17th November, 2015

To,
The Reserve Bank of India
Financial Markets Regulation Department,
23rd Floor, Central Office Building,
SB Road, Fort
Mumbai-400001

Sub: Representation on Legislative and other Changes for Bond Market in India.

Kind Attn: Mr. Vivek Singh

Dear Sir,

Indian Securitisation Foundation (ISF)

ISF is a not-for-profit entity representing the securitisation industry in India. The membership of the Foundation includes banks, NBFCs, microfinance institutions, other issuers and investors and securitisation professionals for promoting interest of securitisation and fixed income securities in India. As ISF is dedicated to the cause of promoting securitisation, asset-based financing and related areas in India, we humbly submit our representation herein below on suggesting legislative and other changes necessary to vitalize the Indian bond market.

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Executive Summary

1. **Highlight features of Indian bond market, not found elsewhere in the world:**

   - Issuer profile in India is dominated by financial sector while other non-financial entities hardly account for total issuances made in 2013-14.[1] Given the legislative framework there is no scope for non-financial corporates to issue bonds.
   - Bonds in India are almost entirely secured bonds, whereas globally, unsecured bonds seem to be the norm.[2]

2. **Permit unsecured Debentures to be issued to QIBs**

   - Unsecured debentures are treated as public deposits, which are allowed only to the extent of 25% of net worth of the issuer; in any case, too difficult and impractical for most issuers.
   - Hence, debentures have to be necessarily secured. Most corporate, other than NBFCs, do not have assets to create charge in favour of bond/ debenture holders, as the assets are already charged in favour of banks.
   - It is counter intuitive to expect a corporate to issue secured bonds; if the corporate had security to offer, it may be easier to access bank loans. It is when companies exhaust their security interests that they opt for bonds. Bonds are an incremental, additional source of funding, and not the first source of borrowing for most companies.
   - There is no reason to restrict the bond markets to secured bonds, as long as the investor is a qualified institutional buyer (QIB) and/ or the bond issuance is rated. As QIBs can easily take a credit call on the issuer, the security offered is of no relevance. In any case, the security feature may be a question of pricing/ rating of the bond, and the regulation does not have to impose any fetters in this regard.
   - The suggested change does NOT require a change of law – the same may be done by a minor amendment of the Companies (Acceptance of Deposits) Rules, 2014.

3. **Permit unsecured Debentures to be issued by Non-NBFCs and non-HFCs**

   - There is no reason to only permit NBFCs and HFCs to issue unsecured bonds, provided the minimum subscription per investor is Rs. 1 crore. Corporate, other than these entities, should also be permitted to issue unsecured bonds where the ticket size

[1] http://www.sebi.gov.in/cms/sebi_data/statistics/corporate_bonds/publicissuedata.html
[2] http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb110403.pdf

is huge and/ or the bond issuance is rated. So long as the investors can easily take a credit call on the issuer, the security offered is of no relevance. In any case, the security feature may be a question of pricing/ rating of the bond, and the regulation does not have to impose any fetters in this regard.

- The suggested change does NOT require a change of law – the same may be done by a minor amendment of the Companies (Acceptance of Deposits) Rules, 2014 in the manner it was done in case of public deposit directions governing NBFCs and HFCs.

4. Requirement of Debenture Redemption Reserve is completely misplaced

- DRR is simply an accounting reserve, not a fund.
- There is no other country in the world which insists on creation of a DRR.
- While DRR is inapplicable in case of certain private placements, it is applicable in case of public offers. This discourages companies from making public offers of bonds, and restricts the bond market to private placements only, which is not desirable.
- Not only is the DRR a drag on the distributable profits of the company, it also adds to the cost of issuance, since in the year of maturity, the issuer is required to create a funded DRR to the extent of 15% of the amount of debentures being redeemed.
- Therefore, the creation of DRR does not at all help in repayment of the debentures.
- DRR is completely unnecessary and should be done away with.
- No legislative change is required: exemption may be given by way of Rules u/s 71 of the Companies Act, 2013.

5. Companies Act, 2013 requiring charge on "Specific" Asset is creating difficulties

- Specific asset means ascertainable assets, which is in the nature of a fixed charge.
- As data shows, the issuers are predominantly (to the extent of about 98%)[3] NBFCs and HFCs.
- The only assets on which NBFCs/ HFCs create security interest are receivables, which are in the nature of a current asset. The charge is, therefore, naturally, a floating charge.
- However, MCA vide Companies (Share Capital and Debentures) Amendment Rules, 2015 exempted NBFCs thereby permitting NBFCs to create security on any movable property. However, HFCs are still governed by the said requirement.
- Therefore the term specific restricts NBFCs from issuing bonds.

