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Masala Bonds -Innovation in Financing

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Abstract:
There is a need for significant volume of fund for infrastructural development in India. Every option is being explored whether domestic or international. One such means to bring foreign funds to India is Masala Bonds. Paper tries to understand the Masala Bonds in detail and to understand the various benefits it offers to various stakeholders. Study is based entirely on secondary data.

Keywords: *Long Term financing, bonds, Indian Currency*

1. Introduction

Masala Bonds are basically the flavor of the season considering the needs of funds in India primarily for infrastructural development It provides a significant opportunity to bring foreign funds to India at a significantly lesser cost and at the same time benefitting all the parties involved. This paper tries to understand the Masala bonds in the present Indian scenario while trying to assess whether it can become a sustainable source of funding.

The study is entirely based entirely on secondary data. Secondary data has been collected mainly from books, journals, and reports.

1.1. Objective of the Study

The main objective of this paper is to have a detailed understanding of Masala Bonds and to understand the probable reasons for a very positive response to Masala bonds in Indian Scenario.

1.2. Masala Bonds

Bonds are basically the debt instrument use for financing. Masala bonds are bonds which are denominated in rupee and are issued to offshore investors. They can be used by Indian Corporates for raising funds from abroad but in INR. Thus masala bonds is one of the many ways in which corporates can raise money from abroad. Other avenues include ECB that is External Commercial Borrowings and Foreign Currency bonds etc. Name Masala comes from an attempt to give it an Indian Flavors, similar to Samurai bonds which are denominated in Japanese Yen and Dim-Sum bonds which are denominated in Chinese Yuan.

Background: Allocation of resources without consideration of political boundaries is a welcome move. But in reality there are various factors which complicate international borrowing and lending. One such factor is currency value. For obvious reasons international debt would be denominated in credible currency. This ultimately leads to borrowings by less developed countries in foreign currency. This is called as Original Sin. Original Sin refers to," Inability to borrow abroad in terms of domestic currency and to borrow domestically"[i]. This also leads to currency mismatch in the balance sheet as the asset would be denominated in local currency[ii].

Decision about the currency in which borrowers intend borrowing involves various considerations such as interest rate, difference in exchange rates and also the transaction cost of debt issues[iii].

As per a study conducted 97%, of the total global bond issues in 2014 were done in following five major currencies. USD, Yen, Euro, Swiss Franc and British Pound and borrowers have not shown any home bias in choice of currency[iv].

In the Indian Scenario, during the first nine months of 2015, Indian corporate sector borrowed close to 20 billion USD by the way of ECB. However major risk faced by borrowers in ECB is the currency risk and this currency risk is only increasing because of depreciation in Indian Rupee leading to increasing possibility of default.

Indian Corporates and Financial Institutions issued foreign currency bonds denominated in USD to the extent of 3 Billon USD and in Chinese Yuan to the extent of 102 million Yuan. Such bonds are issued for lower coupon rate of interest but the depreciation in rupee neutralizes the advantage of lower coupon rate of interest.

Masala bond provides an option to raise money without the botheration of currency risk. Technically speaking in the case of inter market fund transactions, the currency risk cannot be eliminated completely. However who bears this currency risk is the question all about. In ECB, it is the issuer who bears the currency risk, whereas in case of Masala Bonds, it is the investor who is bearing the currency risk.

1.3. Common Features

Followings are the common features of Masala Bonds:

- Masala Bonds are issued in off shore markets to be invested by foreign investors
- The bonds can be bought both by the retail as well as institutional investors.
- One important feature of this bond is though they are issued and payable in INR but the redemption of bond is linked to foreign exchange rate subjecting them to exchange rate risk but the risk is borne by the investors.

For example consider that there is a company X issuing Masala Bonds in foreign market, the price will be in rupee terms but the payment will be in dollar terms at the time of maturity. For example the price of bonds is Rs1000 at the time of issue and redemption value is Rs 1050. Assumption being that INR/USD rate being 65 on investment date, then the investment in dollar terms comes out to be approximately 15.38$. Now if on redemption date if INR/USD rate becomes 70, then redemption amount works out to be 15$. This is benefitting borrowers. However if rupee appreciates on redemption date, for example, it becomes INR/USD rate becomes 50, then redemption amount works out to be 21$, benefitting lenders as lender is paying 15.38$ and getting back 21$.

On 29th September 2015, RBI issued guidelines which allowed corporates, NBFCs, Infrastructure investment trusts and also real estate investment trusts for the issue of rupee denominated bonds to investors off shore. They have put a limit of issue to 750 million $ and have also specified price caps of different tenures. Very recently in August 2016, RBI even permitted banks to issue masala bonds for financing infrastructure, affordable housing.

