

Legal and Regulatory Issues in Debt Derivatives

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Introduction

The area of exchange rate and interest rate derivatives in foreign currencies has been substantially de-regulated over the last few years. Companies and financial institutions have a large degree of freedom to transact in these derivatives with authorised dealers in India, or with their branches overseas. Authorised dealers continue to cover all their positions arising from such derivatives on a back-to-back basis with overseas branches.

The only exchange rate derivative product, aside from a forward contract that is hedged onshore, has been the recently introduced currency swap product. This product is hedged through the forward exchange market. The number of banks willing to quote for these transactions is limited given their internal constraints in taking gap positions for long tenors.

While exchange rate derivative products are essential for corporates to hedge their long term foreign currency liabilities, risks in a much larger market – the onshore money and bond market – remain unhedged.

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Paper presented in October 1997

The Legal Environment

The Securities Contract Regulation Act (SCRA), the Indian Contracts Act (ICA), the Foreign Exchange Regulation Act (FERA), and under it, the Exchange Control Manual (ECM), determine the legal environment for over the counter and exchange traded interest rate derivatives.

The primary issue is that all these laws were designed and introduced without derivatives regulation in mind. Thus, these laws have no specific intention to regulate or prohibit Rupee derivatives. A financial intermediary wishing to transact in Rupee derivatives is left to interpret these laws as they exist and determine with legal opinions whether derivatives transactions are possible within the existing framework. Moreover, there is no clear understanding on which entities are permitted to transact in Rupee derivatives.

Thankfully, the issues are not very many.

Securities Contract Regulation Act (SCRA)

In the SCRA, the deletion of the words “options in securities” in Section 20, has opened the door for equity index futures on our stock exchanges. However, considerable confusion prevails because Section 16, which talks of “contracts in securities”, continues to be retained. This section prohibits contracts in securities, other than those by specific notification by the Central Government. This would effectively prevent the introduction of OTC bond and interest rate options, or forward contracts in bonds.

Indian Contracts Act (ICA)

Most interest rate derivative contracts are settled by differences or net settlement. Under the ICA, contracts that can be settled only by differences, may be seen as “wagering contracts” and thus be unenforceable in a court of law. This issue impacts currency swaps transacted under Indian Law as well. In the state of Maharashtra, collateral contracts to wagering contracts – such as margin contracts – are void as well.

Exchange Control

It is possible to design bonds, issued by Indian entities and settled in Indian Rupees, that link repayment and interest to the prevalent foreign exchange spot or swap rate. Again, it is possible that this may be seen as being prohibited under FERA, although no foreign exchange flow takes place.

Exchange Traded Vs. OTC

Some of these legal issues are being sought to be side-stepped by introducing interest derivative products on exchanges. Two products that have been suggested by the NSE Debt Committee are Gilt Futures Contracts and FRA Futures. Both would require the concurrence of the Reserve Bank of India, and a notification from the Ministry of Finance, making the futures contracts securities. As far as the SCRA is concerned, the issues are no different from that of introducing equity index futures.

However, there is a broader issue here. Exchange traded derivative products cannot survive by themselves. All emerging and developed markets have vibrant OTC and exchange traded markets running in parallel. While exchange traded derivatives satisfy requirements of users who want to trade standardised products with little counterparty credit risk, OTC products help users obtain customised solutions for their hedging needs. There is a need to develop an INR derivatives regulation, for both these markets in parallel.

Regulating Onshore Derivatives

The Reserve Bank of India, together with the Ministry of Finance, is the central regulatory authority for all foreign exchange derivatives. There is no clear regulatory authority established for Indian Rupee derivatives.

In the absence of any clear regulation on derivative contracts in the securities markets, the market may develop in two ways. Counterparties may decide to transact based on informal or legally unsustainable documentation. The Reserve Bank of India, Securities and Exchange Board of India, or the Ministry of Finance will not be aware of these transactions, and there is a serious possibility of a large 'grey' market developing.

Secondly, counterparties may be offered these products in offshore jurisdictions. These potential developments expose the market to serious systemic risks. The regulatory authorities also lose the chance to guide market development in a desired direction.

