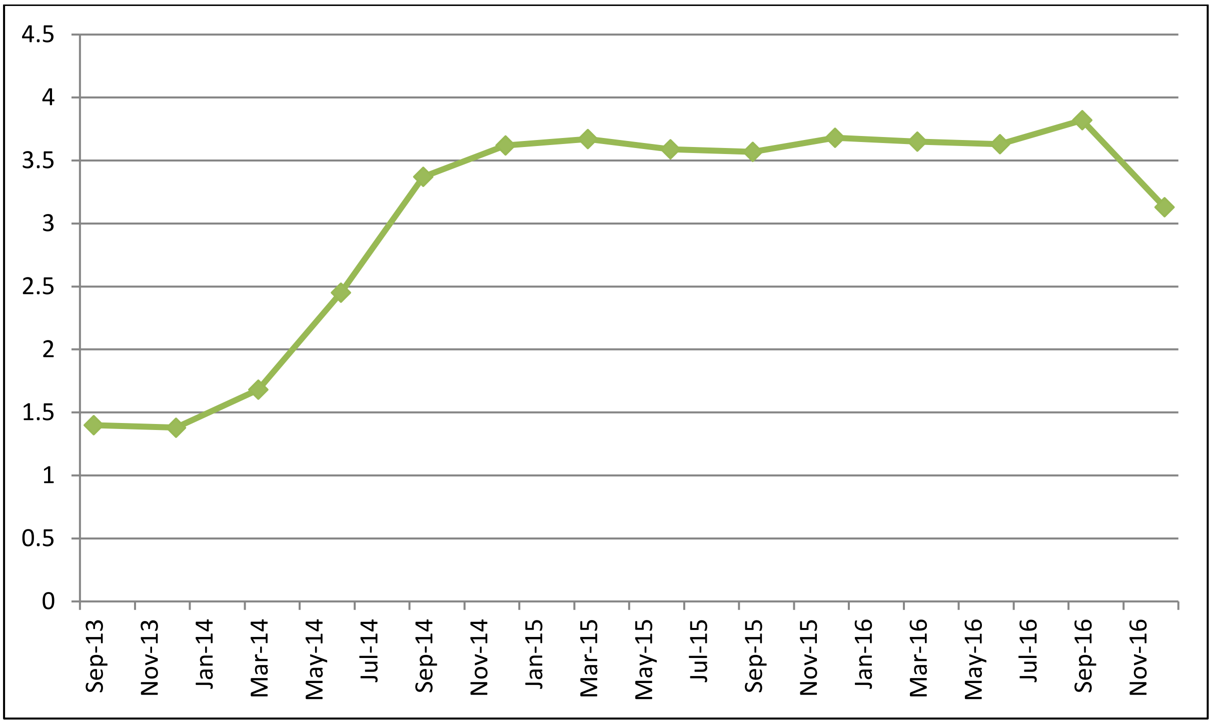


Table 9: FPI % Holdings in G-Sec
Source: RBI

Ownership Pattern in Government Securities

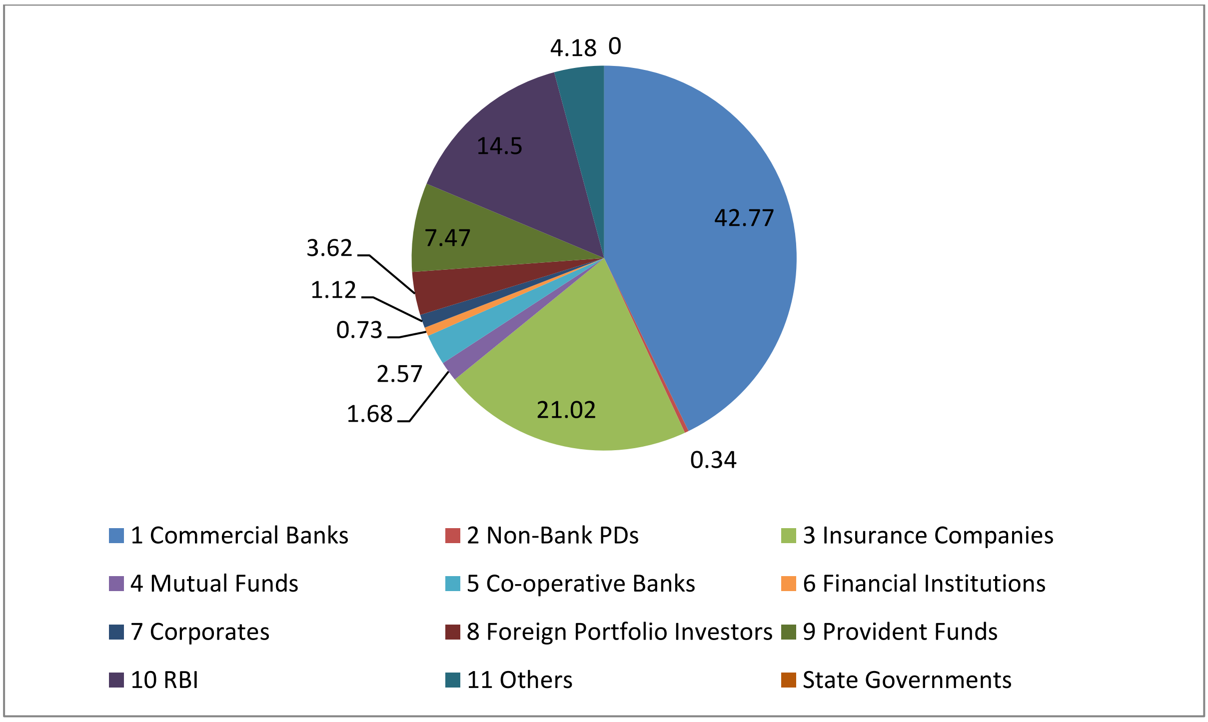
Over the last three years we have seen reduced ownership in government bonds by commercial banks. This has been as a result of SLR cuts by RBI. The SLR or "Statutory Liquidity Ratio" is a requirement for all regulated banking entities to invest a certain proportion of their total assets in G-Secs. This ratio has varied over the years but in recent years, the trend has been down. SLR rates have been reduced by 25 bp every quarter starting from April 2016. One of our key advocacy points has been for a reduction in the SLR, which has indeed come down over the years to 20.8% currently, from levels in excess of 38% a few years ago. Nevertheless, the continuing large government fiscal deficits will tend to limit the extent to which SLRs can fall. On the other hand RBI has gradually opened FPI limits which have increased FPI participation and ownership since the last three years. FPI holdings have increased from 1.4% in September 2013 to 3.13% in December 2016.

Yet another factor worth noting is that FPI investments in the Indian bond markets overall (and not just in the G-Secs market) would receive a significant boost is if India is included in the major bond indices (specifically the JPM EM bond index). Thus, India should strive to be included in the relevant bond indices globally, more so as the world is moving towards "passive indexing" as the dominant investment philosophy. This is an effective way of not only attracting but also retaining funds in India as these are "long-term" flows and not hot money.

Holding Pattern in G-Secs

% Holding in G-Secs	2014	2015	2016
Commercial Banks	42.77	43.59	40.92
Non-Bank PDs	0.34	0.35	0.28
Insurance Companies	21.02	21.9	22.55
Mutual Funds	1.68	2.52	1.96
Co-operative Banks	2.57	2.71	2.63
Financial Institutions	0.73	0.68	0.86
Corporates	1.12	0.86	1.05
Foreign Portfolio Investors	3.62	3.68	3.13
Provident Funds	7.47	7.11	6.24
RBI	14.5	12.07	14.61
Others	4.18	4.51	5.77
State Governments	0	0	1.8

Dec 2014



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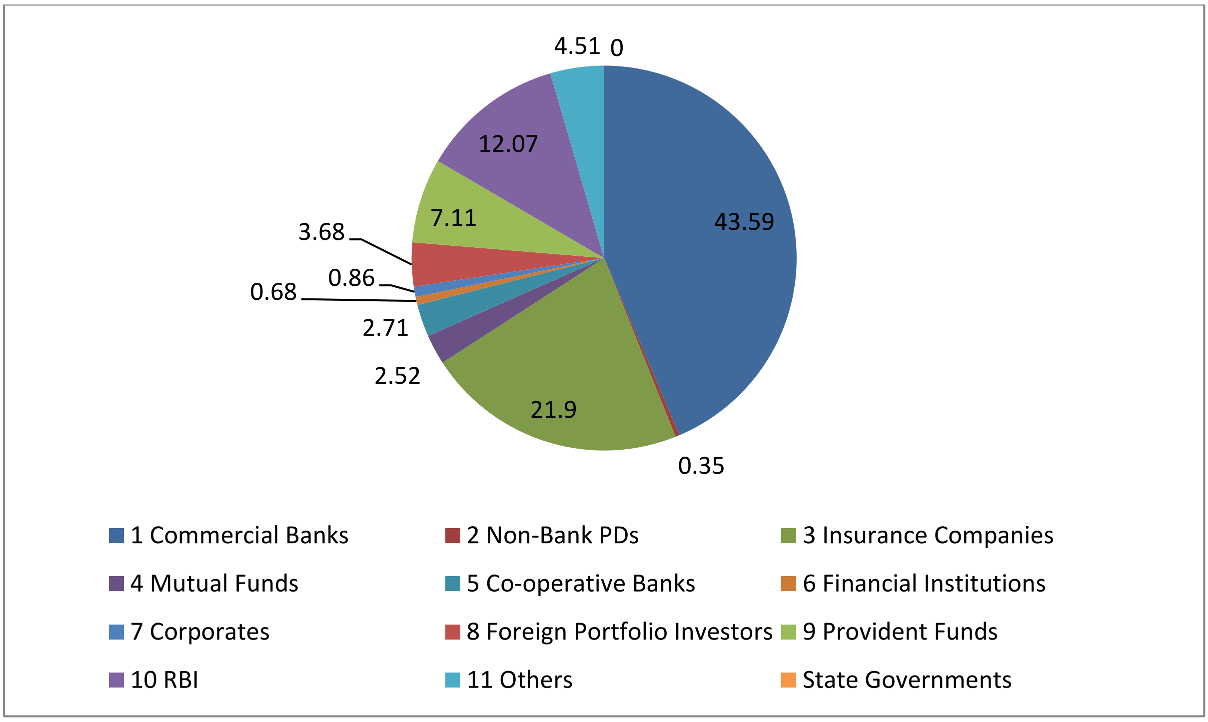

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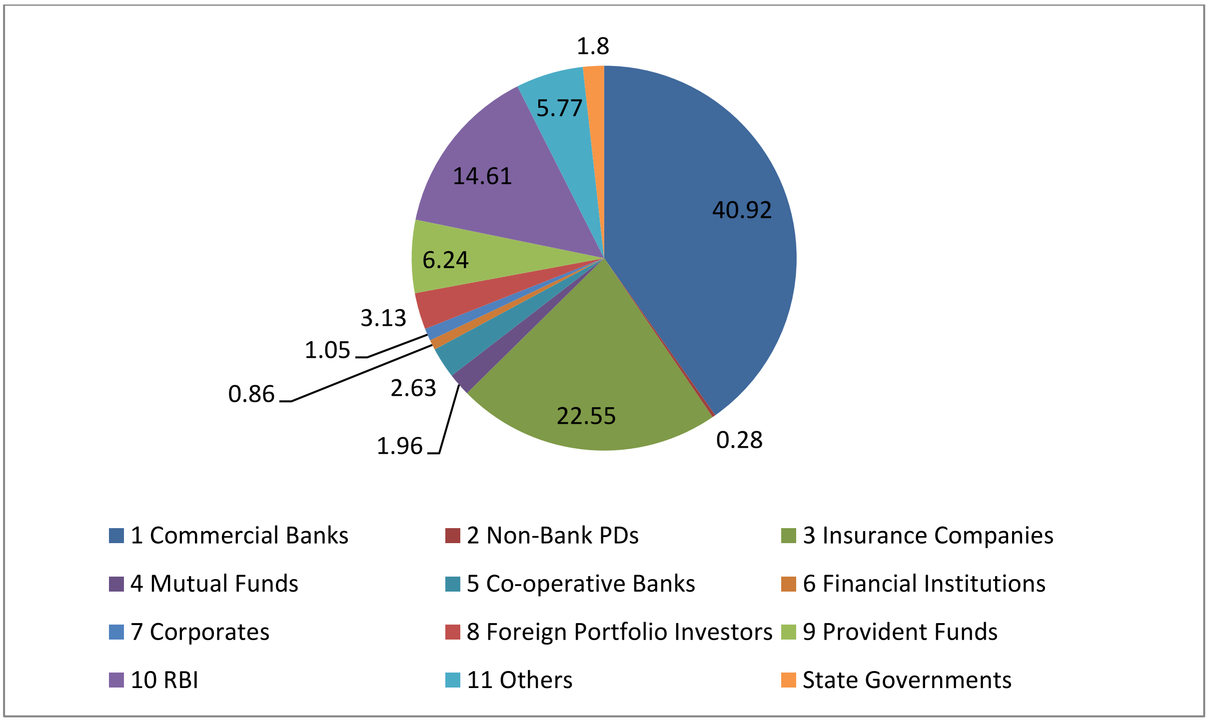

Table 10: Holding pattern in G-Secs
Source: RBI

6. Introduction of New Products - Development of Derivative Markets

In our 2013 report, ASIFMA had advocated for the development of futures, swaps and derivatives markets, to effectively complement the cash bond markets. Over the last 4-5 years, significant developments have occurred in this regard, with the establishment of interest rate futures markets traded on the exchanges and the trading of INR interest rate derivatives introduced on the CCIL.

Exchange now offers futures on 5, 10 and 13-year G-Secs and 91-day treasury bills. These instruments are cash-settled and can be used for hedging the risk arising from interest rate movements as well as for trading. There have been significant developments in the Interest Rate Futures (IRF) market over the past few years with futures being introduced on the 5y and 15y on-the-run bonds in 2015 in addition to the future on 10y bonds. The near month maturity IRF on the 10y benchmark bond continues to be the most traded future and accounts for the majority of volumes. After a weak start of IRF market in 2003 there was a significant push from RBI to make the market more liquid and robust. The total value traded increased from January 2014 and continued to increase in 2015. However, the total value traded has decreased in 2016.

Total Value Traded in NSE IRF Market (INR billion)

	Total Value Traded
2014	2967.8
2015	5832.85
2016	3156.78

Table 11: Total Value Traded in NSE IRF Market
Source: NSE

The other active segment in the derivative market is interest rate swaps. Recently CCIL has launched ASTROID – Anonymous System for Trading in Rupee OTC Interest Rate derivatives. This platform was launched in August 2015 and offers trading in MIBOR from 1 month up to 10 years. The swaps traded on ASTROID are guaranteed from the point of trade. The trades executed on this platform are linked to CCIL's clearing and settlement system for rupee Overnight Index Swap (OIS) trades. The volumes on ASTROID platform have picked up since inception; however it continues to be low compared to the traditional platforms. The volumes in the OIS market have also decreased over the years as is evident from the table below.

Interest Rate Swaps Transactions (INR billion)

	No of Trades	Notional Amount
2007-08	79,495	47,281
2008-09	40,912	26,448
2009-10	20,352	14,521
2010-11	33,057	23,597
2011-12	33,642	24,510
2012-13	22,713	20,216
2013-14	25,514	22,967

2014-15	21,153	20,292
2015-16	20,746	21,329

Table 12: Interest Rate Swaps Transactions
Source: CCIL

7. Corporate Bonds: Evolution of the Secondary and Primary Markets

While the corporate bond market is small as compared to the government bond market, the growth seen in this space is worth noting. Historically, corporates have primarily depended on banks for their sources of funding. With banks taking a back seat due to various issues like high cost of funds, Non-Performing Assets (NPAs), stress in the balance sheet, etc., better rated corporates started tapping the bond markets because of the lower cost of funding in these markets. Lower deposit rates, the lack of tax free bonds, tax efficient return from debt funds ensured large flow of funds into their debt schemes. This phenomenon continued over the last few years and as a result we see much more liquid and vibrant credit markets. We have seen a substantial growth in the corporate bond market – over 35% Compound Annual Growth Rate (CAGR) in last 7 years. FY 2013-2014 was abnormal when RBI hiked overnight rates to defend the currency and most of the issuers went back to the loan markets. The issuance of corporate bonds in the year 2015-2016 was lower because of the absence of large power sector financing companies because of the implementation of the "Ujjwal DISCOM Assurance Yojana" (UDAY) scheme by the Government of India, whereby State Electricity Boards converted their loans to bonds. By way of further background, this scheme is aimed at the revival and revitalization of the distressed State Electricity Distribution Companies (the so-called DISCOMs).

The recently concluded FY 2016-17 witnessed the highest ever total of funds raised through corporate bonds through private placement, totaling INR 7,035bn. These funds were raised by a total of 661 institutions and corporates. Also, according to Prime Database, total public corporate bond issuance through yearend March 2017 rose 51% yoy to USD 51bn.

Total Debt Private Placements (INR billion)

Year	Amount	% Change
2010-11	2,026	
2011-12	2,592	28%
2012-13	3,528	36%
2013-14	2,879	-18%
2014-15	4,657	62%
2015-16	4,922	6%
2016-17	7,035	43%

Table 13: Total Debt Private Placements
Source: Prime Database

95% of the issuance happens in fixed rate bonds because of the demand for these bonds. The liquidity of both floating rate and structured bonds is very poor in the secondary market, as a result of which there are very few issuances.

The growth of debt mutual funds has played a large role in increasing the primary and secondary volumes of corporate bond markets.

Growth in Debt Mutual Funds (INR billion)

Year	Income	Liquid fund	Gilt	Total	Change
2012	2908.44	803.54	36.59	3748.57	
2013	3959.85	933.92	80.74	4974.51	32.7%
2014	4606.71	1332.8	61.15	6000.66	20.6%
2015	5157.73	1625.62	146.14	6929.49	15.5%
2016	5654.59	1994.04	163.06	7811.69	12.7%
2017	7437.83	3140.86	148.75	10727.44	37.3%

Table 14: Growth in Debt Mutual Funds
Source AMFI

Debt Fund Deployment of Funds

Type of Instrument	2014	2015	2016	2017 YTD
Credit Products	75.0%	69.6%	73.4%	75.0%
Govt Bonds	12.2%	18.0%	16.8%	11.2%
Banks CD/FD	6.9%	7.7%	6.6%	6.9%
CBLO Others	5.8%	4.7%	3.1%	6.8%

Table 15: Debt Fund Deployment of Funds
Source: SEBI

The above table shows how debt mutual funds have been allocating funds into various assets classes. On average, the allocation to credit products has been 75%.