[3] http://www.sebi.gov.in/cms/sebi_data/statistics/corporate_bonds/publicissuedata.html

- No legislative amendment required; Rules may be amended by amending the proviso to Rule 18 (1) of Companies (Share Capital and Debentures) Rules, 2014. .

6. Extend the benefit of SARFAESI Act to debenture trustees.

- The Act currently permits a trustee acting only on behalf of banks/ FIs to exercise the powers of the said Act and not where the bondholders are entities other than banks/ FIs.
- Necessary amendments may be introduced to include other debenture investors too.
- Under section 71 of the Companies Act, 2013 a debenture holder can enforce payment on a debenture only through CLB/ NCLT. In case of secured debentures, it should be possible to enforce security interest rather than invoke the jurisdiction of a quasi judicial authority.

7. Debt Recovery Tribunal (DRT) laws can also pass orders in the absence of security interest

- The Debt Recovery Tribunal (DRT) laws are equipped with a power to pass orders even where there is no security interest whereas SARFAESI Act has no such power.
- As per common practice in the market, banks use SARFAESI Act where there is security interest, and the DRT law where there is none, or insufficient security interest.
- Hence, DRT law may be activated even in case of unsecured bonds also.

8. Procedure of Private Placement provided under Companies Act, 2013

- Private Placement procedure was introduced an anti avoidance maeasure, subsequent to Sahara case. The intent is to protect small retail investors from being duped..
- So long as the issuance is being made to QIBs and/or to others above a particular ticket size, followed by listing, the procedure prescribed under Section 42 of Companies Act, 2013 read with allied rules should be exempted from being adhered to.

9. Concerns arising from Companies Act, 2013and allied rules

- Companies which have listed only debt securities, and not equity, are treated as "listed companies" under the Companies Act, 2013 and hence, are subjected to the whole discipline of the Act applicable to listed companies.
- Typically, bond issues may be listed even by private companies.
- This is deterring companies from listing their bonds.

- Micro, Small and Medium Enterprises to get its debt securities listed the regulatory compliance burden may outweigh the benefits of price discovery, liquidity and transparency and the repercussion may be such companies may not be able to attract angel investors either
- Needs amendment of the definition of "listed company" under the Companies Act, 2013.

Our Representation

The need for a strong bond market in India is almost unarguable. A reasonably well-developed corporate bond market is very much required in any economy to supplement banking credit and the equity market and to facilitate the long-term funding requirement of corporate sector as well as infrastructure development in the country.

Though, the development of the corporate bond market has been an important area and has received greater policy attention in recent times, it is yet to take off in a significant manner. On worldwide scenario, bond financing is rather more popular than bank financing, but the picture that India presents is totally reverse. It can be said that the impeding growth of the corporate bond market is due to overhang of government bond market because of high fiscal deficit.

Issuer profile in India is concentrated among a few categories of market participants dominated by financial sector including banks, Non-Banking Financial Companies (NBFCs), financial institutions, housing finance companies (HFCs) and Primary Dealers (PDs), while other non-financial entities hardly account for total issuances made in 2013-14.[4] Given the legislative framework there is no scope for non-financial corporate to issue bonds.

Bonds in India are almost entirely secured bonds, whereas globally, unsecured bonds seem to be the norm. Similarly, on demand side, majority of investment are made by banks and institutions including Foreign Institutional Investors (**"FIIs"**) with very little or negligible part played by retail investors. Thus, there is an urgent need to further develop the Indian corporate debt market The factors which can be attributed to such impeding growth of corporate debt market are:

i) Tight liquidity or trading in secondary market;
ii) Tax deductibility and stamp duty issues;
iii) Issues around bankruptcy laws
iv) Bond ratings also deter the growth which cannot be totally done away with,
v) Global shocks and foreign flows in recent years
vi) Reduction in number of foreign investors
vii) Several regulatory authorities and lack of clarity on the regulations/ laws

[4] http://www.sebi.gov.in/cms/sebi_data/statistics/corporate_bonds/publicissuedata.html

Required Legislative and other Reforms

A. Permit unsecured Debentures to be issued to QIBs

Unsecured debentures are treated as public deposits and under Companies (Acceptance of Deposit) Rules, 2014 are allowed only to the extent of 25% of net worth of the issuer. The provisions with regard to acceptance and maintenance of deposits make the option impractical for most issuers. Hence, debentures have to be necessarily secured to be exempted from the purview of the rules.