The solution is for the Reserve Bank of India, the Securities and Exchange Board of India, or the Ministry of Finance to introduce enabling regulations for the development of the onshore derivatives market. The approach should be to form broad overall regulations, rather than a prescriptive, single product based approach. This would allow the market to develop specific products tailored to Indian hedging needs. Importantly, it would also allow products to fail at a low cost.

Briefly, I suggest that :

1. A joint derivatives body, with representation from the Reserve Bank of India, the Securities and Exchange Board of India, and the Ministry of Finance be established, which will look into implementing changes in the SCRA and Indian Contracts Act to enable and regulate domestic debt derivatives.
2. The derivatives body establish clear guidelines on participation in the domestic derivatives market – on the lines of the authorised dealers scheme for foreign exchange markets. Authorised financial intermediaries should include scheduled banks, domestic financial institutions and financial companies with adequate internal expertise in managing risks associated with a derivatives book.
3. The derivatives body establish clear requirements for :
 - Underlying documentation for derivatives contracts
 - Capital adequacy for financial intermediaries
 - Contract documentation standards
 - Periodic reporting requirements for customers and financial intermediaries
 - Accounting and disclosure standards for derivatives

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- Tax treatment of derivatives expenses and income
4. Membership in a self regulatory body for domestic derivatives should be broad based – including issuers, banks, financial institutions, mutual funds, investment institutions and finance companies.

Prudent use of derivatives adds liquidity to the underlying market and reallocates risks within our market. With appropriate regulatory changes and strict reporting requirements, Rupee derivatives should become widely used tools in Indian financial markets.

Legal Issues for FII Debt Investments

Foreign Institutional Investor (FII) debt funds are the newest entrant into the Indian debt market. As overseas investors in the Indian debt market, FIIs face some legal issues that are unique. These issues, we believe, are responsible for the poor level of investments made by FIIs in the Indian debt market. The cumulative level of investment made by FII debt funds is under \$100 million. This is against the cumulative approved fund size of \$1800 million.

Primary Debt Issue Approval

If an issuer wished to make a primary issue of debt to an FII debt fund, it has to apply for permission to the RBI. In contrast, the FII debt fund permissions allow them to freely buy and sell debt securities in the secondary market. This is an anomaly that needs to be removed. Moreover, permissions are granted under the 24% scheme for FIIs / NRIs / OCBs. This is more relevant to primary equity issues than debt.

The primary debt issue approval is an unnecessary procedural delay – particularly for investors who have been screened and approved by the RBI and SEBI.

Withholding Tax

All FII debt investments are subject to a withholding tax deduction on coupons. A withholding tax of 20%, clearly makes investments in Indian Government securities uneconomical. A three year Government security at a premium yielding 10.18% today, after deduction of WHT on the coupon yields 7.82% per annum. If the cost of hedging exchange risk is now factored, returns from government debt drop to unacceptably low levels.

Withholding tax exemptions are routinely given for interest payments made by Indian companies on their foreign currency debt. FII debt investment, in contrast, places no incremental exchange risk on the country. This should be incentivised by removing withholding tax on all debt investments made by FIIs.

Lax Documentation and Transfer Standards

For domestic participants in the debt market, poor documentation and transfer standards are a major issue. However, many of us have no choice but to live within this environment. The FII debt fund has a choice. It can simply stop making investments.

The private placement debt market is largely unregulated. As the level of due diligence differs between merchant bankers, many issues have poor or incomplete documentation.

Security is often created as late as six months after the date of allotment of bonds. Issuers have been given multiple extensions by pliable trustees to create security. There are secured bonds which have been retired as letters of allotment, without certificates ever being issued. There have been several issues where the trustee appointment has been made after the debt issue was closed and money collected from investors. Some issuers take more than a month to effect transfer of bonds.

To a first time investor in the corporate debt market, these issues are bewildering. These weaknesses in documentation and security creation undermine investor interest and often place the investor on par with

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unsecured creditors to the company. It is essential that the private placement market be regulated and clear standards be established for documentation, security creation and transfer requirements.

Other Issues

FII debt funds can be significant participants in a repo market. This would impart liquidity to the underlying bond markets. FII debt funds should be permitted to participate in any repo market in domestic debt. We are confident that if some of these suggestions are implemented, there will be a significant increase in FII debt investment.