Growth of Secondary Volumes for Corporate Bonds (INR billion)

Year	No of Trades	Value
2007-2008	19079	959
2008-2009	22683	1,482
2009-2010	38230	4,012
2010-2011	44060	6,053
2011-2012	51533	5,938
2012-2013	66383	7,386
2013-2014	70887	9,708
2014-2015	75791	10,913
2015-2016	70123	10,224
2016-2017	88495	14,707

Table 16: Growth of Secondary Volumes for Corporate Bonds
Source: SEBI

Percentage Break up by Issuer Type

Issuer Type	2012-13	2013-14	2014-15	2015-16	2016-17
Public Sector Financial Institutions	52.46%	53.49%	54.13%	40.56%	27.27%
State Financial Institutions	1.53%	0.55%	0.20%	0.00%	0.04%
Public Sector Undertakings	11.24%	11.53%	7.22%	6.56%	9.55%
State Level Undertakings	2.44%	1.36%	1.40%	4.85%	2.91%
Private Sector-NBFC & Others	32.33%	33.07%	37.05%	48.04%	60.23%

Table 17: percentage Break up by Issuer Type
Source: Prime Data base

Rating Profile of the Issuer

Rating	2012-13	2013-14	2014-15	2015-2016
AAA	64.32%	69.90%	64.79%	56.05%
AA+	15.47%	13.55%	13.97%	11.05%
AA	7.21%	5.64%	5.63%	6.09%
AA-	4.69%	3.47%	6.09%	5.93%
Others	8.32%	7.44%	9.52%	20.88%

Table 18: Rating Profile of the Issuer
Source: Prime Data base

Historically 80% of the issuance used to be in the AAA and AA+ categories, but this trend has been changing recently with mutual funds starting credit funds comprising of lower rated bonds, as lower rated corporates looking to tap corporate bond markets have tended to move away from banking loans which are very expensive. Moreover, with bank NPLs growing and capital charges on bank loans to lower-rated companies becoming onerous, corporates have no recourse but to turn to the corporate bond market.

Certificates of Deposit (CD) and Commercial Paper (CP) Issuances

As the credit growth slowed down in India, we saw CD issuance drop drastically. But, at the same time, with banks taking long time in transmitting the rates cuts from RBI, we saw more and more corporates tapping the CP market.

CD and CP Issuances (INR billion)

Date	CP Outstanding	% Change	CD Outstanding	% Change	Total	% Change
2012	911.9		4195.3		5107.2	
2013	1092.6	19.8%	3896.1	-7.1%	4988.7	-2.3%
2014	1066.1	-2.4%	3758	-3.5%	4824.1	-3.3%
2015	1932.7	81.3%	2809.7	-25.2%	4742.4	-1.7%
2016	2602.4	34.7%	2105.9	-25.0%	4708.3	-0.7%
2017	3979.7	52.9%	1557.4	-26.0%	5537.1	17.6%

Table 19: CD and CP Issuances
Source: RBI

8. Corporate Bonds: New Endeavours

As mentioned above, the corporate sector relies too heavily on banks for lending and raising funds to finance their business going forward. Everyone, including the RBI, understands that developing a strong and sound corporate bond market will alleviate the pressure on banks and provide corporations an alternative way to finance themselves. Further, not only does a strong corporate bond market foster healthy competition, the transparency of corporate bond markets will also force corporations to respond directly to the concerns of investors and stakeholders. This will in turn facilitate the development of a deep corporate bond market which will improve the corporate governance, efficiency and discipline within the corporate sector.

Given this, the Indian regulatory authorities have greatly increased incentives for corporate bond issuance. These include the granting of permission to banks to issue lower-rated bonds that are Basel 3 compliant (AT1 and Upper T1 & T2 issuance) to shore up capital, the liberalization of FPI limits to invest in domestic corporate bonds, creating a framework for institutional investors to invest in real estate & infrastructure trusts and the introduction of offshore INR bonds or Masala bonds, described below:

Introduction of New Products: Masala Bonds

Masala bond is a - INR denominated, euro-clearable, any currency settled (currency risk lies with the investors) bond issued offshore. It was introduced in 2016 and so far, has already seen an issuance of INR 200bn – refer Table 20.

Masala Bond Issuance (INR billion)

Issuer Name	Cpn	Issue Date	Maturity	Amount Issued
Housing Development Finance Corp Ltd	7.88	21/07/2016	21/08/2019	30.00
Adani Transmission Ltd	9.1	29/07/2016	29/07/2021	5.00
NTPC Ltd	7.38	10/08/2016	10/08/2021	20.00
Housing Development Finance Corp Ltd	7	09/09/2016	09/01/2020	20.00
Indiabulls Housing Finance Ltd	8.57	15/09/2016	15/10/2019	13.30
Fullerton India Credit Co Ltd	8.13	24/10/2016	24/11/2019	5.00
ECL Finance Ltd	9.05	28/10/2016	28/12/2019	5.02
Shriram Transport Finance Co Ltd	8.25	18/01/2017	18/02/2020	11.50
Housing Development Finance Corp Ltd	6.88	30/03/2017	30/04/2020	33.00
NTPC Ltd	7.25	03/05/2017	03/05/2022	20.00
National Highways Authority of India	7.3	18/05/2017	18/05/2022	30.00
				192.82

Table 20: Masala Bond Issuance
Source: Nomura

Masala bonds are an excellent product for the investors as it allows them to: a) invest in INR corporate bond risk without having to go through the cumbersome FPI route (and thus no need to apply for a license); b) since Masala bonds are repo-able, they can take leverage against it, thereby enhancing their returns; c) these bonds are euro-clearable and hence allow for an opportunity for multi-currency settlement.

For issuers, while they have to bear 15-20bps additional cost to their equivalent onshore issuance (as 5% withholding tax (WHT) is paid by the issuer in this case), such costs should actually be compared against the more costly USD / EUR MTN where they run currency risk and pay high hedging cost. Also, this allows them to tap into a completely new and diversified set of customer base.

Further, as corporate bond limits get filled – given the current run rate – this may allow offshore investors to still fund onshore corporates. The legal and regulatory framework around Masala bonds (and some of the more recent changes to this framework), are discussed in Section E below. Additionally, a comprehensive overview of the entire Masala bond framework including an exhaustive analysis of investor access channels and the tax framework can be found in Section F and Annexure B respectively.

Other Work-In-Progress Potential Measures

The H R Khan working group on development of corporate bonds in India made many recommendations which have been partially implemented and some are work-in-progress.

Some of the key recommendations are:

1. Reissuance of bond by frequent issuers to improve the liquidity of the ISINs. For more on this topic see the "Proposals of SEBI for developing the Indian bond market" in Section C below.
2. FPIs are now allowed to invest in unlisted bonds of issuers who will not use those funds for real estate and capital markets exposure.
3. Electronic book of private placement of bonds has been introduced by the exchanges and has been operating successfully.
4. Uniform valuations guidelines across regulators for valuation of corporate portfolios of different investors class like banks, mutual funds, insurance companies are in the pipeline.
5. The introduction of DvP settlement for bonds traded OTC has been implemented.

Repo in corporate bonds through an electronic platform operated by Central Counterparties (CCPs) is one of the key reforms in progress.

9. Securitisation and Covered Bond Market (ASIFMA)

A well-regulated securitisation system is commonly recognized as an efficient financing mechanism for mortgage financing, credit cards, auto loans and even infrastructure enhancements and municipal expansion. Covered bonds and high quality securitisations are a means of tapping the capital markets for funding, backed by pools of good quality assets. Under the securitisation model, loans are issued by an originator (typically a commercial bank), and then aggregated and packaged into multiple securities with different characteristics of risk and return that appeal to different investor classes.

The development of securitisation of non-performing assets in India received a major boost over the 2002-05 period, following the enactment of the Securitisation and Reconstruction of Financial Assets & enforcement of Securities Interest Act (SARFAESI), 2002 ('the Act') 1. The Act encompasses the areas of: securitization of financial assets; reconstruction of non-performing financial assets; recognition to any security interest created for due repayment of a loan as security interest under the Securitisation Act, irrespective of its form; banks and financial institutions have the power to enforce the security without intervention of the courts; setting up the Central Registry for registration of the transaction of securitisation, reconstruction and creation of security interests.

One specificity and problem with securitisation in India is that securitisations follow a trust structure i.e. the assets are transferred by way of sale to a trustee, who holds it in trust for the investors. In this situation, a trust is not a legal entity in law but it is entitled to hold property that is distinct from the property of the trustee. Therefore, the trust performs the role of the Special Purpose Vehicles (SPV), without having the legal status of an SPV.

Market Developments

Growth in Residential Mortgage Backed Securities (RMBS), Mortgage-Backed Securities (MBS) and Collateralized Debt Obligations (CDOs) fueled the rapid growth of the securitisation market through 2005, as new classes of investors and issuers gained confidence in the stability of and prospects for the further development of the market. Furthermore, investor familiarity with the underlying asset classes, stability in the performance of past pools and the relatively short tenor of issuances also helped boost the market.

After a brief dip in 2006, caused by the tightening of capital requirements, strong growth in ABS and CDO volumes boosted the Indian securitization market through the first half of 2009, when the after-effects of the global financial crisis did have a negative impact. Even so, the absence of transactions involving complex derivatives and CDS in the Indian context meant that Indian securitization volumes did stay relatively robust, in the immediate aftermath of the financial crisis.

The structured issuance volumes have grown considerably in the last few years in India. ABS is the largest product class driven by the growing retail loan portfolio of banks and other Financial Institutions (FIs), investors' familiarity with the underlying assets and the short maturity period of these loans. The MBS market has been rather slow in taking off despite a growing housing finance market due to the long maturity periods, lack of secondary market liquidity and the risk arising from prepayment/repricing of the underlying loan.

During FY2014, the overall securitisation market (including rated bilateral transactions) in India shrunk further by 5% over the previous year, in value terms. The number of transactions was also lower by 4% in FY2013 than that in the previous fiscal year. While the number and volume of ABS transactions declined by about 14%, the number of RMBS transactions more than doubled in FY2014, (an increase of 75% in value terms).

Trend in Securitisation Issuance by Value per Financial Year (INR million)

	FY 13		FY 14		FY 15		FY 16		FY 17*	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share
ABS	272,300	90%	235,040	82%	163,300	95%	246,860	99%	281,700	31.3%
RMBS	30,250	10%	52,960	18%	8,400	5%	2,700	1%	145,800	16.2%
Total Retail Securitization	**302,550**	**100%**	**288,000**	**100%**	**171,700**	**100%**	**249,560**	**100%**	**427,500**	**100%**
Vehicle Loans*	-	-	-	-	-	-	-	-	324,000	36%
Microfinance+Others *	-	-	-	-	-	-	-	-	148,500	16.5%
Overall Total	**302,550**	**100%**	**288,000**	**100%**	**171,700**	**100%**	**249,560**	**100%**	**900,000**	**100%**
Growth	*-20%*		*-5%*		*-40%*		*+45%*			*NC.*
Avg. Deal Size	*1,510*		*1,490*		*1,040*		*1,170*			*NC*

Financial Year 2013 - 17, i.e. April 1, 2013 to March 31, 2017. FY2017 data are estimates

- Data available for FY2017 only

Table 21: Trend in Securitization Issuance by Value per Financial Year
Source: ICRA

Issues and Recent Developments

India's growth is expected to remain stronger than the global average and more robust than the median for similarly rated sovereigns. India will have long-term funding needs which could be provided by the securitisation market to finance housing, infrastructure and urbanization projects.

The legal framework for securitisation is at a nascent stage in India as it is restricted to certain institutions namely, banks and financial institutions only. Amendments to the Securities Contracts Regulation (SCR) Act are certainly futuristic steps and well-deserved appreciation must be given towards these steps. It is hoped that in the future, more and more transactions may be included under the Act so that the market matures and reaches an advanced stage like the UK or the US, as this process will support economic growth.

Development of the market for securitisation in India will need efforts of the Central Government, State Governments, RBI and SEBI, has permitted mutual funds to invest in these securities. To galvanize the market, FPIs can also be allowed to invest in a wide range securitised debt instruments – a process that has already begun. FPIs are already familiar with these instruments in other markets and can, therefore be expected to help in the development of this market. However the measures taken in India are still incomplete and more dedicated efforts would be necessary for a robust growth of asset securitisation market in India.

There are several issues facing the Indian securitisation market such as:

- Stamp duty: In India, stamp duty is payable on any instrument which seeks to transfer rights or receivables. Therefore, the process of transfer of the receivables from the originator to the SPV involves an outlay on account of stamp duty, which can make securitization commercially unviable in states that still have a high stamp duty. A number of states have reduced their stamp duty rates, though quite a few still maintain very high rates ranging from 5-12 per cent. To the investor, if the securitized instrument is issued as evidencing indebtedness, it would be in the form of a debenture or bond subject to stamp duty, and if the instrument is structured as a Pass Through Certificate (PTC) that merely evidences title to the receivables, then such an instrument would not attract stamp duty. Some states do not distinguish between conveyances of real estate and that of receivables, and levy the same rate of stamp duty.

SEBI has suggested to the government on the need for rationalization of stamp duty with a view to developing the corporate debt and securitization markets in the country, which may going forward be made uniform across states as also recommended by the Patil Committee.

- Foreclosure Laws: Lack of effective foreclosure laws also prohibits the growth of securitization in India. The existing foreclosure laws are not lender friendly and increase the risks of MBS by making it difficult to transfer property in cases of default.

- Taxation related issues: Some ambiguity remains in the tax treatment of MBS, SPV trusts, and NPL trusts. However, one positive development is that the taxation structure has been changed from distribution tax at SPV level to taxation in the hands of investors, thereby increasing total after-tax returns. This has led to a boost in securitization/ABS issuance through FY2017.

- Legal Issues: Investments in PTCs are typically held-to-maturity. As there is no trading activity in these instruments, the yield on PTCs and the demand for longer tenures especially from mutual funds is dampened. Till recently, PTCs were not explicitly covered under the Securities Contracts (Regulation) Act, definition of securities. This was however amended with the Securities Contracts (Regulation) Amendment Act, 2007 passed with a view to providing a legal framework for enabling listing and trading of securitized debt instruments. This will bring about listing of PTCs which in turn will support market growth, which will hopefully help to resolve the “lack of liquidity” issue.

Securitisation requires a stable and predictable operating environment. India must establish clear legislative, legal and regulatory guidelines for market participants, incentivize the development of high quality data for proper risk assessment, and increase foreign participation.

To this end the regulators have carried out an amendment to the rules governing investment by FPIs in India by expanding the list of areas in which FPIs can invest: These include:

Securitised debt instruments, including (i) any certificate or instrument issued by a special purpose vehicle (SPV) set up for securitisation of asset/s with banks, FIs or Non-bank Financial Companies (NBFCs) as originators; and/or (ii) any certificate or instrument issued and listed in terms of the SEBI “Regulations on Public Offer and Listing of Securitised Debt Instruments, 2008”.

On reading of the above text, it is quite clear that FPIs will be able to invest in both listed and unlisted certificates/ instruments issued by SPVs set up for securitisation of assets. Here it is also important to note that the originators of the assets should be either banks, FIs or NBFCs.

In February 2017, SEBI explicitly permitted FPIs to invest in securitized debt instrument (SDI). The SDIs include (i) certificate or instrument issued by a special purpose vehicle set up for securitization of assets where banks, financial institutions or non-banking finance companies are originators; and/or (ii) certificate or instrument issued and listed in terms of the SEBI (Public Offer and Listing of Securitsed Debt Instruments) Regulations, 2008.

(Sources: ASIFMA, ICRA, Vinodkothari.com)

10. Rates and Credit Market Infrastructure (including Ratings) (ASIFMA)

One of the most important elements for a robust credit/fixed income market is an independent credit ratings industry, which renders a bond market attractive and accessible. While India has seen the creation of a number of local ratings agencies (such as CRISIL, ICRA & CARE) and the entry of the international ratings agencies through acquisition or via the creation of standalone local entities, more remains to be done. To this end, it is gratifying that SEBI intends to announce a ratings agency framework with greater supervision. A well-supervised and established credit rating industry will provide investors with more transparency with respect to the types of securities they are trading. In particular, one of the reasons why investors are not willing to participate in the bond market is the mismatch between the price of the bonds and the actual and real risk they carry. To create a more attractive environment for investments, the credit rating industry must adhere to international best practices. By doing so, investors can take advantage of an international standardized rating, which will in turn make the market more transparent and reliable which will attract both domestic and foreign investors.

With the premise that the government is able to halt the tendency of rising interest rates, banks must also start to recognize mark-to-market losses. By doing so, they would be compelled to trade securities, rather than holding them to maturity. The more advanced the trading in the secondary market is, the more necessary is the establishment of a solid risk management function. If banks can actually develop an independent risk management function, they can become involved in the trading of corporate bonds, at every level of the yield curve. This would give the option of access to the bond market for some corporations whose issued bonds carry a low rating and high yield. This is the stage where an appropriate risk management function kicks in, assessing the bank exposure to a certain type of security and taking further action to hedge and balance out the exposure.

Nurturing a thorough market infrastructure system also entails meeting the need for international settlement and financing of local bonds. This will help the Indian financial system to be further embodied within the international system. Local bonds will then have a wider range of potential investors, competing with each other and therefore allowing more efficient and less costly financing. Also, this openness will attract foreign firms and give them the opportunity to participate in the market and to reuse the bonds in their funding efforts.

To further integrate the Indian financial market within the international marketplace, CCPs such as the CCIL have now been internationally recognized by the European Securities and Markets Authority (ESMA) in order to provide clearing services for all market participants. This is a positive development, since it signals that CCIL will now comply with international practices, thus being even more attractive to foreign investors. ASIFMA has long supported CCIL's application for recognition and is glad to note that this objective has now been attained, at least partially. One point worth noting is that recognition of CCIL by the Commodities and Futures Trading Commission (CFTC) in the US, is still outstanding.

The trading and clearing of government securities and corporate bonds by CCIL, the clearing agency for G-Secs, and NSCCL, the clearing arm of the National Stock Exchange (NSE) of India, has been functioning smoothly, thereby giving more credit to the clearing system as a whole. The use of clearing systems for the reporting of usage of not just cash bonds/securities but also derivatives instruments such as futures, CDS and other swaps is an encouraging step, since the focus will then be on the reporting of risk, rather than the restriction of derivatives usage. Also, tailoring the use of these derivatives instruments in line with the usage of similar instruments globally will encourage usage and acceptability.