Most corporates, other than NBFCs, do not have assets to create charge in favour of bond/ debenture holders, as the assets are already charged in favour of banks. It is counter intuitive to expect a corporate to issue secured bonds; if the corporate had security to offer, it may be easier to access bank loans. It is when companies exhaust their security interests that they opt for bonds. Bonds are an incremental, additional source of funding, and not the first source of borrowing for most companies.

Bonds may be secured or unsecured as per the option of the issuer. Hopefully, secured bonds will carry lower coupon rates – allowing for a greater play of market forces. Moreover, there is no reason to restrict the bond markets to secured bonds, as long as the investor is a qualified institutional buyer (QIB) and/or the bond issuance is rated; as QIBs can easily evaluate the risk in investments and take a credit call on the issuer, the security offered may not be of relevance. In any case, the security feature may be a question of pricing/rating of the bond, and the regulation does not have to impose any fetters in this regard.

The suggested change does NOT require a change of law – the same may be done by a minor amendment of the Companies (Acceptance of Deposits) Rules, 2014. The definition of deposits may be amended to accommodate unsecured debentures in the exclusions from the definition.

B. Permit Companies other than NBFCs and HFCs to issue unsecured debentures

RBI issued notification on February 20, 2015 - Guidelines on Private Placement of NCDs (maturity more than 1 year) by NBFCs in supersession of Guidelines issued on 27th June, 2013 and clarification issued on 2nd July, 2013. Similarly, NHB amended issuance of NCDs on private placement basis (NHB) Directions, 2014 on similar lines. As a result of the said amendments, NBFCs/ HFCs can issue NCDs of following two categories:

a) With a maximum subscription of less than Rs. 1 crore (**Category A**)

b) With a minimum subscription of Rs. 1 crore and above (**Category B**)

Security creation is mandatory for Category A and optional for Category B. The limit of subscribers has been prescribed 200 for Category A. No such limit exists for Category B. This enabled NBFCs/ HFCs to issue unsecured debentures, other than subordinated debt for capital purpose.

This benefit should also be extended to other entities. Corporate, other than these entities, should also be permitted to issue unsecured bonds where the ticket size is huge and/ or the bond issuance is rated. So long as the investors can easily take a credit call on the issuer, the security offered is of no relevance. In any case, the security feature may be a question of pricing/ rating of the bond, and the regulation does not have to impose any fetters in this regard.

The suggested change does NOT require a change of law – the same may be done by a minor amendment of the Companies (Acceptance of Deposits) Rules, 2014 in the manner it was done in case of public deposit directions governing NBFCs and HFCs respectively.

C. Requirement of Debenture Redemption Reserve to be removed

Redeemable debentures, whether short term or long term, require creation of debenture redemption reserve (**"DRR"**) in terms of Section 71(4) of the Companies Act, 2013.

- The requirement of DRR is completely misplaced. DRR is simply an accounting reserve, and not cash. There is no other country in the world which insists on creation of a DRR.
- DRR is applicable in case of public offers whereas it is inapplicable in case certain private placements. This discourages companies from making public offers of bonds, and restricts the bond market to private placements only, which is not desirable.
- Not only is the DRR a drag on the distributable profits of the company, it also adds to the cost of issuance, since in the year of maturity, the issuer is required to create a funded DRR to the extent of 15% of the amount of debentures being redeemed.
- Therefore, the creation of DRR does not at all help in repayment of the debentures. DRR is completely unnecessary and should be done away with.
- No legislative change is required; exemption may be given by way of Rules u/s 71 of the Companies Act.

D. The term 'Specific' should be dropped

The Company (Share Capital and Debentures) Rules, 2014 require the debentures to be secured by way of a charge or mortgage to be created in favour of the debenture trustee on:

- Any **‘specific’** movable property of the company (not being in the nature of pledge); or
- Any **‘specific’** immovable property wherever situate, or any interest therein.

Specific asset means ascertainable assets, which is in the nature of a fixed charge. The term ‘specific’ property does not relate to creation of floating charge but implies that there should be a specific and identifiable asset ear-marked for the purpose of creating security.