International Finance Corporation(IFC) in November 2015, issued Rs 1000 crores bonds, for duration of 10 years in London to be listed in London Stock Exchange. The purpose of bond issue is to finance infrastructure projects in India. Then in July 2016, HDFC has also raised 3,000 crores Rs through the masala bonds at a fixed interest rate of 7.875% to be paid semiannually of a tenor of 3 years 1 month, with an annualizes yield of 8.33%. With this the HDFC became the first company to issue masala bonds. The issue was oversubscribed by 4.3 times. Thereafter NTPC on August 4 raised Rs 2000 crores with an annual yield of 7.48% by the way of green masala bond. The proceeds to be used only for renewable energy investment. Bonds have a maturity period of 5 years and will be listed in London Stock Exchange. Both the above issues have been only for institutional investors. Seeing the success of these bonds, various other companies

2. Benefits of Masala Bonds

Masala bonds are certainly the flavor of the moment. That is probably because of the advantages it is offering to various stake holders. Masala bonds enjoy the full backing of RBI[v].

- Benefits to the Borrowers:

One significant advantage of this bond to the borrower is that borrowers gets to borrow at lower interest rates. as the prevailing interest rate in well-developed market is much less as compared to what is prevailing in India. This works out to be approximately less than 200 basis points on an average.

Here the currency risk is borne by the investors

It provides an opportunity to the borrowers to diversify their bond portfolio.

It significantly diversifies the investor base for borrowers.

It increases the liquidity.

- Benefits to Investors:

Masala bonds offer significant benefits to off shore investors as well. They stand a chance of earning more returns than what they would have got by investing in their own country as interest rates in US, Europe and for that matter in developed economies is on a lower side. For example, Indian entities issue bonds which are offering rates higher than 200 basis points on an average than LIBOR (London Interbank Offered Rates)

With the India's GDP and National Income on a rising spree and all projections indicating that it is expected to rise in the years to come, there stands a great chance for institutional investors to make money.

- Benefits to India:

Indian Economy is also poised to benefit from masala bonds. Significant capital can be attracted at a relatively lesser cost which can be used for infrastructure development. This is especially valid in Indian Scenario where various infrastructure projects are on hold due to shortage of capital.

This is also beneficial to Indian Economy in a way that it will increase the confidence of off shore investors. It can also possibly increase the status of rupee internationally and can lead towards full currency convertibility

There can also be increase in demand of rupee leading to appreciation in rupee. Classic example is the case of Dim-Sum bond of China which has provided investment avenues for investors holding RMB outside China and has also led to noteworthy appreciation of RMB.

Trend suggests that Rupee has been falling against the major currencies and it is expected that this trend will continue. Now since in these bonds, currency fluctuation risks are borne by the lenders, savings can happens during repayment if rupee depreciates. Considering the advantages these bonds are offering, there is a list of companies which are planning to come up with masala bonds. For example, Yes Bank, PFC, IRFC, NHAI, EESL, Neyveli Lignite to name a few. As per statement of Union Minister Piyush Goyal, Power Companies have plans to raise around 2 billion dollars by way of Masala Bonds[vi]. Government is also taking various steps to make it more attractive. For example, reducing the rate of withholding tax from 20% to 5% and also exceptions of capital gain from tax.

3. Word of caution

Though it is a welcome sign to issue rupee debt abroad, but all such borrowings will be considered to be a part of India's foreign borrowings. There are also possibilities that off shore investors may hedge their investment in rupee bonds in non-deliverable forward market overseas and in that situation RBI will have no control over that. There can also be a distinct possibility of adverse impact on the growth of Indian Corporate Bond Market and also on Indian Banks.

Since currency risk in these bonds is to be borne by the investors, they will scrutinize the issue a lot more before subscribing. Firms with higher credit ratings will find it comparatively easy to raise money by this route.

Financial experts recommend using masala bonds only in moderation. As per them relying too much on them can lead to downgrading by rating agencies.

4. Conclusions

Rupee bond is definitely going to be a new beginning to raise money from abroad where there is plenty of liquidity but very limited investment options and comparatively lower interest rates. It is a win win situation for all. It can bring in more foreign funds to the country for the development of infrastructure which is the pressing need of time, whereas interest rate burden on borrowers can reduce. The fact remains that the all masala bonds issued till now have been issued by well-established and reputed firms and they were very competitively priced. This is a reason for their grand success because of the investor support.

Taking into consideration the investor's perspective, it is well known that investors look for attractive yield and a currency which is stable and appreciating. Now, considering that fact that Chinese economy is slowing down, India is considered to be on growth trajectory and performance of rupee is much better than other emerging markets. It sets the right momentum for the rupee bonds.

However success of such bonds depends to a great extent on market scenario. For getting success in the long run, it is extremely important to create and maintain sound macroeconomic fundamentals. Stability of rupee will be a deciding factor in the long run.

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