Nonetheless, bridging the local settlement system with ICSDs (Euroclear/Clearstream), would constitute a further step in the development of the bond market, as they allow easier movement of global collateral across borders via their "collateral highway". Combined with offshore settlements, this could create the basis for using local bonds as collateral in the event that market participants need access to USD cash, as we have seen recently.

C. The Current Overall Bond Market Legal and Regulatory Framework, Netting, Bankruptcy and Resolution

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Regulatory Updates on the Developments in the Indian Bond Market

Given that a well-developed bond market is vital for the health of the economy, endeavours have been made by the financial regulators in India for promoting exactly that objective in an orderly manner.

In India, bonds are largely governed by the provisions of the Companies Act, 2013; notifications and regulations issued by the RBI and regulations and circulars issued by SEBI. On the overall policy front, the Ministry of Finance (MOF), through various departments, acts as the premier policy maker with respect to financial legislation, capital markets regulation and taxation. In addition, the MOF, through the recent establishment of the Public Debt Management Office (PDMA) is also taking on a bigger role in managing the country's internal debt. The Companies Act, 2013 *inter alia* makes provisions for the mode of issuance of bonds (private placement or public issue). RBI, *inter alia* is charged with the responsibility of regulating the issuance of and investments in bonds by banks and non-banking finance companies, foreign investments in India and modes of raising capital offshore and money markets. SEBI, the capital markets regulator of India, concerns itself with issuance and listing of bonds on the stock exchanges and regulating intermediaries

The Indian regulators are working in tandem to develop a bond market which complements the banking system in India and provides an alternative source of finance to corporates for long term investments.

1. Recent Entries in the Indian Bond Market

In the past, the conventional bond market in India mainly involved products such as non-convertible debentures, foreign currency bonds, zero coupon bonds and structured products. A need was felt to introduce new products in the bond market that would supplement the Government's wave of developing infrastructure in India by raising debt both onshore and offshore. The Indian bond market thus witnessed the introduction of two new products i.e. Municipal bonds and Masala bonds (we will take a more detailed look at the regulatory framework for Masala bonds in the section below). Further, the Government is making an attempt to popularize holding gold in dematerialized form through gold sovereign Bonds (GSBs) while Indian entities are entering the arena of Green Bonds, (which is discussed in the section below).

a. Municipal Bonds

While municipal bonds have been utilised to their maximum potential in countries like the US and China, it was only in 2015, that SEBI issued the SEBI (Issue and Listing of Debt Securities by Municipality) Regulations, 2015 (Municipal Bond Regulations) making provisions for issuance and listing of municipal bonds. Municipal Bond Regulations define a municipal bond (also known as '*muni-bond*') as a long-term bond issued directly by the local municipality or state-owned enterprise for funding infrastructure projects, e.g. public institutions, roads, and highways.

The Municipal Bond Regulations classify municipal bonds into revenue bonds and general obligation bonds. The classification is based on the underlying assets that will be used to service the principal and interest payments. While the revenue bonds will be serviced by revenues from one or more identified projects, the general obligation bonds would be serviced through tax revenues collected by the municipalities. To ensure investor confidence, SEBI has ensured that the Municipal Bond Regulations prescribe strict disclosure standards for the municipal bodies.

After the introduction of the Municipal Bond Regulations, the Pune Municipal Corporation became the first local body in the India to raise public coffer aggregating to INR 2bn by issuing municipal bonds. As per reports, the issue was oversubscribed six times and received subscriptions worth INR 12bn, thereby showing the appetite of the Indian investors for such bonds.

The municipal bond market has massive potential in India. Infrastructure projects are the need of the hour in India and a regulated municipal bond market will ensure a steady flow of capital necessary to fund these projects. As regards investment opportunities, it may provide an alternative investment opportunity to conservative Indian investors investing in fixed deposits, small saving schemes or gold as it provides reasonable return with relatively less risk. This may in turn deepen the capital markets.

However, various supply side constraints could prove to be challenging in the development of the municipal bond market. To prepare for these challenges, capital investments and other financial management decisions made by municipal bodies need to be made with caution. Increasing the marketability of municipal bonds, establishing bond banks and creating a secondary bond market are some of the ways to strengthen the municipal bond market and ensure its optimal functioning.

b. Gold Sovereign Bonds ("GSBs")

The Sovereign Gold Bonds scheme was introduced by the Government of India in 2015 under the Government Securities Act, 2005. The scheme is keeping in line with the Government's efforts to restrict its excessive gold imports into India along with other schemes such as Gold Deposit and Gold Monetization. Each year, gold is the second-largest imported commodity in value. A huge amount of gold is currently locked away in Indian households, thereby not playing a productive role in the economy.

GSBs provide an alternative of holding gold in dematerialized form so as to deal with the investment demand of physical quantities of gold whilst reducing importation of gold into India and diverting investment in more productive areas of the economy. The terms and conditions of the issuance of the GSBs are notified by the RBI periodically, depending upon the number of series announced for subscription per year, along with an annual set of Operational Guidelines for the same. GSBs are issued in the form of Government of India stock, for which the investors receive a physical holding certificate. The physical holding certificate is eligible for conversion into dematerialized form. Currently, only a person resident in India can subscribe to GSB.

The three important benefits of GSBs are (i) coupon rate; (ii) tax exemptions; and (iii) physical security. GSBs have been exempted from capital gains tax arising on the redemption of these bonds. GSBs allow the investor to hold gold as investment and benefit from capital appreciation as well as receive a small interest income.

2. Inter-linkage of the Indian Bond Market with Repos, Swaps and Futures Markets

Development of the bond market is harmonious with the development of repos and swaps market. Repos provide the primary dealers with a broader range of hedging strategies by linking the money markets and bond markets. This allows the security dealers to obtain short term liquidity and even cheap capital to finance their bids at auctions of new issues. Swaps markets enable the market of a specific country to integrate into the broader international financial system by bringing together two counterparties who have different interests in different markets and help in attracting a wider number of foreign investors who in turn bring portfolio investments thus enabling the bond markets to grow even further. Similarly, a well developed futures market is beneficial for attracting foreign capital into India, since futures allow for the hedging of interest rate and currency risks.

a. Repo Market

Repos have been permitted in government securities (issued by both the Central Government and State Governments) and corporate bonds in the Indian market. Repos in corporate bonds *inter alia* include repos in commercial papers, certificate of deposits, non-convertible debentures and bonds issued by multilateral financial institutions like the World Bank Group (e.g., IBRD, IFC), the Asian Development Bank or the African Development Bank and other such entities as may be notified by the RBI from time to time.

Traditionally, the repo market in India differed from the “classic” repo which envisages the transfer of title of security and allows the counterparty to use the security for a variety of purposes. This permits the counterparty to further use the security as it owns the security for a new repo, covering naked short positions, collateral, and securities lending or as a liquidity management instrument. However, in India, the security acquired under repo could not be sold by the repo buyer (lender of the funds) during the period of repo. RBI, in 2015, relaxed this restriction by permitting re-repo in government securities acquired under reverse repo, subject to certain conditions. At present, re-repo is restricted to government securities and does not extend to corporate bonds.

RBI has further made reporting of repo trades mandatory on platforms created by the CCIL or its subsidiary the Clearcorp Dealing Systems (India) Ltd.

RBI’s most recent initiative has been the introduction of Tri-Party Repo (Tri-Party Repo Framework) in relation to both government securities and corporate bonds. The proposed Tri-Party Repo Framework by the RBI is aimed at enabling market participants to use underlying collateral more efficiently and facilitates the development of the term repo market in India. It is not yet clear whether this will finally result in the use of GMRA documentation.

b. Swaps Market

The swaps market in India broadly is composed of parties with varied exposures to interest rate and currency risk, such as banks, primary dealers, mutual funds, insurance companies and corporates. Swaps have been traded in the Indian markets since the 1990s. While banks and primary dealers (to a limited extent) have been permitted to make markets in India, all other entities are permitted to use these products only to hedge their currency or interest rate risk.

The Indian swaps market has evolved over the years. The products that have been traded in the markets have gradually evolved from being simple 'plain vanilla' swaps to some sophisticated cost reduction structures. The Indian OTC derivatives market has witnessed significant growth over the last few years. While there has been limited growth in the options and credit derivative markets, the OTC derivatives market has largely evolved on the basis of the swap market in India.

RBI has made tremendous efforts to ensure a healthy swaps market by implementing G-20 initiatives. The steps taken by the RBI in this direction include mandatory central clearing, bilateral margining requirements, and the creation of an LEI, all meant to guarantee the security of these transactions. RBI has appointed CCIL for the purpose of providing entities with an LEI. The local operating units (LOU), are the local implementers of the LEI system and provide the primary interface for entities wishing to register for LEI. CCIL has been designated as the pre- LOU in India. CCIL has also been registered as a pre- LOU by the Regulatory Oversight Committee.

In the current context, it may be relevant to note that on 1st June 2017, RBI mandated the implementation of the LEI system for all participants in the OTC markets for INR interest rate derivatives, foreign currency derivatives and credit derivatives in India, in a phased manner (ending March 2018).

c. Futures Market

SEBI, in consultation with the RBI, introduced exchange traded cash settled IRF on a range of underlying G-Sec maturities.

To further protect the interest of the investor and bring transparency, SEBI has mandated stock exchanges in India to provide information regarding aggregate gross long position in futures markets taken together at end of the day to the depositories National Securities Depository Ltd and the Central Depository Services India Ltd.

The depositories are required to publish the data on their website.

With such initiatives in the repo, swaps and future market, we expect the markets to maintain pace in the coming years and see the development of a more viable bond market.

A number of other steps have also been taken to make the investment environment more attractive.

3. Concrete Steps for Attracting Foreign Investment

The role of foreign investments in the bond market cannot be emphasized enough. Recent benefits given to the FPIs show the commitment of the Indian regulators towards attracting foreign investments in the Indian bond market.

a. FPI limits for investment in government securities has been enhanced to INR 1877bn; and

b. In February 2017, SEBI finally permitted FPIs to invest in unlisted corporate debt securities in the form of non-convertible debentures/bonds issued by public or private Indian companies This is subject to minimum residual maturity of three years and end-user restriction on investment in real estate business, capital market and purchase of land.

c. SEBI has released a consultation paper dated 28th June 2017 for easing of access norms for investments by FPIs. SEBI vide this consultation paper *inter alia* proposes to rationalize the foreign portfolio investment route by untangling the procedures to attract more funds.

4. Protection of Investors *'a must'*

For the development of the bond market, confidence of the investors is sine qua non. Realizing the importance, the Indian regulators have taken concrete steps to instill the faith of investors in the bond market.

a. Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("LODR Regulations")

In September 2015, SEBI notified the LODR Regulations providing for disclosures to be made by a listed entity if it has outstanding listed debt . Chapter V of the LODR Regulations contains detailed provisions with respect to compliances for listed debt securities. These provisions aim to increase transparency in the market and enable investors to make informed decisions.

b. Netting

With increasing multiplicity and complexity of transactions, the concept of netting has gained tremendous momentum.

Netting gives the investors a right to off-set giving them more confidence to remain in the market. This affirmation is particularly relevant for banks and investment managers who are significantly exposed to counterparty risk if exposures are grossed up and not netted. Thus, these types of institutional investors set limits to reduce the level of exposure in the market, hampering liquidity even further in the secondary market.

In the recent past, enforceability of netting has been doubted by certain segments of the markets as regards sovereign owned entities. Concrete steps have been taken under the new Insolvency framework to give formal recognition to the concept of netting in India.

i. The Insolvency and Bankruptcy Code, 2016 ("IB Code")

The IB Code is the Government of India's response to resolve the growing crisis faced by banks in India as regards impaired debt and low recovery rates. The inimitable feature of the IB Code is that it has an overriding effect over all other legislations – Central or State. This is a first for any Indian legislation.

The concern as regards netting has been partly addressed by the enactment of the IB Code. Section 36 of the IB Code stipulates that any assets of the corporate debtor that could be subject to mutual dealings and set-off would not form part of liquidation estate of the corporate debtor.

Further, the Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, 2016 states that *"where there are mutual dealings between the corporate debtor and another party, the sums due from one party shall be set-off against the sums due from the other to arrive at the net amount payable to the corporate debtor or to the other party"*.

ii. Financial Resolution and Deposit Insurance Bill, 2017 (FRDI Bill)

The MOF introduced the draft FRDI Bill in September 2016. After taking feedback from key stakeholders, a revised draft is to be placed before the Indian Parliament in the monsoon session of 2017. It proposes to establish a special resolution regime to be administered by Resolution Corporation. This will cover financial service providers such as banks, insurance companies, financial market infrastructure entities, payment systems.

As regards netting of financial entities, the FRDI Bill proposes to establish a special resolution regime for financial service providers. The FRDI Bill will be amending the Reserve Bank of India Act, 1934 and providing a statutory basis to netting for all classes of counterparties. It is expected that the Resolution Corporation will protect the stability and ensure the resilience of the financial system.

Once implemented, the FRDI Bill together with the IB Code will go a long way in giving comfort to the investors by unambiguously implementing the principle of netting, ultimately leading to a flourishing bond market.

5. Indian Bond Market: The Road Map Ahead

SEBI has been making ongoing efforts in strengthening the Indian bond market. Through its various initiatives, SEBI, intends to create a more transparent and liquid bond market in India.

a. Re-issuance and Consolidation of Bonds

SEBI *vide* its circular dated 30 June 2017 has made provisions for re-issuance and consolidation of debt securities issued on private placement basis. As per the circular, an issuing company will be permitted a maximum of 17 International Securities Identification Numbers (ISINs) maturing per financial year that shall include 12 ISINs for plain vanilla debt securities and 5 ISINs for structured debt/market linked debentures. An issuer issuing only structured/market linked debt securities has been permitted 12 ISINs in a financial year.

This may however, cause some practical difficulties to issuers who are used to doing multiple issuances in a year. Same ISIN may be granted to only those debt securities having a common maturity and coupon. This may limit the number of issuances an issuer can make in a financial year. While the proposed amendments are expected to increase liquidity in the market, this will need to be weighed with the clubbing of liabilities for the issuer.

b. Electronic Book Provider (EBP) Mechanism

The use of the EBP mechanism is currently mandatory for all private placements of debt securities with an issue size of INR 5bn. With its consultation paper dated 22nd May, 2017, SEBI has expressed its intention of making EBP mechanism mandatory for all private placement of debt securities with an issue size of INR 500mn. SEBI proposes to provide an option of direct bidding to non-institutional investors. Currently, only institutional investors have a choice of either participating through an arranger or entering bids on proprietary basis on their own.

Though the purpose of SEBI for introducing the consultation paper is achieving better and transparent price discovery through the bidding process, having a threshold as low as INR 500mn shall increase the cost of fund raising for small and medium size issuers and may thereby discourage small issuers from the corporate bond market.

D. Settlement & Operations – Recommendations

J.P.Morgan

1. Uniform Settlement Cycle for Government Debt Securities

Background

At present the settlement cycle for FPIs trading in government debt via the OTC route is T+2 with different cutoff time for reporting / confirmation of sale and purchase trades. While the sale trades are required to be reported on day T ('T' being the trade date) the purchase trades can be reported until 1 pm on day T+1. For trades executed on NDS-OM Web the settlement cycle is T+1. The challenge for investors is to manage different reporting dates for purchase/ sale. Global custodians and FPIs prefer not to have differential treatment of reporting / confirmation of purchase and sale trades as it requires considerable changes in systems and bespoke procedures at their end. Also, for certain FPIs, reporting of trades on day T is a challenge as the necessary instructions to the local custodian via the global custodian may not flow on day T before the reporting / confirmation deadline.

Recommendation

We suggest moving the settlement cycle to T+1 with custodian reporting/confirmation in the first half of T+1, uniformly for purchases and sales, allowing FPIs across time zones sufficient time to send instructions to the local custodian via the global custodian overnight and to make necessary arrangements for margin and settlement funding.

2. Rationalization of Debt Limit Rules

Background

a. The existing debt limit rules have multiple nuances making the process of pre-trade due diligence and limit monitoring of available limits quite complex for the foreign investors. The monitoring of limits is particularly complex on account of multiple categories and sub-categories of limits and nuances pertaining to reinvestment eligibility. The practice of auction of limits when overall FPI utilization is more than 90% of the total limit under the general category (non long term) also adds to the complexity.

b. The custodians are required to ensure that the cumulative value of the purchase trades of their respective clients in a given day does not exceed the threshold of 90% utilization (90-N) and 100% utilization (100-N) for General Category limits and Long Term Category limits respectively. This results in uncertainty and potential commercial impact to FPIs when utilization approaches the thresholds, as 'in flight' trades that fail the (100-N) & (90-N) are not reported on NDS-OM by the custodian. Also, this check performed by the custodians is error prone due to the manual nature of such monitoring.

c. The utilization of reinvestment eligibility is calculated by FPIs and Custodians manually and is reported daily to NSDL. NSDL consolidates the positions based on reporting by the custodians and hosts the cumulative utilization on its website daily. The multiple legs in the process and the manual intervention in the process heighten the risk of incorrect calculation of cumulative utilization.

d. Recently, FPIs have been allowed to access real time anonymous order matching platform NDS OM-Web Module for trading in government debt. However for FPI trades executed on this platform custodians cannot perform checks such as the monitoring of (100-N) and (90-N) threshold and adherence to residual maturity, restrictions applicable to FPIs.

e. There is also an ask from FPIs to increase the time window available to avail of reinvestment facility upon sale or maturity of their debt holdings.

Recommendation

Automated monitoring of debt limits on the NDS–OM platform eliminates complex monitoring and tracking procedures described above. As a practical matter, to prevent commercial impact to the FPIs whose 'in flight' purchase trades are not reported due to intraday breach of the ceiling due to automated monitoring by NDS-OM, it is recommended that such trades be allowed to settle and this incremental utilization be adjusted against the subsequent quarterly infusion of fresh limits. Finally, we recommend that reinvestment period available to FPIs, especially for the reinvestment of free limits for government debt and auction limits for corporate debt may be increased.

3. Introduction of Early Pay-In

Background

CCIL applies initial margin on both the sale and purchase legs of the government debt trades and custodian banks advise the clients to make the necessary funding arrangement for the margin prior to reporting the trade on NDS-OM platform. The margin collected by the custodians is credited back into clients' account once the underlying trade is settled. The debit on account of margin and subsequent refund upon settlement of trade also increases the load on reconciliation process at the FPIs' end.