Data shows that the issuers are predominantly (to the extent of about 98%) NBFCs and HFCs[5]. The only assets on which NBFCs/ HFCs create security interest are receivables, which are in the nature of a current asset and do not remain fixed over time. The charge is, therefore, naturally, a floating charge. MCA vide Companies (Share Capital and Debentures) Amendment Rules, 2015 exempted NBFCs thereby permitting NBFCs to create security on any movable property. However, HFCs are still governed by the said requirement.

However, the insistence in the Rules, 2014 on “specific” charge would mean HFCs will have to create charge over the receivables dynamically and that there will be filing of a charge, and satisfaction of a charge, almost on a monthly basis. This condition is too difficult to comply, and is not serving any change. Therefore the term specific restricts HFCs from issuing bonds.

No legislative amendment required; Rules may be amended by amending the proviso to Rule 18 (1) of Companies (Share Capital and Debentures) Rules, 2014.

E. Amendment of SARFAESI Act (the Act) Provisions

The Act currently permits a trustee acting only on behalf of banks/FIs to exercise the powers of the said Act and not where the bondholders are entities other than banks/FIs. Necessary amendments may be introduced to include other debenture investors too.

Under section 71 of the Companies Act, 2013 a debenture holder can enforce payment on a debenture only through CLB/NCLT. In case of secured debentures, it should be possible to enforce security interest rather than invoke the jurisdiction of a quasi judicial authority.

To broad base bond markets and bring other institutional investors, the following amendments may be made to SARFAESI Act:

> *2 (1) (k) “financial assistance” means any loan or advance granted or any guarantees given or letters of credit established or any other credit facility extended by any bank or financial institution, or investment in listed bonds or debentures held by an investor;*

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[5] http://www.sebi.gov.in/cms/sebi_data/statistics/corporate_bonds/publicissuedata.html

(zd) "Secured creditor" means any bank or financial institution or any consortium or group of banks or financial institutions and includes—

(i) debenture trustee in respect of a listed bond or debenture holding any security interest on behalf of any bank , financial institution or other investor; or

[*] [(ii) securitisation company or reconstruction company, whether acting as such or managing a trust set up by such securitisation company or reconstruction company for the securitisation or reconstruction, as the case may be; or.".]

(iii) any other trustee holding securities on behalf of a bank or financial institution, in whose favour security interest is created for due repayment by any borrower of any financial assistance;

F. Amendment in Debt Recovery Law

The overarching difference between the DRT law and SARFAESI Act is that the DRTs are equipped with a power to pass orders even where there is no security interest. As per common practice in the market, banks use SARFAESI Act where there is security interest, and the DRT law where there is none, or insufficient security interest. Hence, DRT law may be activated even in case of unsecured bonds.

The following amendments may be made to DRT law to apply in case of bonds/debentures:

2 (g) "debt" means any liability (inclusive of interest) which is claimed as due from any person by a bank or a financial institution or by a consortium of banks or financial institutions during the course of any business or investment activity undertaken by the bank or the financial institution or the consortium under any law for the time being in force, in cash or otherwise, whether secured or unsecured, or assigned, or whether payable under a decree or order of any civil court or any arbitration award or otherwise or under a mortgage and subsisting on, and legally recoverable on, the date of the application;

(h) "Financial institution" means—

(i) A public financial institution within the meaning of Section 4A of the Companies Act, 1956 (1 of 1956);
(ia) debenture trustee in respect of a listed bond or debenture holding any security interest on behalf of any bank , financial institution or other investor; or
(ii) Such other institution as the Central Government may, having regard to its business activity and the area of its operation in India by notification, specify;

G. Concerns arising from Companies Act, 2013 and allied rules

[*] **Subs. by Amendment Act, 2004, w.e.f. 11-11-2004.**

Despite these measures, the sea of amendments in the corporate laws may bring some high tides for the bond market. Under Companies Act, 2013 any company that lists any of its securities on a recognised stock exchange shall be called a listed company. Section 2 (52) of the CA, 2013 defines listed company as:

> (52) "listed company" means a company which has any of its securities listed on any recognised stock exchange;

This would mean any company including a private company which has any security, which includes debt instruments listed on a recognised stock exchange shall be called a listed company for the purpose of the Act his Act and all the provisions of the listed company shall be applicable to such companies as well. Compare this with the erstwhile Companies Act 1956, where the definition of listed companies excluded private companies, even if such private companies had listed debt or structured debt securities. Simply put, private companies which have not yet gone public through an IPO do not have its equity share listed but has listed debt securities with a stock exchange are covered in the new regime under the definition of listed companies.