Recommendation

Allow FPIs flexibility to 'Early Pay-in' their entire settlement obligation on trade day (T) itself for sale trades to eliminate the margin requirement. This flexibility will not only simplify operational procedures but will also reduce transaction cost for FPIs.

4. Other Recommendations

a. There are multiple circulars / notifications pertaining to FPI investment in debt. The issuance of a comprehensive consolidated set of guidelines for FPI investments in government debt and corporate bonds would be beneficial for FPIs as well as market intermediaries.

b. The Union Budget 2014-15 proposed allowing settlement of debt instruments through ICSDs like Euroclear and Clearstream. Operationalization of this initiative will provide foreign investors additional avenue to invest in Indian debt market.

E. Offshore Issuance by Indian Issuers – Structures & Legal Framework*

CLIFFORD CHANCE

Indian issuers, or "credits", typically access internal G3 currency markets through the avenues of high-yield issuance, off investment-grade or so-called "cross-over credit" style medium term note programme platforms, and more recently, through the Rupee-denominated bond (or "Masala bond") framework introduced by the RBI. This chapter seeks to summarise the essential features of the structures and legal framework of those product types, and introduce both a comparison to the regulatory and commercial approach of other Asian markets, as well as consider refinements which could make Indian credit more competitive when seeking to attract capital in the international currency markets.

1. High Yield Issuance

From first principles, high yield bonds are typified by their covenant package: as high yield bonds are usually issued by sub-investment grade issuers (or by issuers with either or both of a substantial amount of debt, or incurring new debt which is subordinated to other senior debt), the covenant package is designed to mitigate this inherent credit risk by putting in place a set of incurrence covenants around a restricted group of subsidiaries, regulating and controlling elements of the credit such as total indebtedness, restricted payments and the ability to grant security over assets in the group.

There were 13 New York-style covenant high yield issuances in India in 2016 and 2017 (to date). Unlike Chinese high yield offerings (where real estate predominates), there is no dominant industry, and Indian high yield issuers have come from a broad cross-section of industries, including the transportation, manufacturing, internet, pharmaceutical, energy, real estate and agricultural sectors.

Similarly, the types of covenant packages seen from Indian issuers are not as standardized as one sees for comparable Chinese high yield offerings. Covenant packages in Indian offerings usually include covenants that are customized to the company's specific business needs and credit risk profile.

The following table gives a general overview of the range of covenant ratios recently seen in Indian high yield offerings:

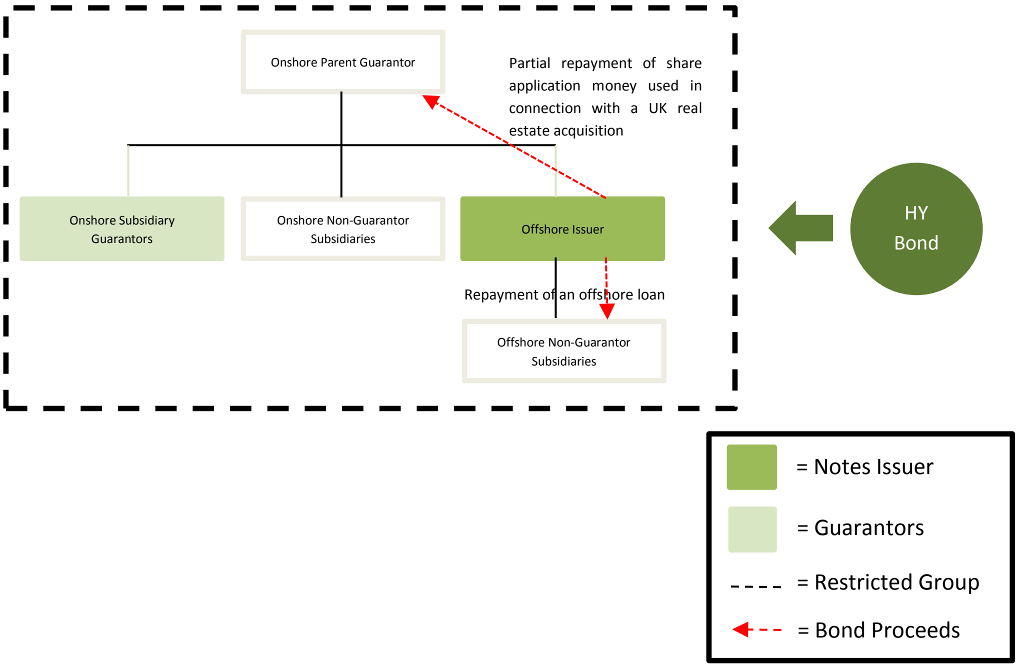
Issuer	Ratio Debt
HPCL-Mittal Energy	Leverage Ratio (ratio of long-term debt to tangible net worth) 3.0x
Glenmark Pharmaceuticals	Fixed Charge Coverage Ratio: 3.0x Consolidated Priority Debt Leverage Ratio: 0.4x
Samvardhana Motherson Auto	Fixed Charge Coverage Ratio: 2.0x Senior Secured Leverage Ratio: 3.5x
Greenko Investments	Combined Leverage Ratio: 5.5x

In addition, the following table gives a general overview of the range of credit enhancement (whether by way of guarantees or collateral) structures seen from Indian issuers and credits:

Issuer	Credit Enhancement
HPCL-Mittal Energy and Delhi International Airport	No guarantees; no security
Jain Irrigation	Parent guarantee; no upstream guarantees from operating subsidiaries
Samvardhana Motherson Auto	Upstream guarantees from various subsidiary guarantors Shares and partnership interests, certain bank account and substantially all material assets of the issuer and certain restricted subsidiaries

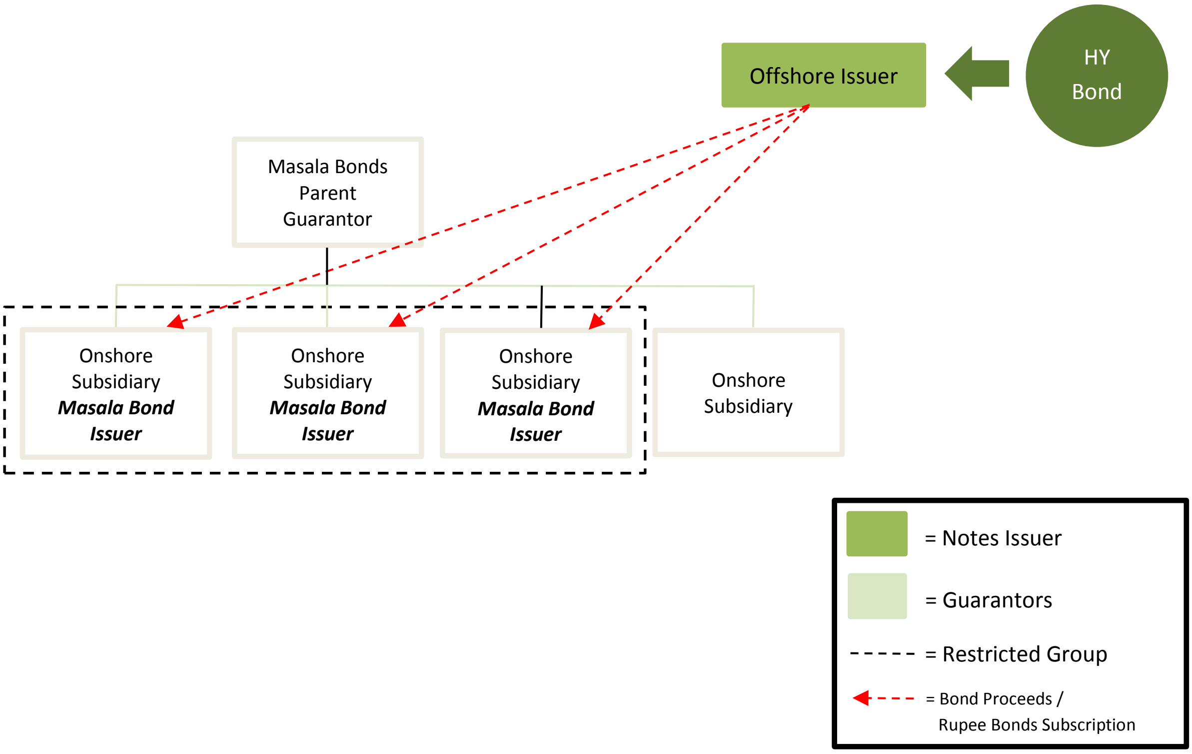
Traditionally, due to local regulations, non-investment grade Indian issuers tapped the international debt capital markets only when the issuer had an entity incorporated offshore, and it could use the bond proceeds outside India. For example, Indiabulls used an offshore subsidiary as the issuer of bonds and used the proceeds for projects in London (i.e. without bringing funds onshore into India):

Indiabulls Real Estate



Recently, Indian companies have used Masala bonds to inject the proceeds of international bonds into India. For example, ReNew Power used an orphan SPV incorporated in Mauritius (Neerg Energy) to issue bonds in the international capital market and moved the proceeds onshore using Masala bonds. This was the first orphan issuer structure that was used in a live deal in Asia.

Neerg Energy



However, the recent release by the RBI of A.P. (DIR) Series Circular No. 47, the newly introduced requirement that entities which are permitted investors under the Rupee bond guidelines should not be "related parties" within the meaning of the applicable Indian accounting standard has effectively meant that the Neerg Energy structure is unlikely to be replicated.

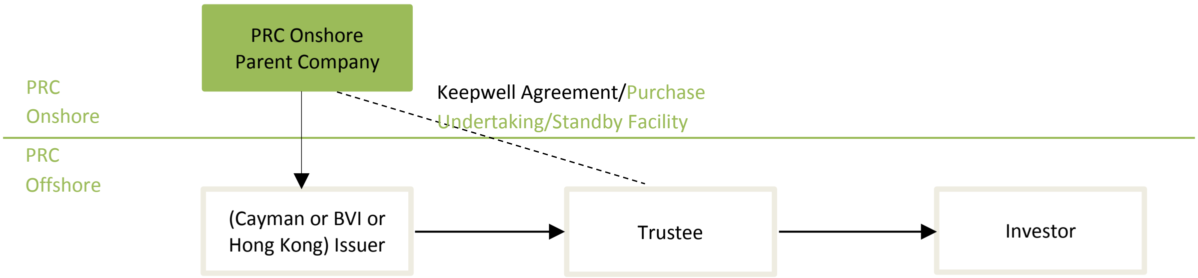
These structures are different from what is typically seen in other jurisdictions in the region. For example, PRC companies may directly issue bonds in the international market or directly guarantee bonds issued by an offshore subsidiary. Both, direct issuance by a PRC issuer and PRC onshore parent guarantee require NDRC Circular (2015) No. 2044 registration compliance, and a PRC onshore parent guarantee also requires post-issue filing and registration with State Administration of Foreign Exchange (SAFE).

If PRC companies cannot or do not want to obtain approval from, or make registration with, the authorities but needed credit support from PRC on-shore entities, they use a keepwell structure, sometimes supplemented by equity interest purchase undertakings (EIPUs) or standby facilities, which are fundamentally not "guarantees" within the meaning of PRC regulation or English or New York law.[1] Whereas a typical guarantee (under either New York or English law)[2] is, legally, a conditional payment

[1] A keepwell deed is essentially an undertaking, usually from a holding company to a subsidiary, in terms of which the parent company undertakes to keep the issuer as a subsidiary; to ensure the issuer maintains a positive net worth at all times; and to ensure that the issuer is in sufficient funds to meet its obligations under the bonds, and to do so on time. An EIPU is similar in the nature of obligations it creates, but includes an undertaking by the parent to inject equity capital should the issuer not have sufficient funds to meet its obligations under the notes.

[2] The two most prevalent governing law regimes for international bond offerings.

obligation allowing a creditor (in our case, a bondholder) to claim directly against a guarantor for an unpaid obligation of a debtor (i.e. an issuer) – essentially, a liquidated sum – a keepwell or EIPU is more in the nature of a "pure guarantee", any breach of which does not entitle the bondholder to a claim for a liquidated sum against the provider, but rather, a simple claim for damages for breach of contract (with a duty to mitigate losses that does not exist in a conditional payment guarantee).



A crucial comparative difference, therefore, between India and competitor markets such as China or issuers in the ASEAN region is an effective "negative" regulatory arbitrage: in our understanding, the RBI will treat any keepwell or EIPU structures as 'guarantees' of payment obligations requiring prior approval, when as a matter of legal reality, they are not, and are not so treated in other markets. Accordingly, lower grade issuers in other markets do appear to have greater flexibility in the design of their credit structure, by using such non-guarantee credit devices, than Indian issuers are able to use, thereby limiting the scope for financial innovation that may otherwise be available in other markets. While covenant packages may go some way to imposing a degree of credit quality control on Indian issuers, the inherent subordination in a given credit structure means that this is not a universal salve to the credit quality conundrum that non-investment grade Indian credits would otherwise find themselves in.

In addition, in most high yield issuances out of China, the issuer is the Cayman Islands or BVI entity that is listed on HK Stock Exchange, and the bonds are guaranteed by offshore subsidiaries only, i.e., the on-shore operating PRC subsidiaries will be within the restricted group but will not provide a subsidiary guarantee.

2. Masala Bonds

The issue of A.P. (DIR Series) Circular No.171 by the RBI, commonly referred to as the “Rupee-Denominated Bond Guidelines” (“RDB Guidelines”), initially paved the way for Indian issuers to quickly and efficiently issue Indian Rupee-denominated bonds in the international debt capital markets pursuant to the RBI’s overarching Master Circular on External Commercial Borrowings and Trade Credits (the “ECB Guidelines”), without having to seek prior approval from the RBI.

The introduction of the “RDB Guidelines” was pursuant to the robust demand made by the International Finance Corporation (“IFC”) and the Asian Development Bank. IFC was the first to issue RDBs outside India.

The RDB Guidelines permits banks, corporates, non-banking finance companies, infrastructure investment trusts and real estate investment trusts to issue RDBs overseas. The introduction of the RDB Guidelines has ushered a new era for debt-raising by Indian entities.

Initially, the Rupee Bond Guidelines have relaxed a number of the requirements for Indian credits to access foreign funding and, in the process, opened up a potentially flexible form of funding for Indian companies through the issuance of so-called 'Masala bonds', which are bonds denominated in Indian Rupees but settled in a foreign currency (for example, U.S. dollars). This synthetic settlement feature of Masala bonds means that issuers enjoy the benefits of raising capital in their home currency, with currency fluctuation risk shifting to investors, while at the same giving them an opportunity to tap an international investor base in the G3 markets. Similarly, the Rupee Bond Guidelines present foreign fixed income investors with the first real opportunity to gain portfolio exposure to the Indian Rupee – a currency that, at the time of the introduction of the Rupee Bond Guidelines, enjoyed significantly lower implied volatility compared to its Asian peers and other emerging market currencies in the wake of the RBI's inflation targeting policies. In addition, the Indian Finance Ministry has reduced the withholding tax on interest income of such bonds to 5 per cent from 20 per cent and capital gains from rupee appreciation have been exempted from tax, thus providing an additional source of attraction to foregin investors.

While Masala bonds did not introduce any regulatory flexibility insofar as credit enhancement elements, covenant packages and related structural techniques are concerned, the effective passing of currency risk to an investor base that was seemingly happy to assume it led to an initial spate of issuance, especially following the reduction of the minimum average maturity period from five years to three years – thereby ensuring that fixed income investors had access to a U.S. dollar-Indian Rupee currency swap market that was sufficiently deep to hedge their currency exposure (a market which did not otherwise exist with a minimum average maturity of five years and over). It was thus widely expected that Masala bonds would provide an opportunity for mid-size Indian corporate issuers, who would otherwise not meet the ECB Guidelines requirements in order to access foreign investors, to access an international fixed income investment base. This was especially the case for non-bank financial companies, such as Indiabulls Housing Finance Limited and HDFC, who did not have the benefit of a deposit base: Masala bonds essentially provided them with an entirely new source of funding. In Indiabulls Housing Finance's case, a reduction in the cost of funding was achieved further by securing the bonds against its loan portfolio, on a pari passu basis with the rest of its loans.

However, since the introduction of the Rupee Bond Guidelines, the requirements for issuers to be able to use them as an instrument have become increasingly stricter, with the most recent A.P. (DIR Series) Circular No.47 effectively increasing the average maturity back to five years (for issues above USD 50 million); including an all-in cost ceiling limited of 300 basis points above the prevailing yield of Indian sovereign securities of equivalent maturity, and – as indicated in the discussion on high yield bonds above – excluding the use of Masala bonds as part of a broader structure by requiring investors not to be related parties.

It is our view that these recent changes to the regulatory framework represent an obstacle to the further development of the Indian capital markets – the imposition of "pricing caps" fails to distinguish higher-rated issuers from lower rated ones and it is our view that this is best left to the market to decide pricing levels – the information possessed by both ratings agencies and investors are in our view sufficient for all market participants to make informed decisions with respect to individual Masala bond issues.

Yet another restriction that is in place is that domestic investors are not allowed to invest in Masala bonds in the secondary markets. We recommend that domestic investors should be allowed to buy Masala bonds in the secondary market, as this would substantially improve liquidity and increase the marketability of Masala bonds among foreign investors.

The technology underlying the synthetic settlement of Masala bonds is not new, with Chinese issuers such as Shui-On Land and Evergrande having issued synthetic RMB bonds in the past. However, the synthetic settlement on those offerings were designed to take the capital raising exercise outside of the regulatory perimeter of Chinese capital controls, whereas for Masala bonds, that perimeter remains carefully circumscribed.

INR Denominated External Commercial Borrowings

In November 2015, the Reserve Bank of India liberalized the External Commercial Borrowings framework. The Revised Guidelines enabled INR denominated bilateral lending to Indian corporates by Recognized Lenders/ Investors.

Masala Bonds and INR ECBs provide a new avenue of funding Indian entities. Both routes have largely similar features, the key being FX hedging transferred to offshore Lenders/Investors. Transfer of FX hedging requirement to offshore Lenders/Investors would systemically reduce the complexity for Indian borrowers in managing FX risks to their Balance Sheets.

From a tax policy perspective however, there is a lack of parity between the two products. Based on our experience and advice from Indian tax advisers, while the Withholding Tax (WHT) rate on interest income from Masala Bonds is 5%, there is no concessionary WHT rate applicable to interest on INR ECBs which means that the applicable WHT rate defaults to the normal rate of 40% (subject to applicable tax treaty relief, if any). This is also significantly higher than the concessional rate of 5% given under section 194LC of the Income Tax Act, 1961 which is applicable to Foreign Currency denominated ECB.

3. Medium Term Note Programmes

Medium Term Note Programmes, or "MTNs", are essentially no different to any other bond issue (with no significant legal or structural difference arising from the use of the phrase, "medium-term"). Their essential feature is that all underlying bond documentation, including a prospectus or offering circular, is agreed in advance (including in-principal regulatory approval from the stock exchange on which the bonds to be issued are to be listed), meaning that issuers can quickly, efficiently and comparatively (to "stand-alone" issuances, which are documented from scratch for each issue) cheaply access international bond markets on the basis of the framework documents agreed on establishment of programme. The use of programmes is, therefore, largely analogous to that of facility agreements and "drawdowns" in the syndicated loan market.

The cost inherent in establishing the programme in the first instance was typically viewed as making MTNs more suitable to frequent issuers with high credit quality. In addition, given the dynamic nature of high yield covenants and the disclosure obligations attendant on high yield issuers, programmes are not seen as being suitable to high yield issuers, as covenants would need to be assessed in detail prior to each issuance, and disclosure updated in detail – an exercise which would largely negate the time and cost benefits associated with programme establishments and drawdowns.

This profile is no different in India compared to other markets, with only established bank credits (for example, Axis Bank) and quasi-sovereign or public sector undertakings (such as the Export-Import Bank of India) establishing programmes, and which had little in the way of credit enhancement features or covenant packages (as these are not needed, in light of the credit quality of the issuer).

However, in light of the fact that no regulatory approvals are required from Indian regulators to establish MTN programmes (as there is no incurrence or issuance of debt on a pure establishment), and in the context of a fast-changing regulatory landscape in India, MTN programmes could provide Indian issuers with a means to be able to quickly and efficiently access international debt capital markets as and when regulations and market dynamics permit. The establishment of a multi-currency programme well in advance of any issuances may therefore provide Indian issuers with the flexibility to go to market quickly, as opposed to suffering the time-lags – and therewith, the potential prejudice to a successful transaction – of execution that would otherwise be the case on a typical four-to-six week execution timetable.

4. Green Bonds

There is no formal or statutory definition of a green or climate bond, nor are they always easily identifiable by a green moniker or a "green bond" title. Essentially a green bond or climate bond is a fixed income product the proceeds of which are used for projects which have environmental benefits and typically promote a low carbon economy. Green bonds are popular amongst issuers for various reasons, although at the moment improved pricing on issue does not seem to be one of them. Corporate green bonds are currently pricing flat on issuance with the issuer's other debt. There is logic to this as the credit is the same. Interestingly however, many of the green bond issuances are creating demand from a wider range of investors, and in some cases investors who are new to the particular issuer. For example, on the GDF Suez issuance it was reported that 64% of investors were sustainable investors, many of whom were investing in GDF bonds for the first time. Increased investor demand and diversification may eventually translate to a pricing differential. A recent report by Barclays indicates that green bonds trade at a premium in the secondary market, up to 17 basis points tighter than conventional bonds, attributed in part to demand from environmentally-focused funds. In addition, issuers benefit from positive publicity resulting from green bond issuance – green bonds present an opportunity to align corporate strategy with fund raising.

Although multilateral investment institutions such as the European Investment Bank and the World Bank have been issuing green bonds since 2007, the first corporate green bonds were only issued in November 2013 (with Indian's first certificated green bond in international markets being raised by Axis Bank Limited in 2016, listing on the London Stock Exchange).

In India, green bonds have also been issued by other Indian entities such as Yes Bank Ltd., Exim Bank, IDBI Bank Ltd. and have received positive response in the market. Keeping in mind the potential of green bonds, SEBI, in May 2017, notified disclosure requirements for issuance and listing of green bonds ("Green bonds Circular").

As per the Green bonds Circular, green bonds can be issued *inter alia* for projects and/or assets relating to renewable sources of energy, waste management and climate change adaption. To ensure bona fide utilization of funds, SEBI has placed the issuing company under an obligation to utilize the proceeds for the stated environment purpose, and ensure that the projects/assets meet the eligibility criteria. SEBI has prescribed additional disclosure requirements for issue of green bonds.

Since 2013, the global market has seen exponential growth, from USD 11bn in 2013 to approximately USD 93bn in 2016 (Reuters data), and the number and range of issuers entering the green bond market continues to expand. The emergence of the green bonds market has been recognised by the United Nations in its "Trends in Private Sector Climate Finance" on 9 October 2015 as representing "one of the most significant developments in the financing of low-carbon, climate-resilient investment opportunities".

There is no legal definition of a "green bond": it is effectively issuers themselves who determine if their bonds are green and market them as such. Similarly, the ongoing commitments of green bond issuers, such as ensuring that the proceeds are used for the green purposes described in the bond offering documentation and complying with any reporting obligations that they have agreed to adhere to, are not generally included as contractual covenants enforceable by investors – investors must rely on market reprobation to ensure issuer compliance. The key players in the green bond market see benefit in self-regulation by the market, but also recognise that minimum standards and criteria give confidence to investors, enable better and quicker execution and trading and improve comparability across bonds. To address the lack of uniform standards the Green Bond Principles (GBP) and the Climate Bonds Initiative (CBI), amongst others, have sought to develop general principles and certification programmes. In conjunction with these initiatives there is an increased focus across the sector on standardising the provision of assurance, verification and reporting.

While the introduction of green bonds, and their adoption by Indian issuers, are seen as being a positive development in the world of sustainable finance, the commercial reality remains that green bonds are ultimately no different – from a credit profile and credit analysis perspective – than any other corporate bond issuance. Accordingly, the issues and challenges faced by Indian companies seeking to engage a broader "green" investor base, and enhance its access to sustainable financing, will be subject to the same obstacles surrounding pricing parameters and the lack of viable credit enhancement, synthetic settlement and pricing alternatives attendant on any other issuance of debt securities.

* PLEASE NOTE THE INDIAN REGULATIONS DO NOT PERMIT FOREIGN LAW FIRMS TO ADVISE ON INDIAN LAW. THE PRECEDING CHAPTER WAS PREPARED WITH INPUT FROM INDIAN COUNSEL, REFLECTS CLIFFORD CHANCE'S UNDERSTANDING OF THE INDIAN REGULATIONS AND ITS EXPERIENCE ON TRANSACTIONS IN INDIA. IN THE CASE OF ANY QUESTIONS OR CLARIFICATIONS ON INDIAN LAW, THE VIEWS OF INDIAN COUNSEL SHOULD BE OBTAINED.

F. Access Channels and Taxation of Debt Instruments

1. Access Channels for Debt Investments

The Indian Government in recent years, has taken several steps to revamp the Indian debt market and encourage greater foreign participation. Some of these include steps to increase the breadth of the debt markets by introducing new investment products such as rupee denominated bonds issued outside India (Masala Bonds) and the depth of the markets by increase in investment limits, allowing FPIs to re-invest their coupons in Government securities and allowing them to trade directly in the corporate bond market.

"Access channels" with respect to Indian debt markets can broadly be divided into "offshore funding" routes such as investment by FPIs and other non-resident investors in Indian debt instruments and "onshore funding" routes such as an Alternative Investment Fund, Non-Banking Financial Company (NBFC), etc. to lend or invest in Indian companies. This paper largely focusses on the offshore funding route for debt investments in India. In this context, "access channels" available to foreign investors, divided across borrower categories, are tabulated below:

Issuer	Name of the Instruments	Description
Government	Dated Government Securities	Dated Government securities are long term securities and carry a fixed or floating coupon payable, at fixed time periods (usually half-yearly). The tenor of dated securities can be up to 30 years. In India, the Central Government issues dated securities while the State Governments issues bonds or dated securities, which are called the State Development Loans (SDLs).
Corporates	Non-Convertible Debentures (NCDs)/Bonds	NCDs are rupee denominated debt securities issued by Indian companies which evidence a debt due to the NCD holder and entitle such holder to the principal amount with a pre-agreed interest and/or premium.
	Perpetual Debt Instruments (Tier I and Tier II)	Perpetual Debt Instruments, which are popularly known as a 'perpetual' or 'perp', are debt instruments with no maturity date. The issuer pays coupon on perpetual debt instrument throughout the life of the bond. These bonds are generally not redeemed.
	Credit Enhanced Bonds	Credit enhancement refers to a method whereby a company attempts to improve its debt or credit worthiness. Through credit enhancement, the lender is provided with reassurance that the borrower will honor the obligation through additional collateral, insurance, or a third party guarantee.

	Zero Coupon Bonds (ZCBs), Deep Discount Bonds (DDBs) and Discounted Bonds (DBs)	ZCBs means a bond in respect of which no payment and benefit is received or receivable before maturity or redemption from infrastructure capital company or infrastructure capital fund or public sector company. DDB and DBs are generally issued at a price lower than its face value and the face value is repaid to the investor at the time of the maturity of the bond. These bonds do not carry coupon during their lifetime.
	Masala Bonds	Masala Bonds are generally coupon bearing bonds issued by Indian corporates outside India. These bonds are denominated in Indian rupees and are either placed privately or listed on overseas exchanges as per host country regulations.
	Indian Rupee Denominated External Commercial Borrowing (ECB)	ECBs are borrowings raised by permitted resident entities from recognised non resident entities. ECBs can be denominated in either foreign currency or Indian rupees.
	Foreign Currency Denominated Bonds (FCB)	These bonds are issued by Indian companies overseas. They are denominated in foreign currency, generally listed on an overseas stock exchange and carry a fixed coupon rate. Issuance of these bonds by Indian companies are governed by the External Commercial Borrowing (ECB) framework of the RBI.
Others (Trusts, SPVs, etc.)	Units of Debt Oriented Mutual Funds	Debt oriented mutual fund schemes are mutual fund schemes which allocate major part of the funds in government securities, corporate bonds, debentures and at times fixed deposits.
	Infrastructure Debt Fund (IDF)	IDFs are investment vehicles which can be sponsored by commercial banks and NBFCs in India in which investors can invest through units and bonds issued by the IDFs. IDFs essentially act as vehicles for refinancing existing debt of infrastructure companies, thereby creating fresh headroom for banks to lend to fresh infrastructure projects.
	Security Receipts Issued by Asset Reconstruction Companies (ARCs)	Security receipt means a receipt or other security, issued by a securitisation company or reconstruction company. It is issued to any qualified institutional buyer pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial asset involved in securitisation.

	Securitised Debt Instruments	A securitised debt instrument is any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledges the beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be. Securitisation involves the pooling of financial assets and the issuance of securities that are re-paid from the cash flows generated by these assets.
	Units of Real Estate Investment Trusts (REITs)/Infrastructure Investment Trusts (InvITs)	A REIT is an investment vehicle that owns and operates real estate-related assets, and allows individual investors to earn income produced through ownership of commercial real estate without actually having to buy any assets. An InvIT is like a mutual fund, which enables direct investment of small amounts of money from possible individual/institutional investors in infrastructure projects to earn a small portion of the income as return.
	Cash Settled IRFs	An IRF is a futures contract with an underlying instrument that pays interest. An IRF is a contract between the buyer and seller agreeing to the future delivery of any interest bearing asset. IRFs allow the buyer and seller to lock in the price of the interest bearing asset for a future date.

An overview of the Indian tax and regulatory aspects relevant to above debt instruments has been enclosed as Annexure A and B.

2. Emerging Tax Landscape

a. Recent Treaty Developments

Traditionally, Mauritius, Singapore, Cyprus and Netherlands have been usually preferred for debt investments into India. Often, concerns have been expressed over possible misuse of these platforms for avoiding Indian taxes. In a defining step, the Indian Government has renegotiated its tax treaties with jurisdictions such as Mauritius, Singapore and Cyprus.

Hitherto, capital gains arising to Mauritius, Singapore and Cyprus tax residents from transfer of Indian securities were generally not taxable in India. With effect from 1 April 2017, capital gains earned by residents of these jurisdictions from alienation of shares of an Indian company acquired on or after 1 April 2017 is now taxable in India. Investments in shares made before 1 April 2017 have been grandfathered and will generally continue to enjoy the benefits of the erstwhile tax treaty provisions. Capital gains arising on alienation of instruments other than shares (bonds, debentures, derivatives, etc.) continue to be exempt from tax. This exemption, is of course, subject to application of Indian General Anti-Avoidance Rules which are discussed later.

As far as interest income is concerned, the amended India – Mauritius tax treaty now provide for a tax rate of 7.5% on interest income earned by a Mauritian tax resident. The taxation of interest income under the amended India – Singapore and India – Cyprus tax treaties remain same as earlier i.e. 15% under the India – Singapore tax treaty and 10% under the India – Cyprus tax treaty.

b. General Anti Avoidance Rules (GAAR)

GAAR provisions have been codified in the Indian tax law to counter aggressive tax planning arrangements. These provisions are applicable to income arising on or after 1 April, 2017. GAAR provisions empower the Indian Revenue Authorities (IRA) to declare certain transactions as "*impermissible avoidance arrangements*".

The expression "*impermissible avoidance arrangement*" essentially means a step or an arrangement, whose "main purpose" is to obtain a tax benefit and the arrangement, amongst others, lacks or is deemed to lack commercial substance in whole or in part.

GAAR also makes a presumption in favour of the tax department where an arrangement that is entered into for the tax benefit alone (thus an impermissible avoidance agreement), unless the same is rebutted by the taxpayer. The burden of proof has been shifted on to the taxpayer to establish that obtaining a tax benefit was not the main purpose of the arrangement; else the arrangement shall be presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit. Hence, GAAR is expected to bring a big change in the underlying tax treatment including eligibility of foreign investors to claim tax treaty benefits.

Certain relaxations and clarifications have however been provided with respect to application and implementation of GAAR provisions. For example, these provisions are not applicable in the following cases:

- Where the tax benefit from an arrangement in a relevant tax year does not exceed INR 30mn (approx USD 450,000)
- Where FPIs registered with the Indian market regulator do not avail any tax treaty benefits
- Investment made by a non-resident by way of offshore derivative instruments or otherwise, directly or indirectly, through an FPI
- Gains arising from transfer of investments made up to 31 March 2017
- If the jurisdiction of FPI is finalised based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain tax benefit

- If the arrangement is held as permissible by the Authority for Advance Ruling (AAR) or where the Court has explicitly and adequately considered the tax implication while sanctioning an arrangement

To limit application of GAAR provisions only to justifiable cases, it is clarified that GAAR provisions will be invoked only after the arrangement is vetted by the Principal Commissioner / Commissioner of Income tax at the first stage and then by the Approving Panel headed by the judge of a High Court at the second stage.

Once the arrangement is declared as *impermissible avoidance arrangement, the IRA could possibly, amongst others, deny tax treaty benefits,* disregard, merge or re-characterise any step in any arrangement, or re-characterise equity in to debt and vice versa, treat place of residence, situs of asset or transactions at different place.

c. Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

Another global tax development is the introduction of the 'Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting' (MLI) by the Organisation of Economic Co-operation and Development (OECD). The MLI aims, amongst others, to implement tax treaty related measures to prevent Base Erosion and Profit Shifting'. The MLI is new global tax avoidance agreement, that is signed by 68 countries (including India). Several other countries are expected to sign the MLI in due course.

Once adopted, MLI will supplement/modify the existing tax treaties that India has with several countries and incorporate anti-avoidance rules/Limitation of Benefits (LOB) conditions. These rules/conditions are to be finalised based on positions adopted by signatories to the MLI.

The MLI, amongst others, includes a "principal purpose test" (PPT), wherein tax treaty benefits can be denied if one of the principal purposes of an arrangement or a transaction was to, directly or indirectly, obtain tax benefit, unless it is established that granting that benefit would be in accordance with the object and purpose of the provisions of the relevant tax treaty. The PPT appears to be wider than the India GAAR which is invoked if the “main purpose is to obtain tax benefit”.

d. Thin Capitalisation Rules

Thin capitalisation rules have recently been introduced in the Indian tax law to curb companies from claiming excessive interest deductions. These rules are an outcome of the Base Erosion and Profit Shifting (BEPS) Action Plan 4 adopted by the OECD which proposed a 10 to 30% of Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA) range for limit on interest payments.

Under the Indian tax law, where an Indian company or Permanent Establishment (PE) of a foreign company makes interest payments (or similar consideration) exceeding INR 10mn which is deductible in computing income chargeable under the head "profits and gains of business or profession" to its:

- Non-resident associated enterprise (AE); or
- A third party lender (non AE) but where the AE provides implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender

then such interest shall not be deductible in the hands of the Indian company/ PE to the extent of the "excess interest". Excess interest means total interest in excess of 30% of the EBITDA of the Indian company / PE. These provisions are not applicable to borrowers engaged in banking or insurance businesses.

The above move could have a significant impact on investments into India through the debt route.

e. Income Computation and Disclosure Standard (ICDS) - Timing of Taxability

Interest income received from investment in debt securities is generally taxable under the head "income from other sources". The timing of taxability of such interest income i.e., whether on due basis or accrual basis has been subject matter of debate. The issue is more relevant with respect to investment in discounted instruments where no coupon is generally paid.

f. Overseas Transfer Provisions

The Indian tax law incorporates provisions to tax overseas transfers i.e. transfers of shares or interest in an offshore entity where the value of such shares or interest is substantially derived from assets located in India (overseas transfer provisions). Certain debt securities owned by foreign investors in India could be regarded as assets located in India, and hence the provisions are relevant.

The overseas transfer provisions are applicable if, on a specified date (which could be the latest balance sheet date or transfer date, depending on facts of the case), fair market value of Indian assets (without reduction of liabilities) (1) exceeds INR 100mn; and (2) represent at least 50% of the value of all the assets owned by such foreign company or entity.

Certain relaxations have been provided with respect to applicability of overseas transfer provisions. For example, these provisions are not applicable to shareholders not holding right of management or control or to small shareholders holding less than 5% of the voting power/share capital/interest in the offshore entity or on dividend pay-outs by the foreign company.

Further, the Indian Government recently amended the tax law to exclude Category I and Category II FPIs from the ambit of overseas transfer provisions. It is expected that the Indian Government will clarify that overseas transfer provisions shall not apply in case where redemption of shares or interests outside India as a result of or arises out of redemption or sale of investment in India which is chargeable to tax in India.

g. Safe Harbour Provisions for Offshore Funds Investing in the Indian Capital Market

India has introduced safe harbour provisions in the Indian tax law to encourage offshore fund managers who are of Indian origin and managing offshore funds to relocate to India. These provisions essentially provide that fund management activities carried out through an eligible fund manager shall not constitute a 'business connection' of that fund in India. Also, an offshore fund shall not be considered as being resident in India merely because the fund manager undertaking the fund management activities is situated in India.