As a listed company, these companies they will have to comply with the following provisions of the CA, 2013Act:

a) **Audit Committee requirement** -- The listed company shall be required to have an audit committee and such audit committee shall consist of minimum three directors with independent directors forming a majority. While section 149 (4) of the CA, 2013 does not prescribe for a need for an independent director but pursuant to this section will require independent directors (Section 177). In the Companies Act, 1956 only public companies public companies, but not private companies, were required to have an Audit Committee.

b) **Nomination and Remuneration Committee requirement** -- Listed companies will be required to have a nomination and remuneration committee as well comprising of three or more non-executive directors out of which not less than one-half have to be independent (Section 178).

c) **Secretarial Audit** -- Though the section says secretarial audit for bigger companies, all listed company be required to provide for a secretarial audit report along with the board's report which shall be duly signed by company secretary in practice (Section 204). The PCS has to confirm that the company has complied with the provisions of several regulations which include RBI, SEBI, SCRA, listing agreement, depositories, FEMA, competition, there is a long list.

d) **Vigil Mechanism** -- Listed company to establish a vigil mechanism for directors and employees to report genuine concerns in such matters as may be prescribed (Section 177 (9)).

e) **Rotation of auditors** -- Listed Company cannot appoint an individual as an auditor for more than one term of five consecutive years and an audit firm as auditor for more than two terms of five consecutive years. There shall be a cooling off period for the individual auditor and the audit company for a period of five years after their expiry of term mentioned above. Then you cannot appoint an audit firm whose partner or partners are common to other audit firm whose tenure expired (section 139(2)).

f) **Other compliances –**

   i. The annual return of the listed company will have to be certified by a company secretary in practice (Section 92(2)).
   ii. Listed company to file with RoC changes in the no. of shares held by the promoters and top 10 shareholders of the company within 15 days from such change (Section 93).
   iii. Listed companies to have its website and place the financial statement of the company on its website (Section 136).

Further section 138 read with Rule 13 of Companies (Accounts) Rules, 2014 requires every listed company to appoint an internal auditor, appoint a woman director on Board under section 149 (1) read with Rule 3 of Companies (Appointment and Qualification of Directors) Rules, 2014 and also appoint Key Managerial Personnel as per section 203 of CA, 2013Act read with Rule 8 of Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 which shall include a managing director, company secretary and a CFO.

While some of these disclosure requirements could be called to be well placed for listed public companies but the current provisions seem to have been implemented without considering such companies which list their debt only. Also the fine imposed for contravention of the provisions of some of the sections may result call for an imprisonment of a term which may extend upto one year or fine which may extend to Rs. 5 lacs or both.

For a MSME to get its debt securities listed the regulatory compliance burden may outweigh the benefits of price discovery, liquidity and transparency and the repercussion may be such companies may not be able to attract angel investors either. While funding is critical for the growth of the companies and the development of the economy, the burden of compliance of being a listed company is too high. Given this fact it surely will come in the way of attaining the goal of having a robust corporate debt market. Such extensive compliance requirements are onerous for private and small companies, for they entail extra regulatory costs and burden. Therefore amendment of the definition of “listed company” under the Companies Act 2013 is required.

In addition to above regulatory reforms, the points mentioned below can also be considered to overcome the challenge:

i) Relaxation of investment conditions for pension, provident, and insurance funds to enable the participation of long term investors in the corporate bond market;
ii) Measures to increase liquidity, transparency in price discovery and stimulating growth in trading volumes of bonds and setting up a suitable framework for market making in corporate bonds;
iii) Relaxing tax and stamp duty norms to make the sector more attractive;
iv) Measures to make the corporate bond market attractive to the foreign investors;
v) Developing safe and sound market infrastructure.
vi) Establishing a sound bankruptcy regime
vii) Stimulating growth of securitisation and other financial instruments.
viii) Introduction of new products as covered bonds, municipal bonds, credit default swaps, and securitization receipts may be considered more attractive for public issuance of bonds at reduced cost.

A vibrant bond market for the corporate can ease financing constraints both in terms of cost of funds as well as ease of access to funds. On a macro-economic level development and growth in the capital markets leads to the development of the economy as well.

As ISF is dedicated to the cause of contributing to the development of the financial services sector and capital market instruments in particular, in the event of any further clarification needed, we would be happy to provide the same.

Thanking you,

Yours Faithfully,
For ***Indian Securitisation Foundation***

Sd/-

(Vinod Kothari)