The above safe harbour benefits will be available to offshore funds and fund managers who fulfil certain specified conditions. The key conditions specified in this regard include diversified holdings at the offshore fund level and registration of the fund manager with the appropriate authority in India.

h. International Financial Services Center (IFSC)

An IFSC is a designated area for providing financial services to non-residents and residents, in currency other than Indian Rupees. The purpose for setting up an IFSC is to bring financial services transactions, which are currently carried out outside India by overseas financial institutions and overseas branches/subsidiaries of Indian financial institutions, to a designated center on Indian soil, while being subject to the same financial ecosystem as their present offshore location.

India's first IFSC is launched at Gujarat International Finance Tech-City (GIFT City). Amongst others, the permissible securities traded in IFSC include debt securities issued by eligible issuers and interest rate derivatives.

The Indian Government has extended certain regulatory and fiscal incentives to attract foreign investors on the international stock exchange in IFSC, such as waiver of Securities Transaction Tax (STT) and commodities transaction tax on transactions, and no requirement of any additional registration or approval for FPIs already registered with SEBI. IFSC could emerge as an important destination in the Indian financial services sector.

G. Annexure A

1. Overview of Taxability in India

a. Streams of Income

Foreign investors investing in debt securities would generally earn following types of income from their India investments:

- Long term capital gains or short term capital gains on transfer of debt securities
- Interest income from investments in debt securities

b. Charge of Tax

The Indian tax law is contained in the Income-tax Act, 1961 and is administered by the Central Board of Direct Taxes (CBDT). Income tax is levied on the total taxable income earned by a person during the previous year. Total income has to be computed in accordance with the provisions of the Indian tax law and the Income-Tax Rules, 1962.

The basis of charge of Indian income tax depends upon, amongst others:

- the residential status of the tax payer during the year; and
- the nature/source of the income earned.

c. Residential Status of the Tax Payer

Broadly, a non-corporate tax payer (other than individual) is treated as tax resident in India, except in a case where during the year, the 'control and management' of its affairs is situated wholly outside India. A company is considered as a tax resident in India if its Place of Effective Management (POEM) is in India during that year. The term POEM is defined as "the place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made".

A person who is regarded as an Indian tax resident is liable to taxation in India on worldwide income, subject to tax exemptions, provided under the Indian tax law. A person who is regarded as a non-resident for Indian income-tax purposes is generally subject to tax in India only on such person's Indian-sourced income or income received in India.

Income earned by foreign investors from investments made in India should generally be regarded as Indian sourced income and should be taxable in India as per the provisions of the Indian tax law.

d. Accrual of Income

Income accruing or arising, whether directly or indirectly, through the transfer of a capital asset situated in India shall be deemed to accrue or arise in India.

Interest income shall be deemed to accrue or arise in India where, it is payable by a person who is an Indian tax resident, except where such interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such Indian tax resident outside India or for the purposes of making or earning any income from any source outside India.

e. Characterisation of Income

In the absence of express provisions in the Indian tax law, characterisation of gains earned by foreign investors from transactions in securities has been the subject matter of debate. In order to provide certainty, the Indian tax law was amended in 2014 to provide that any investment in securities made by FPIs in accordance with SEBI FPI Regulations shall be regarded as a capital asset. Accordingly, gains arising to FPIs on transfer of such Indian securities shall be characterised as "capital gains".

Further, the CBDT has clarified that, gains arising from transfer of listed shares and securities (which were held for more than 12 months before sale) would be regarded as 'capital gains' as against 'business income', except where the tax payer itself treats such income as business income.

Characterisation of premium on redemption of debt securities (on face value in the context of discounted debt securities), whether "interest income" or "capital gains", is a vexed issue. Where the debt securities carry coupon which is commensurate with the market rate, redemption premium could be arguably, regarded as capital gains.

f. Minimum Alternate Tax (MAT)

As per the Indian tax law, MAT is levied at the rate of 18.5% on the adjusted book profits of companies whose tax payable under normal Indian tax law provisions is less than 18.5% of their adjusted book profits.

The liability to pay a minimum tax of 18.5% on book profits is entrusted to Indian as well as foreign companies. However, a foreign company is not liable to pay MAT if India has entered a tax treaty with the country in which the foreign company is a resident and it does not have a PE in India. In cases where India has not entered a tax treaty with the country in which the foreign company is a resident, the company will not be liable to pay MAT if it is not required to seek registration in India under any law in force that relates to companies.

g. Tax Treaty Provisions

Under the Indian tax law, non-residents can generally avail benefits under tax treaties to the extent such tax treaties provide a more concessional treatment as compared to the Indian tax law.

To avail tax treaty benefits, non-residents are required to obtain a Tax Residency Certificate (TRC) containing prescribed particulars certifying their tax residence in their home country. Further, non-residents are also required to maintain and furnish such other documents and information that may be required by the IRA.

The table below outlines taxation in accordance with tax treaties signed by India with some of the key jurisdictions preferred for debt investments in India:

Tax Treaty between India and	Capital Gains on Transfer of Debt Securities	Tax Rate on Interest Income
Cyprus	Exempt	10%
Japan	Exempt	10%
Korea	Exempt	15%
Mauritius	Exempt	7.5%
Netherlands	Exempt	10%
Singapore	Exempt	15%

h. Withholding Tax

As per the Indian tax law, any person responsible for paying to a non-resident any sum chargeable to tax is required to deduct tax thereon at the rates in force. However, no deduction of tax is required from any income by way of capital gains arising to FPIs from transfer of securities.

H. Annexure B – Tax and Regulatory Overview of Different Instruments

1. Dated Government Securities

<table>
<tr><th>Instrument</th><th>Dated Government Securities</th></tr>
<tr><td>Issuer</td><td>The Central Government of India through auctions conducted by the RBI.</td></tr>
<tr><td>Eligible foreign investors</td><td>Long term FPI investors such as Sovereign Wealth Funds, Multilateral Agencies, Pension/Insurance/Endowment Funds and Foreign Central Banks (referred to as 'long term FPIs');
FPIs (other than the above);
Non-resident Indians (NRIs).</td></tr>
<tr><td>Key investment conditions</td><td>Dated Government securities can be bought in the primary market or the secondary market [including Over the Counter (OTC), Negotiated Deal System - OM (NDS - OM)].
Key investment conditions:
FPIs are permitted to invest in Government securities having minimum residual maturity period of 3 years;
There is no lock-in period and FPIs are free to sell the securities to the domestic investors;
FPIs are permitted to invest in Government securities on tap till the overall investment limit reaches 90% (tabulated below), after which an auction mechanism is initiated for allocation of the balance limit;
Aggregate FPI investments capped at 20% of the outstanding stock of each Government security;
Increase in the limit of FPI investment in Government securities to be allocated in the ratio of 75% (for Long Term FPIs and 25% for the other FPIs); and
FPIs are permitted to re-invest in Government securities bought on tap and coupons on Government securities subject to certain conditions.</td></tr>
<tr><td>Investment limits**</td><td><table>
<tr><th>Type of Investors</th><th>Limit in USD million (approx.)</th><th>Limit in INR million*</th></tr>
<tr><td>Long term FPIs</td><td>8,354</td><td>543,000</td></tr>
<tr><td>FPIs (other than the above)</td><td>28,876</td><td>1,8,77,0o0</td></tr>
<tr><td>Re-investment of coupons in Government securities (For all FPIs)</td><td>656</td><td>42,670</td></tr>
</table>
* The limit in dated Government securities are to be gradually increased by March 2018.
** as on 4 July, 2017</td></tr>
<tr><td>Exchange rate risk</td><td>Since the investment is in INR, the exchange rate risk is borne by the foreign investor</td></tr>
<tr><td>Period of holding for classification as a long term capital asset</td><td>12 months or more</td></tr>
</table>

Taxation of capital gains under the Indian tax law^^	• FPIs: Long-term capital gains - 10 %; and Short-term capital gains - 30 % • NRIs: Long-term capital gains - 10%/20%; and Short-term capital gains – 30%
Taxation of interest income under the Indian tax law^^	• FPIs: 5% • NRIs: 20%/30%
Withholding tax rate on interest income in India^	• FPIs: 5% • NRIs: 20%/30%

^^ Treaty provisions where beneficial may be applied
^As a practical matter, no tax is withheld by the Government
#1 USD = 65 INR

2. State developmental Loans (SDLs)

<table>
<tr><th>Instrument</th><th>State Developmental Loans (SDLs)</th></tr>
<tr><td>Issuer</td><td>State Governments through auctions conducted by the RBI</td></tr>
<tr><td>Eligible foreign investors</td><td>• Long term FPIs;
• FPIs (other than the above);
• NRIs.</td></tr>
<tr><td>Key investment conditions</td><td>SDLs can be bought in the primary market or the secondary market (including OTC and NDS – OM)
Investment conditions for FPI investors:
• FPIs are permitted to invest in SDLs having minimum residual maturity period of 3 years;
• There is no lock-in period and FPIs are free to sell the securities to the domestic investors;
• Increase in the limit of FPI investment in Government securities to be allocated in the ratio of 75% (for Long Term FPIs and 25% for the other FPIs); and
• Aggregate FPI investments capped at 20% of the outstanding stock of each SDL.</td></tr>
<tr><td>Investment limits**</td><td><table>
<tr><th>Type of Investors</th><th>Limit in USD million (approx.)</th><th>Limit in INR million*</th></tr>
<tr><td>Long Term FPIs</td><td>707</td><td>46,000</td></tr>
<tr><td>FPIs</td><td>4,385</td><td>285,000</td></tr>
</table>
* The limit in SDLs are to be gradually increased by March 2018
** as on 04 July, 2017</td></tr>
<tr><td>Exchange rate risk</td><td>Since the investment is in INR, the exchange rate risk is borne by the foreign investor.</td></tr>
<tr><td>Period of holding for classification as a long term capital asset</td><td>12 months or more</td></tr>
</table>

Taxation of capital gains under the Indian tax law^^	• FPIs: Long-term capital gains - 10 %; and Short-term capital gains - 30 % • NRIs: Long-term capital gains - 10%/20%; and Short-term capital gains – 30%
Taxation of interest income under the Indian tax law^^	• FPIs: 5% • NRIs: 20%/30%
Withholding tax rate on interest income in India^	• FPIs: 5% • NRIs: 20%/30%

^^ Treaty provisions where beneficial may be applied
^As a practical matter, no tax is withheld by the Government
#1 USD = 65 INR

3. Deep Discount Bonds (DDBs), Zero-Coupon Bonds (ZCBs) and Discount Bonds (DBs)

Instrument	Deep Discount Bonds (DDBs)/ Zero Coupon Bonds (ZCBs)/ Discount Bonds (DBs)
Issuer	Usually financial institutions, infrastructure capital fund, Government undertakings, scheduled banks and large Indian companies including infrastructure capital companies.
Eligible foreign investors	• FPIs • NRIs
Key investment conditions	Key investment conditions: • FPIs are permitted to invest in DDBs, ZCBs and DBs having minimum residual maturity period of 3 years; and • There is no lock-in period and FPIs are free to sell the securities to the domestic investors.
Investment limits**	**Type of Investors** / **Limit in USD million (approx.)** / **Limit in INR million*** FPIs / 37,588 / 2,443,230 ** the overall limit of INR 2,443,230mn (USD 37,588mn) is earmarked for FPI investment in corporate debt* *** as on 04 July, 2017*
Exchange rate risk	Since the investment is in INR, the exchange rate risk is borne by the foreign investor.
Period of holding for classification as a long term capital asset	• 12 months or more for listed securities • 36 months or more for unlisted securities
Taxation of capital gains under the Indian tax law^^	• DDBs (as per a clarification issued by the Government) - Transfer before maturity - difference between sale price and the cost of bond (value as on last valuation date) taxable as short term capital gains. • ZCBs (as per the Indian tax law) - Transfer before maturity - difference between sale price and the cost of bond taxable as capital gains;

	- On maturity or redemption – difference between face value of bond and acquisition price taxable as capital gains. • DBs - Transfer before maturity - difference between sale price and the cost of bond taxable as capital gains; - Where the DBs carry coupon which is commensurate with the market rate, redemption premium could be arguably, regarded as capital gains. FPIs: Long-term capital gains - 10%; and Short-term capital gains - 30 % NRIs: Long-term capital gains - 10%/20%; and Short-term capital gains – 30%
Taxation of interest income under the Indian tax law^^	• DDBs (as per a clarification issued by the Government) Yearly accretion - Bonds to be marked to market at every year end; - Accretion (difference between bid price/cost and market value at the year end) generally taxable as interest income. On maturity or redemption - Difference between redemption price and value as on the last valuation date/cost is generally taxable as interest income. • DBs On maturity or redemption - Difference between face value of the bond and acquisition price is generally taxable as interest income. FPIs: 5%/20% Others: 20%/30%
Withholding tax rate on interest income in India	Income in respect of investment in ZCB is not subject to withholding tax rate. Interest in respect of investment in DDBs and DBs is subject to withholding tax at the rates mentioned below: • FPIs: 5%/ 20% • NRIs: 20%/30%

^^ Treaty provisions where beneficial may be applied
 # 1 USD = 65 INR

4. Perpetual Debt Instruments – Tier I and Debt Capital Instruments – Tier II

Instrument	Perpetual Debt Instruments – Tier I and Debt Capital Instruments – Tier II
Issuer	Indian Banks
Eligible foreign investors	• Long term FPIs; • FPIs (other than the above); and • NRIs.
Key investment conditions	No specific investment conditions apply
Investment limits	• Investments by all FPI in Perpetual Debt Instruments (Tier I) should not exceed an aggregate ceiling limit of 49% each issue; • Investments by an individual FPI in Perpetual Debt Instruments (Tier I) should not exceed the limit of 10% of each issue; • Investments by all NRIs in Perpetual Debt Instruments (Tier I) should not exceed aggregate ceiling limit of 24% of each issue;

	• Investments by an individual NRI in Perpetual Debt Instruments (Tier I) should not exceed the limit of 5% of each issue; • Investments by FPIs in Debt Capital Instruments (Tier II) should not exceed the overall limit of INR 2,443,230 million (USD 37,588 million) earmarked for FPI investment in corporate debt; and • Investments by NRIs in Debt Capital Instruments (Tier II) should be within the limit prescribed for investments in other debt instruments for NRIs.
Exchange rate risk	Since the investment is in INR, the exchange rate risk is borne by the foreign investor.
Period of holding for classification as a long term capital asset	• 12 months or more where listed • 36 months or more where unlisted
Taxation of capital gains under the Indian tax law^^	• FPIs: Long-term capital gains - 10%; and Short-term capital gains - 30% • NRIs: Long-term capital gains - 10%/20%; and Short-term capital gains – 30%
Taxation of interest income under the Indian tax law^^	• FPIs: 5%/ 20% • NRIs: 20%/30%
Withholding tax rate on interest income in India	• FPIs: 5%/ 20% • NRIs: 20%/30%

^^ Treaty provisions where beneficial may be applied
 # 1USD = 65 INR

5. Listed Non-Convertible Debentures (NCDs)/Bonds (including Credit Enhanced Bonds)

<table>
<tr><th>Instrument</th><th>Listed NCDs/Bonds (including Credit Enhanced Bonds)</th></tr>
<tr><td>Issuer</td><td>Indian companies</td></tr>
<tr><td>Eligible foreign investors</td><td>• FPIs
• NRIs</td></tr>
<tr><td>Key Investment conditions</td><td>Key investment conditions:
• FPIs are permitted to invest in listed NCDs having minimum residual maturity of 3 years;
• There is no lock-in period and FPIs are free to sell the securities to the domestic investors; and
• NRIs can invest in listed NCD subject to certain prescribed conditions.</td></tr>
<tr><td>Investment limits**</td><td>
<table>
<tr><th>Type of Investors</th><th>Nature of Instrument</th><th>Limit in USD million (approx.)</th><th>Limit in INR million*</th></tr>
<tr><td>FPIs</td><td>Listed NCDs and bonds issued by an Indian company</td><td>37,588</td><td>2,443,230</td></tr>
<tr><td>FPIs</td><td>Credit enhanced bonds</td><td>3,685</td><td>239,530</td></tr>
</table>
*the overall limit of INR 2,443,230mn (USD 37,588mn) is earmarked for FPI investment in corporate debt.
** as on 04 July, 2017
</td></tr>
</table>

Exchange rate risk	Since the investment is in INR, the exchange rate risk is borne by the foreign investor.
Period of holding for classification as a long term capital asset	12 months or more
Taxation of capital gains under the Indian tax law^^	• FPIs: Long-term capital gains - 10%; and Short-term capital gains - 30% • NRIs: Long-term capital gains - 10%/20%; and Short-term capital gains – 30%
Taxation of interest income under the Indian tax law^^	• FPIs: 5%/ 20% • NRIs: 20%/30%
Withholding tax rate on interest income in India	• FPIs: 5%/ 20% • NRIs: 20%/30%

^^ Treaty provisions where beneficial may be applied
 # 1 USD = 65 INR

6. Unlisted Corporate Debt Securities

Instrument	Unlisted Corporate Debt Securities (Bonds and NCDs)
Issuer	Indian companies
Eligible foreign investors	• FPIs • NRIs
Key investment conditions	Key investment conditions: • FPIs are permitted to invest in unlisted corporate debt securities having minimum residual maturity of 3 years; • Indian company issuing unlisted corporate debt securities is subject to end use restriction on investment in real estate business, capital markets and purchase of land.
Investment limits**	<table><tr><th>Type of Investors</th><th>Limit in USD million (approx.)</th><th>Limit in INR million</th></tr><tr><td>FPIs</td><td>5,385</td><td>350,000*</td></tr></table>** Within the overall limit of INR 350,000mn (USD 5,385mn) earmarked for FPI investments in unlisted corporate debt securities and securitised debt instruments* *** as on 04 July, 2017*
Exchange rate risk	Since the investment is in INR, the exchange rate risk is borne by the foreign investor.
Period of holding for classification as a long term capital asset	36 months or more
Taxation of capital gains under the Indian tax law^^	• FPIs: Long-term capital gains - 10%; and Short-term capital gains - 30% • NRIs: Long-term capital gains - 10%; and Short-term capital gains – 30%

Taxation of interest income under the Indian tax law^^	• FPIs: 5%/ 20% • NRIs: 20%/30%
Withholding tax rate on interest income in India	• FPIs: 5%/ 20% • NRIs: 20%/30%

^^ Treaty provisions where beneficial may be applied
 # 1USD =65 INR

7. Masala Bonds

Instrument	Masala Bonds
Issuer	Any Indian company, body corporate, Indian banks or REITs or InvITs registered with the SEBI.

Eligible foreign investors	Masala Bonds can be issued in a country and can be subscribed by a resident of a country:
	• that is a member of Financial Action Task Force (FATF) / FATF-style regional body and;
	• whose securities market regulator is a signatory to International Organisation of Securities Commission's (IOSCO) Multilateral Memorandum of Understanding (MMOU) or a signatory to bilateral Memorandum of Understanding with SEBI and;
	• should not be a country identified in the public statement of the FATF as:
	  - a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or
	  - a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the FATF to address the deficiencies.
	Masala bonds can be also be subscribed by Multilateral and Regional Financial Institutions where India is a member country.

Key investment conditions	• Any proposal of borrowing by eligible Indian entities by issuance of Masala Bonds will be examined by the RBI;
	• End use restrictions on proceeds of Masala Bonds are as under:
	  - Real estate activities other than for development of integrated townships affordable housing projects;
	  - Investing in capital market and using the proceeds for equity investment domestically;
	  - Activities prohibited as per the Foreign Direct Investment (FDI) guidelines;
	  - On-lending to other entities for any of the above objectives; and
	  - Purchase of land.
	• The minimum original maturity period for Masala Bonds raised up to USD 50 million equivalent in INR per financial year should be 3 years. For Masala Bonds raised above USD 50 million equivalent in INR per financial year, minimum original maturity should be 5 years;

	• The all-in-cost ceiling for Masala Bonds will be 300 basis points over the prevailing yield of the Government of India securities of corresponding maturity; • Recognised investors should not be related parties of borrowers as per Indian Accounting Standard 24 (IndAS-24; and • Non-resident investors are permitted to hedge their exposure through permitted derivative products.
Investment limits	FPI investment in Masala Bonds to be within the aggregate limit of INR 2,443,230mn (USD 38,175mn approx.) which is earmarked for FPI investment in corporate debt.
Exchange rate risk	Since the investment is in INR, the exchange rate risk is borne by the foreign investor.
Period of holding for classification as a long term capital asset	36 months or more
Taxation of capital gains under the Indian tax law^^	• Transfer of Masala Bonds outside India should be exempt from tax in India • Gains arising on account of fluctuation of currency between the date of issue and the date of redemption should be exempt from capital gains tax
Taxation of interest income under the Indian tax law^^	• FPIs: 5%/ 20% • Others: 5%/20%/30%/40%
Withholding tax rate on interest income in India	• FPIs: 5%/ 20% • Others: 5%/20%/30%/40%

^^ Treaty provisions where beneficial may be applied
 # 1 USD = 65 INR

8. Indian Rupee Denominated External Commercial Borrowings (ECBs)

Instrument	Indian Rupee Denominated External Commercial Borrowings (ECBs)
Eligible borrowers	• Companies engaged in manufacturing, software development, shipping, airlines, infrastructure sector and miscellaneous services viz. companies engaged in R&D, training (other than educational institutes), supporting infrastructure, logistics services • Holding companies and Core Investment Companies • REITs and InvITs coming under the regulatory framework of SEBI • Non-Banking Financial Companies (NBFCs) • Small Industries Development Bank of India, Units in Special Economic Zones (SEZs), Developers of SEZs/ National Manufacturing and Investment Zones (NMIZs), Export Import Bank of India (only under approval route) • NBFCs-MFIs, Not for Profit entities, NGOs engaged in micro finance and certain specified societies trusts and co-operatives
Eligible lenders	• International banks, International capital markets, Multilateral financial institutions, overseas long term investors like Pension funds, Insurance companies, Sovereign Wealth Funds, Foreign Equity

	Holders, Export Credit agencies, Suppliers of equipment. Overseas branches / subsidiaries of Indian Bank cannot provide Indian Rupee Denominated-ECBs For NBFCs-MFIs, other eligible MFIs, not for profit companies and NGOs, ECB can also be availed from overseas organisations and individuals.
Key conditions	*End use prescriptions* • NBFC's can use ECB proceeds for; - On-lending to the infrastructure sector - Providing hypothecated loans to domestic entities for acquisition of capital goods/equipments - Providing capital goods/equipments to domestic entities by way of lease and hire-purchase • Developers of SEZs/NMIZs can raise ECB only for providing infrastructure facilities within SEZ/ NMIZ; • NBFCs-MFI, other eligible MFIs, NGOs and not for profit companies can raise ECB only for on-lending to self help groups or for microcredit or for bonafide micro finance activity including capacity building. • For other borrowers, ECB proceeds can be used for any purposes excluding the following: - Real estate activities - Investing in capital markets - Using the proceeds for equity investment domestically - On-lending to other entities for any of the above activities - Purchase of land *Minimum Average Maturity is as under* • 3 years for ECB up to USD 50 million or its equivalent • 5 years for ECB beyond USD 50 million or its equivalent *All-in-cost ceiling* • The all-in-cost ceiling for Indian Rupee Denominated ECBs should be in line with market conditions *Thin Capitalisation* • ECBs (more than USD 5 million) from foreign equity holders should not exceed 4 times the equity contributed by such holder (under automatic route) and 7 times (under approval route).
Borrowing limits	• ECB can be raised by an eligible entity under the automatic route in a financial year as under: - Up to USD 750mn or equivalent for the companies in infrastructure and manufacturing sectors; NBFC-IFCs, NBFC-AFCs, Holding Companies and Core Investment Companies - Up to USD 200mn or equivalent for companies in software development sector; - Up to USD 100mn or equivalent for entities engaged in micro finance activities; and - Up to 500mn or equivalent for remaining entities • ECB proposals beyond aforesaid limits require prior regulatory approval.

	For computation of INR limits, exchange rate prevailing on the date of agreement should be taken into account.
Exchange rate risk	Since the lending is in INR, the exchange rate risk is borne by the foreign lender.
Taxation of interest income under the Indian tax law*	30%/40%
Withholding tax rate on interest income in India*	30%/40%

**Assuming ECBs are in form of loans and not securities*
**Treaty provisions where beneficial may be applied*

9. Foreign Currency Bonds (FCBs)

Instrument	Foreign Currency Bonds (FCBs)
Issuer	Indian companies
Eligible foreign investors	International banks, International capital markets, Multilateral financial institutions, overseas long tem investors like Pension funds, Insurance companies, Sovereign Wealth Funds, etc.
Key investment conditions	Issue and subscription of FCBs is subject to ECB framework. The ECB regulations prescribe eligible borrowers, eligible lenders, end use restrictions and other parameters for investment. Broadly, the ECB framework comprises the following: • Track I - Medium term foreign currency denominated ECB with Minimum Average Maturity (MAM) of 3/5 years. • Track II: Long term foreign currency denominated ECB with MAM of 10 years.
Investment limits	• ECB can be raised by an eligible entity under the automatic route in a financial year as under: - Up to USD 750mn or equivalent for the companies in infrastructure and manufacturing sectors; - Up to USD 200mn or equivalent for companies in software development sector; - Up to USD 100mn or equivalent for entities engaged in micro finance activities; and - Up to 500mn or equivalent for remaining entities • ECB proposals beyond aforesaid limits require prior regulatory approval.
Exchange rate risk	FCB shall be denominated in USD. Therefore, the exchange rate risk will be borne by the Indian issuing company.
Period of holding to considered for classifying a long term capital asset	36 months or more
Taxation of capital gains under the Indian tax law^^	• Transfer of any FCB outside India should be exempt from tax in India

	• Gains arising on account of fluctuation of currency between the date of issue and the date of redemption should be exempt from capital gains tax
Taxation of interest income under the Indian tax law	• FPIs: 0%/5%/20% • Others: 0%/5%/20%
Withholding tax rate on interest income in India	• FPIs: 0%/5%/20% • Others: 0%/5%/20%

^^ Treaty provisions where beneficial may be applied

10.Cash Settled Interest Rate Futures (IRFs)

Instrument	Cash Settled Interest Rate Futures (IRFs)
Trading	Traded on recognised Indian stock exchanges
Eligible foreign investors	FPIs
Key investment conditions	• IRF contracts generally have Government bonds as underlying securities; • Currently the available IRFs are as under: - 6 year Government of India security; - 10 year Government of India security; - 13 year Government of India security. • Each futures contract shall represent 2000 underlying bonds of total face value of INR 0.2mn; and • Futures contract to be cash settled in INR.
Investment limits	• At any exchange overall open interest on IRF contracts on each underlying shall not exceed 25% of the outstanding of underlying bond; • Category I and II FPI - The gross open positions across all contracts within the respective maturity bucket shall not exceed 10% of the total open interest in the respective maturity bucket or INR 6,000mn, whichever is higher; • Category III FPI – The gross open positions across all contracts within the respective maturity bucket shall not exceed 3% of the total open interest in the respective maturity bucket or INR 2,000mn, whichever is higher; Additional restriction for FPIs • The total gross short (sold) position of each FPI in IRFs, should not exceed their long position in the Government securities and in IRFs at any point in time; and • The total gross long (bought) position in cash and IRF markets taken together for all FPIs shall not exceed the aggregate permissible limit for investment in Government securities for FPIs.
Exchange rate risk	Since the investment is in INR, the exchange rate risk is borne by the foreign investor.
Period of holding to considered for	12 months or more for listed securities

classifying a long term capital asset	
Taxation of capital gains under the Indian tax law^^	FPIs: Long-term capital gains - 10%; and Short-term capital gains – 30%
Taxation of interest income under the Indian tax law^^	Not applicable
Withholding tax rate on income in India	Not applicable

^^ Treaty provisions where beneficial may be applied

11.Units of a Debt Oriented Mutual Fund

<table>
<tr><th>Instrument</th><th>Units of a Debt Oriented Mutual Fund</th></tr>
<tr><td>Issuer</td><td>Scheme of Debt Oriented Mutual Funds registered with SEBI</td></tr>
<tr><td>Eligible foreign investors</td><td>• FPIs
• NRIs</td></tr>
<tr><td>Investment conditions</td><td>Key investment conditions:
• FPIs are restricted to invest in units of liquid mutual funds and money market mutual funds
• No single investor can invest more than 25% of the corpus of the Mutual Fund</td></tr>
<tr><td>Key investment conditions</td><td><table><tr><th>Type of Investors</th><th>Limit in USD million (approx.)</th><th>Limit in INR million*</th></tr><tr><td>FPIs</td><td>37,588</td><td>2,443,230</td></tr></table>* the limit of INR 2,443,230mn (USD 37,588mn) is earmarked for FPI investment in corporate debt
** as on 04 July, 2017</td></tr>
<tr><td>Exchange rate risk</td><td>Since the investment is in INR, the exchange rate risk is borne by the foreign investor.</td></tr>
<tr><td>Period of holding for classification as a long term capital asset</td><td>• 12 months or more for listed securities
• 36 months or more for unlisted securities</td></tr>
<tr><td>Taxation of capital gains under the Indian tax law^^</td><td>• FPIs: Long-term capital gains - 10%; and Short-term capital gains - 30%
• NRIs: Long-term capital gains – 10%/20%; and Short-term capital gains - 30%</td></tr>
<tr><td>Taxation of interest income under the Indian tax law^^</td><td>Dividend income earned from units of a debt oriented mutual fund shall be exempt in the hands of the investor</td></tr>
<tr><td>Withholding tax rate on income in India</td><td>Not applicable</td></tr>
</table>

^^ Treaty provisions where beneficial may be applied
 # 1USD = 65 INR

12.Infrastructure Debt Funds (IDF)

<table>
<tr><th>Instrument</th><th>Infrastructure Debt Funds (IDF)</th></tr>
<tr><td>Issuer</td><td>IDF set up as a NBFC issues either rupee denominated bonds or FCBs
IDF set up as mutual fund issues units</td></tr>
<tr><td>Eligible foreign investors</td><td>Long term FPIs
FPIs (other than the above)
Multilateral financial institutions</td></tr>
<tr><td>Key investment conditions</td><td><u>IDF set up as a NBFC</u>
In case of a non-resident investor, the original or initial maturity of bond, at time of first investment by such non-resident investor, shall be a minimum of 5 years; and
Investment made by non-resident investor shall be subject to a lock in period of 3 years. However, the non-resident investor may transfer the bond to another non-resident investor within such lock in period.
<u>IDF set up as mutual fund</u>
An IDF scheme shall have minimum 5 investors and no single investor shall hold more than 50% of net assets of the scheme;
No IDF scheme shall accept any investment from any investor which is less than INR 10mn;
The minimum size of the unit shall be INR 1mn;
Each scheme launched as an IDF scheme shall have firm commitment from the long term FPIs (including multilateral financial institutions) for contribution of an amount of at least INR 250mn.</td></tr>
<tr><td>Investment limits**</td><td>Limits for investments in rupee denominated bonds issued by IDF set up as NBFC and units issued by IDF set up as a mutual fund are as under:
<table><tr><th>Type of Investors</th><th>Limit in USD million (approx.)</th><th>Limit in INR million*</th></tr><tr><td>FPIs</td><td>37,588</td><td>2,443,230</td></tr></table>*the limit of INR 2,443,230mn (USD 37,588mn) is earmarked for FPI investment in corporate debt
** as on 04 July, 2017
For limits for investments in FCBs issued by IDF set up as a NBFC, please refer to investment limits applicable to FCBs mentioned at serial no. 9.</td></tr>
<tr><td>Exchange rate risk</td><td>In case of investments made in rupee denominated bonds issued by IDF set up as a NBFC and units issued by IDF set up as mutual fund, the exchange rate risk is borne by the foreign investor, since the investment is made in INR.
In case of investments made in FCBs issued by IDF set up as a NBFC, the exchange rate risk is borne by the Indian issuing company, since the issuance is in foreign currency.</td></tr>
<tr><td>Period of holding for classification as a long term capital asset</td><td>12 months or more for listed securities
36 months or more for unlisted securities</td></tr>
</table>

Taxation of capital gains under the Indian tax law^^	FPIs: Long-term capital gains - 10%; and Short-term capital gains - 30% Others: Long-term capital gains - 10%/20%; and Short-term capital gains – 30%
Taxation of interest income under the Indian tax law^^	• Interest income earned from rupee denominated bonds issued by IDF set up as NBFC - taxable at 5% • Interest income earned from FCBs issued by IDF set up as NBFC – taxable at 0%/5% • Income distributed by IDF set up as mutual fund – taxable at 5%
Withholding tax rate on interest income in India	• Interest income earned from rupee denominated bonds issued by IDF set up as NBFC subject to withholding tax at the rate of 5% • Interest income earned from FCBs issued by IDF set up as NBFC subject to withholding tax at the rate of 0%/5% • Income distributed by IDF set up as mutual fund subject to withholding tax at the rate of 5%

^^ Treaty provisions where beneficial may be applied

 # 1 USD = 65 INR

13.Security Receipts and Securitised Debt Instruments

Instrument	Security Receipts and Securitised Debt Instruments
Issuer	• Security Receipt – ARC Trust • Securitised Debt Instrument - Special purpose vehicles (SPV) set up as a trust for securitisation of assets
Eligible foreign investors	• Security Receipt - Qualified Buyers i.e., ARCs, banks, FPIs, mutual funds, insurance companies, public financial institutions, state financial corporation, state industrial development corporation, prescribed NBFCs, Alternative Investment Funds (AIFs), prescribed non-institutional investors etc. • Securitised Debt Instrument - Institutional investors
Key investment conditions	• Securitised Debt Instrument The certificate instrument may be issued by a SPV set up for securitisation of assets where banks, financial institutions or NBFC are originators and listed in terms with the prescribed regulations
Investment limits**	• Security Receipt - FPIs can invest up to 100% of security receipts of each tranche of a scheme of an ARC trust - FPI investment in Security receipts to be within the aggregate limit of INR 2,443,230mn (USD 38,175mn approx.) which is earmarked for FPI investment in corporate debt • Securitised Debt Instrument - Within the limit of INR 35,000 crores (USD 5,385mn) earmarked for FPI investments in unlisted corporate debt securities and Securitised Debt Instruments *** as on 04 July, 2017*

Exchange rate risk	Since the investment is in INR, the exchange rate risk is borne by the foreign investor.
Period of holding for classification as a long term capital asset	• 12 months or more where listed • 36 months or more where unlisted
Taxation of capital gains under the Indian tax law^^	• FPIs: Long-term capital gains - 10%; and Short-term capital gains - 30% • Others: Long-term capital gains - 10%/20%; and Short-term capital gains - 30%/40%
Taxation of income distributed by the trust under the Indian tax law^^	• ARC Trust/securitisation trust has been accorded tax pass through status i.e. any income received by the ARC Trust shall be chargeable to tax as if the income were arising to, or received by an investor, had the investments by the securitization trust been made directly by such investor; • Income from ARC Trust/securitisation trust can be characterised either as 'business income' or 'capital gains' or 'income from other sources'.
Withholding tax rate on income distributed by the trust in India	Income payable by the ARC trust/securitisation trust may be subject to withholding at the applicable rates in force.

^^ Treaty provisions where beneficial may be applied

 # 1USD = 65 INR

14.Units of Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs)

Instrument	Units of Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs)
Issuer	REIT/ InvIT set up in the form a Trust
Eligible foreign investors	Person resident outside India including FPIs and NRIs may invest in units of a REIT or InvIT
Key Investment conditions	• REIT A REIT is required to be publicly placed within 3 years of its date of registration. From an investor perspective: - Minimum subscription amount - INR 0.2mn per investor; and - Minimum trading lot - INR 0.1mn per investor. • InvIT InvIT can raise funds through public or private placement. The units of InvIT shall be mandatorily listed on the designated stock exchanges within the prescribed period from the closure of initial public offer / date of allotment. From an investor perspective: Public placement: - Minimum subscription amount - INR 1 million per investor; and - Minimum trading lot - INR 0.5 million per investor Private placement:

	- Minimum subscription amount - INR 10/250 million per investor; and - Minimum trading lot - INR 10 /20 million per investor
Investment limits	No investment limits apply
Exchange rate risk	Since the investment is in INR, the exchange rate risk is borne by the foreign investor.
Period of holding for classification as a long term capital asset	36 months or more
Taxation of capital gains under the Indian tax law^^	• Long-term capital gains (where STT* is charged) - exempt Short-term capital gains (where STT is charged) - 15 % • Long-term capital gains (other than above) - 20% Short-term capital gains (other than the above) – 30%/40% **STT – Securities Transaction Tax*
Taxation of income distributed by the REIT/InVIT under the Indian tax law^^	• o Dividend income distributed by REIT/InvIT to its unitholders - exempt in the hands of the investor; • o Interest income distributed by the REIT/InvIT – arguably taxable at the rate of 5%; and • o Rental income distributed by the REIT - taxable at the applicable rates in force
Withholding tax rate on income in India	Taxes to be withheld at the rates mentioned above

^^ Treaty provisions where beneficial may be applied

I. Annexure C – Recommendations

Topic	Specific Ask	Recommendation	Rationale
General Economy	Stabilization of the economy through more steady and less volatile economic growth.	This transition can be facilitated and accelerated through the development of robust capital and bond markets. Separately, the government's recent GST initiative is a positive step in fostering steady and less volatile economic growth	Alleviating poverty among the population through a larger corporate sector and new infrastructure needs will require a more balanced and stable growth model fueled by increased spending.
Capital Markets	Indian capital markets must be further developed for India to sustain its economic growth and fund its social and infrastructure initiatives.	Government policies are needed to encourage the development of capital markets in ways that will support its widespread economic and social development initiatives, including the further stabilization of its economy, increasing access to credit, funding municipal infrastructure projects, developing social safety nets and fostering its sweeping urbanization program.	The substantial infrastructure still needed to spread development, extend social safety nets, improve productivity and sustain high economic growth requires the efficient mobilization of private and public capital that only robust capital markets can facilitate.
Bond Markets	India must develop deep, liquid and transparent bond markets.	While considerable progress has been made in developing both the cash bond and derivatives markets, there is still not enough liquidity in off-the-run issues. The inclusion of Indian bonds in the global bond indices, in an environment where passive investment tends to dominate, would	The expansion and deepening of the bond market would better serve the needs of both the private and public spheres in India, especially given the tightened capital requirements under Basel III. Further, robust bond markets are also particularly important to the evolution of the Indian banking sector, whereby capital is not

		encourage long-term flows into India.	available for the corporate sector.
Interest-Rate Liberalization	Interest rates must be further liberalized.	Interest rate liberalization is the first step toward creating deeper, more liquid bond markets and can only be achieved through eliminating restrictions on the all-in-cost ceiling imposed on External Commercial Borrowing (ECBs), and on the ability to provide security over assets.	Further liberalization of interest rates and capital controls will benefit the Indian corporate sector by allowing issuers to issue at every level of the yield curve. Investors, in turn, will be more likely to buy since the price and interest rate of the bond will match its real risk. The creation of the Masala bond market is an important step in the right direction, but price caps and the limiting of structures that permit security on onshore assets is counter-productive.
Benchmark Yield Curve	Stronger and more dependable benchmark yield curves must be developed.	The 10-year, 5-year and 2-year government bonds are currently the most reliant benchmark yield curves in Indian markets for the most actively traded bonds across a range of given maturities – called the "on-the-run" issues. ASIFMA strongly urges regulators to establish benchmarks at every level of the yield curve. One positive development is the introduction of 13-15year G-Secs and futures – but more issuances out to longer maturities – such as the 40y issue described in section 1 above, would be helpful.	The existence of a common benchmark yield curve, grounded on a liquid government bond market, is critical to the financial sector's ability to reach efficient capital allocation and for government policy makers to gauge market expectations, as much of the analysis and pricing activity that takes place in the bond markets revolve around the yield curve.

Secondary Market Trading	Indian regulators must foster the development of a secondary market for government bonds.	A number of steps, such as the development of trading platforms for cash and derivatives, broadening the investor base through the granting of increased access to FPIs – including for shorter-dated securities of less than 3-years' tenor - and the strong growth of the asset management sector in India have all helped to foster growth in the secondary markets. Yet another step has been the steep reduction in the SLR. Even so, more needs to be done.	The growth of a secondary market for government bonds is integral to the overall development of the Indian bond market and provides several important benefits to market participants of all types, including: the establishment of "risk free" reference yield curves and "risk free" assets, like U.S. Treasury Bonds; supports the development of sound corporate debt and money markets; and enables the government to borrow for longer terms at lower funding costs – allowing the government to fund large, country-wide infrastructure and urbanization programs.
Settlement & Debt Limit Issues	The reduction of multiple guidelines and the complexity and monitoring of FPI limits & the need for a uniform settlement cycle are specific recommendations for the Indian regulatory authorities to consider.	Different reporting dates for the purchase/sale of securities, based on whether they are executed OTC are on central platforms like NDS-OM pose a number of challenges – thus, only one reporting date is recommended. Settlement of G-Secs on ICSDs such as Euroclear and Clearstream should be allowed. On the issue of debt limits for FPIs, the manual calculation of utilization once these limits approach between 90 and 100% makes the	Harmonizing India's settlement infrastructure and other regulations governing foreign investment with international norms, would help attract considerably more foreign investment into the country.

		process cumbersome and unreliable and should therefore be automated. On the issue of re-use of quota, FPIs should be given sufficient time post the sale or maturity of their bond holdings, to e-invest the proceeds arising from such sale/maturity.	
Repo Market	India must develop a classic repo market that is aligned with international standards.	India's current repo market (pledge repo system) must be transitioned to a classic repo market (international standard). Certain recent steps, such as allowing for re-repoing certain transactions, the reporting of repo across a central platform and the creation of a framework for tri-party repo have aligned the Indian markets more closely to international standards – but more progress needs to be made.	A "classic" bond repo market allows: (1) market participants to use the bonds they hold for additional purposes, such as further repos, covering short positions, securities lending, and collateral (a pledge repo system does not allow that as the bond title is not transferred); (2) allows market makers, who are critical for developing liquidity in any market, to 'go short,' which enhances liquidity in the cash market and thereby serves as a key prerequisite for the development of the bond futures market and the OTC derivatives market, which requires a sufficiently liquid cash market; (3)allow primary dealers to hedge risk with a wider array of hedging strategies; and (4) broaden funding markets and serve as a critical link between money markets, bond markets, futures markets and OTC derivatives markets.

Futures Market	Once the cash markets are sufficiently liquid, India should further develop its government bond futures market – Significant steps have been taken in this direction.	India's government bond futures market has shown substantial growth and development over the past few years – The fact that they are listed on exchanges, are centrally cleared and cash-settled, across a range of maturities are all in line with international practice – in addition, these are useful hedging tools for market makers. That said, contracts on a wider range of maturities, coupled with increased liquidity in existing maturities, would enhance the market's development.	An active, liquid, and closely supervised government bond futures market would allow participants to hedge large-value positions quickly and reduce risk more effectively, while at the same time deepening the underlying bond and derivative markets. The experience of other countries shows that bond futures enhance the liquidity of the underlying cash markets as market participants are able to manage the risk of their bond inventories more effectively. Thus far, the evolution of the Indian government securities futures market is proceeding in the right direction.
Interest-Rate & Currency Swaps	It is imperative that India develops an interest-rate and currency swap market.	While some progress has been made through the introduction of the ASTROID platform on CCIL for interest rate swaps, the fact that OIS (Overnight Index Swaps) volumes have fallen is a worrisome sign. Nevertheless, considerable growth in volume has been seen in the OTC swaps markets (both interest rate & currency). Furthermore, the introduction of central clearing, bilateral margining and the government's mandating the use of LEIs align India with G-20 market	Interest-rate and currency swaps are an integral part of the fixed-income market. These derivative contracts are an essential tool for investors who typically use them to hedge, speculate, and manage risk, and generate greater liquidity in fixed-income markets. Importantly, interest-rate and currency swaps allow companies to keep under control and revise their outstanding debt by adjusting the interest rate according to current or future market conditions.

		practice and is a positive development.	
Close-Out Netting	The rules governing creditors' rights, more specifically close-out netting, and an efficient recovery mechanism must be strengthened and clarified in order to ensure confidence in the enforceability of transactions and contracts.	The Insolvency & Bankruptcy Code, 2016 and the Financial Resolution & Deposit Insurance Bill, 2017 have gone a long way towards recognizing the concept of netting. This will give a significant boost to creditor rights. While the 2016 Bill is already law, the 2017 Bill needs to be enacted – moreover, the 2017 Bill is more relevant in the context of setting up a netting-friendly regime for financial institutions' recovery and resolution. Thus, there's still some distance to be travelled before "close-out netting" is fully recognized in India.	Close-out netting reduces credit risk by allowing a party to calculate its exposure to a particular counterparty on a net basis. Close-out netting will also result in cost reduction, allowing parties to use credit lines more efficiently and to maintain lower reserves to cover exposure. With the increased cost of capital under Basel III, the impact on risk-weighted assets is much greater for such non-netted trades, driving up costs considerably. The reduction of the uncertainty related to "Close-out" netting in India will also help develop repo and derivatives markets, going forward.
Corporate & Quasi-Sovereign Bond Market	India must develop a more well-rounded corporate debt market.	The liberalization of FPI limits for corporate bond investment, the creation of a framework for real estate and infrastructure trusts, the permission granted to banks to provide increased levels of credit enhancement, the growth in lower rated issuance and the setting up of more efficient settlement and clearing frameworks (such as DvP for OTC trades) and permission being granted to banks for lower-rated issuance (such as Basel-3	In India, a well-developed corporate bond market would serve several functions: (1) it would enable companies to raise funds even if they are not favored customers of the large, domestic commercial banks; (2) it would allow companies to match the durations of their assets with the maturity of their liabilities; (3) with the rise of pension funds, social security funds, and insurance funds, the combination of a

		compliant AT1 securities) are positive steps.	government and corporate bond market is key to ensuring that these funds can match their future payment obligations; and (4) promote greater transparency and improved corporate governance through increased disclosure.
Municipal & Local Authority Bond Market	India must develop a robust municipal bond market.	The introduction by SEBI of regulations in 2015 for Municipal Bond Issuance – both revenue and general obligation bonds - is a welcome first step. Also, the designation of certain municipal bonds as tax-free (if they meet certain conditions) is another positive. Finally, the adoption of a municipal bonds ratings framework by the major Indian ratings agencies is another step forward. That said, the market is still small and more incentives/dissemination of information regarding the benefits of municipal bond issuance to help support the further development of the market is essential.	The creation of a municipal bond market would allow a combination of domestic and foreign private capital to finance municipal infrastructure projects, significantly easing local municipal dependence on Indian central government, and significantly increasing the amount of longer-term capital available for large-scale infrastructure development.
Masala Bonds	The development of an "offshore INR" of "Masala" bond market should be fostered, as it eases foreign investor access go the domestic bond markets	We believe that the recently announced restrictions on the "Masala" bond market are counterproductive: a) Caps on all-in funding costs	There is the need for an active and liquid offshore INR bond market, which can only occur with active FPI and domestic investor participation. Recently announced restrictions stand in the way of the development of this market.

		b) Minimum issuance tenors based on size thresholds and c) The ban on the use of "related party" structures These conditions should be eased. In addition, domestic investors should be allowed to buy "Masala bonds" in the secondary bond markets. Finally, the elimination of the 5% Withholding tax on Masala bonds could be considered.	Removal of the 5% withholding tax on Masala bonds would be beneficial for both issuers (lower all-in funding costs, since there would be no need to gross up for tax purposes) and investors.
Securitisation	India needs to expand and increase access to its existing securitization markets.	The removal of tax at the SPV level and the permission granted to FPIs to invest in "pass through certificates (PTCs)" and unlisted debt securities are positive developments. Bank balance sheet stress, coupled with the need for infrastructure financing and enhanced credit ratings should be supportive of further growth and development in Indian securitisation.	Securitisation allows banks to move illiquid assets, like long-term loans, off their balance sheets, reducing the build-up of risky assets and providing banks with the ability to continue lending. In India, securitisation will increase banks' flexibility to tap additional sources of cash and liquidity, significantly broadening their ability to support economic growth. Additionally, it will provide companies with a cheaper source of capital, lowering the excessive reliance on banks for lending. It will also provide government and local municipalities with cheaper capital to finance themselves.

			Importantly, securitisation also allocates risk with capital, avoiding middleman inefficiencies and can enable companies to access capital markets directly, in most cases at lower cost than the cost of issuing direct debt (such as bonds or commercial paper), as it is collateralized, decreasing investor risk.
Ratings & Credit Market Infrastructure	There is a clear need to further develop the credit rating industry in India, creating an accessible and attractive market for investors.	In a system with stable interest rates, banks may recognize mark-to-market losses, trading securities and investing in corporate bond sector. By so doing, banks will develop their own risk management department, better assessing credit exposure.	A well-supervised and established credit rating industry will provide investors with a guarantee of the type of securities they are trading, ensuring a match of bond price, coupon and risk. With the growth of the homegrown credit-rating industry and international ratings agencies investing in India, the groundwork is in place for the further development of the Indian credit ratings industry. Over time, this will attract more domestic and foreign investors. The growing participation of both domestic and foreign credit rating agencies would provide healthy competition for domestic rating agencies and help improve overall standards of analysis and transparency.
Broadening the Investor Base	India must foster a broad investor base, which allows foreign	The growth of debt mutual funds, the	A broad investor base with different time horizons, risk preferences

	and domestic financial institutions (ranging from commercial banks to insurance companies, pension funds, hedge funds, as well as individual investors) to compete on an equal playing field.	liberalization of FPI limits and the granting of permission to FPIs to invest in a wider range of assets are key first steps in broadening the investor base. The creation of real estate and infrastructure investment trusts will also help foster long-term investment in the country.	and trading motives is vital for stimulating active trading and high liquidity, enabling the government, corporates or financial institutions to execute their funding strategies under a wide range of market conditions. More specifically, a broad investor base provides an important source of stability and liquidity to financial markets, aids in the efficiency of price discovery, reduces market volatility, and stimulates economic growth.
Taxation (1)	Market participants need more clarity on the implementation of, GAAR, PPT under BEPS MLI and overseas transfer tax. Further, domestic withholding Tax in respect of similar products should be aligned.	Deferral of GAAR to FY 2017-18 is a welcome development. However, the lack of adequate guidance on implementation of GAAR continues to be negative. Further, implementation of PPT in India should be aligned thematically and procedurally with the checks and balances established for invoking GAAR. The exclusion of Category I and Category II FPIs from the ambit of overseas transfer provisions is a welcome move. Additionally, a clarification that overseas transfer provisions shall not apply in case of redemption of shares or interest outside India as a result of or arising out of redemption or sale of	Providing clarification with respect to the implementation of GAAR (including PPT) is recommended to allay apprehensions and increase transparency in the market to draw more investors. The Indian Finance Minister while presenting the Union Budget 2017-18 had announced that it will be clarified that overseas transfer provisions shall not apply in case where redemption of shares or interests outside India as a result of or arises out of redemption or sale of investment in India which is chargeable to tax in India. A clarification to this effect is awaited. Not only are WHT tax rates higher for INR ECBs,

		investment in India which is chargeable to tax in India should be issued at the earliest. We further recommend that India extend concessionary WHT of 5% regime towards INR ECBs as done with similar products (e.g., Masala Bonds).	the fact that INR ECB coupons are generally higher than FCY ECB coupons further exacerbate the unattractiveness of INR ECB. Unless a level playing field is established, key policy objectives of launching INR ECBs such as transfer of foreign exchange risk to foreign investors and diversification of the lender base would not materialise. Extending the 5% concessionary WHT would help broaden the offshore lender base for Indian borrowers.
Taxation (2)	Rationalisation of period of holding of unlisted debt securities and units of REITs/InvITs (together referred to as a business trust)	The period of holding of unlisted debt securities to qualify as "long term capital asset" should be reduced from 36 months to 24 months, while for units of business trusts, this should be 12 months	Under the domestic tax law, long term capital gains on transfer of unlisted and listed securities are generally taxable at a lower rate (sometimes nil for listed securities) than the short term capital gains. Currently, gains from transfer of unlisted shares are characterised as long term if they are held for a period of more than 24 months. However, for unlisted debt securities, the corresponding holding period is 36 months. The holding period of unlisted debt securities to qualify as "long-term" should be aligned to the holding period for unlisted shares i.e. if held for more than

			24 months, then regarded as long-term capital asset. As for listed securities, gains from the transfer of these instruments are characterized as long-term if they are held for more than 12 months. Since units of business trusts are required to be listed, gains on the transfer of these should be treated as long-term if they are held for more than 12 months, down from 36 months.
Taxation (3)	Provide clarity on taxability of income distributed by an Asset Reconstruction Company (ARC) trust to an FPI investor	It should be clarified that income distributed by the ARC Trust to an FPI investor will be regarded as 'income in respect of securities' under Section 115AD of the Income tax Act, 1961 (the Act)	Currently, FPIs are governed by a special tax regime under the domestic tax laws wherein income in respect of securities is taxable at a beneficial tax rate of 20%. In case where the FPI holds security receipts issued by an ARC Trust, the FPI shall be chargeable to tax in respect of income distributed by the ARC Trust in a manner as if the FPI has invested directly in the underlying assets held be the ARC Trust. This results in the tax pass through. There is lack of clarity as to whether such income can be regarded as 'income in respect of securities' and can be granted beneficial tax rate of 20% under the

			special tax regime applicable to FPI. Hence, for the purposes of determining the tax rate applicable to FPI, its income from the ARC Trust should be considered to be received in respect of security receipts of the ARC Trust.
Taxation (4)	Clarity on taxability of interest income distributed by business trusts to FPIs	Section 115AD of the Act which provides for taxation of FPIs, should be amended to specifically clarify that interest income distributed by business trusts referred to in Section 194LBA of the Act, to FPIs should be chargeable to tax at the rate of 5%.	Section 194LBA of the Act provides for withholding of tax of 5% on interest income distributed by business trusts to non-residents. Section 115A of the Act which applies to non-residents in general, has been amended to provide for taxability of interest income distributed by business trusts at the rate of 5%. However, Section 115AD of the Act which governs taxability of income earned by FPIs from various securities, provides for taxability of interest income from securities at the rate of 20% (except for interest on certain rupee denominated bonds which are taxable at the rate of 5%) Accordingly, an additional clarification shall be provided by way of an amendment to Section 115AD of the Act which would provide for taxation of interest income from business trust at the rate of 5%. This would ensure that FPIs are not worse-off

			than other non-resident investors investing in business trusts.
Regulation of Financial Markets	India's financial regulatory authorities must become more transparent when drafting and implementing new regulations.	Indian regulators implement bylaws that foster greater regulatory transparency and consistency, genuine market consultation processes, ample notification of new regulations and sufficient time for public comment.	Regulatory transparency and consistency, market consultation processes, sufficient notification of new rules and time for public comment are vital to well-functioning financial markets.

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