

Debt Market Transactions: Legal and Regulatory Issues

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Introduction

We know that the key to developing a liquid and broad-based debt market is:

1. to enable a wider range of players who do not merely have differing *perceptions* but have differing *needs* as well, and,
2. to enable a healthy arbitrage between the risk-return trade-off across the various possible debt instruments and investments available in the market. It is also essential to widen the range and choice of available debt instruments and investments

The other dimension of an ideal debt market scenario, where liquidity is maximised, is to build a national order book on the National Stock Exchange for debt instruments – for both retail and wholesale – as we see on the equity side at the NSE today. A national order book enhances the liquidity by simply bringing all buyers and sellers across the country under one roof (i.e. on a single order book). I will elaborate upon the underlying legal and regulatory framework for each of the above.

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Widening the Range of Players

The Indian gilts market is highly segmented in two respects.

1. One form of segmentation is that the number of corridors available to relatively non-wholesale players, for direct or pass-through participation in the gilts market, are almost non-existent. One of the options is money market funds, which are only recently gathering some limited momentum. The other option, which has been announced but is still unexplored, is the Money Market Deposit Account (MMDA). While a cheque-able money market account would be a great boon to the private sector banks, I believe that a similar facility ought to be extended to the Primary Dealers (PDs) as well. This would enable PDs to offer MMDA product in competition with the banks. Further, PDs should be permitted to offer a cheque-able account for a very limited class of wholesale and semi-wholesale investors, such as provident funds and charitable trusts.
2. This, coupled with a permission to the PDs to operate a second SGL account, would reduce the other form of segmentation which exists in the gilts market i.e. between the dematerialised SGL accounts, and, Gilt certificates and bonds in materialised form. Most Provident Funds (PFs) hold gilts in materialised form. This is a problem which I have also faced. We have a small provident fund in our office which, due to its small size, remains invested in the physical stock of government securities. The physical gilts market is a completely illiquid market, and is therefore, a source of difficulty to many provident funds, and several charitable trusts. Dematerialising gilts held in physical form by PFs, through the second SGL of PDs (who would provide a constituent account service) would be useful. Permitting PDs to operate a funds account for such Provident Funds could add further value by pre-empting loss of overnight interest.

The other regulatory move, which can go a long way in supporting a retail gilts market, would be to retrofit the depository-participant structure into the new incarnation of the Public Debt Act, which is under consideration at the Reserve Bank of India (RBI). This depository-participant structure is available to us in the Depository Act, in all its state-of-the-art form (with all issues – fiscal, regulatory, tax, stamp, etc. having been addressed). Once we resolve the tail-end issue, i.e. of who will do

DVP, a public debt office can be incorporated as a subsidiary of the RBI to function as the national depository for gilts. At the same time, since the depository cannot itself do DVP, the RBI can play the role of conducting DVP. The only other alternative is for the National Securities Clearing Corporation Limited (NSCCL), or some such clearing corporation, to play this role. The NSCCL is currently playing this role for the National Securities Depository Limited (NSDL).

Widening the Range of Investment Instruments in the Debt Market

A closer look at the whole economics of assets securitisation – in terms of the class of target investors, and the kind of returns available to them from comparable available investments – will reveal that asset securitisation looks potentially more viable in retail assets than in corporate assets. This is also true in the global markets. Effectively, we can visualise viable securitisations on automobiles, credit cards, etc. but not so much on industrial exposure or the exposure of financial institutions to industry.

In the realm of exposures to industry, there exists a problem which is common to banks and financial institutions. As far as banks are concerned, we now have a regulatory shift from cash credit to a term loan structure. However considering their asset-liability management and also development of the debt market, it may be far more efficient for the banks, to have a CP structure, where the present cash credit facility gets instrumentalised into a CP-type security. This would enable gradual instrumentalisation of the entire assets of the bank's balance sheet, and make them all potentially tradable assets. Naturally, the trading potentiality would be a function of the liquidity available in the market. But it will eliminate the present need of overlaying a securitisation structure to hive off the un-instrumentalised loans portfolio.

A similar concept should also be considered by the financial institutions. For them, the main issue is that today's loan structures envisage and entail annual repayments. For this, a negotiated corporate bond structure could be devised to fully mimic and replicate the present annual repayment type of loan transactions. The transaction is thus still a loan, but its final legal structure would take the shape of a negotiated, one-to-one, privately placed

corporate bond. The real issue would be the structuring of the annual repayment. There are two ways of doing this :

1. To structure it as a step redemption bond, and,
2. To have a multiple bond structure, with each bond depicting the annual repayment. For example, if the repayment ranges from 5 years to 8 years, four bonds will be required – the tenures of which will be five years, six years, seven years and eight years, respectively. The pricing of each bond will be precisely like the pricing of the loan.

Fiscal Issues in Interest Rate and Foreign Exchange Derivatives

We must understand that, for legal purposes, a derivatives contract is an independent contract. It is, effectively, a contract of transfer of the risk embedded in the volatility of the cash flows from the underlying. A derivative happens by entering into an arrangement (or a derivatives contract) which produces a cash flow of exactly the reverse of that expected from the underlying contract (which risk he doesn't wish to bear). Now, that cash flow, in case of interest rates or currency, is indeed a mere cash flow which does not involve any contract relating to purchase or sale of any goods, commodities, or securities. From a tax point of view, there would usually be two issues in derivatives:

1. Whether the profits or losses which arise to the derivative buyer, would constitute speculative profits or losses, or would they be considered normal business profits or losses? In case of interest rate and currency swaps, and futures or forward contracts, the resulting income stream or cost would not constitute speculative profit or loss. An options contract is like an insurance for which you just pay a premium which is like any other tax deductible insurance premium paid for risk protection.
2. The other issue which arises is, whether there are any withholding taxes applicable on the payments under the interest-rate and currency swaps and futures and forward contract? We must understand that derivatives are independent contracts, distinct from the underlying interest rate or foreign exchange exposure. Such independent contracts produce a cash flow which,

legally, does not constitute interest on debts incurred (on which alone tax needs to be withheld). Therefore, no tax needs to be withheld.

Private Placement: Need to Bring in Presumptive Definition

We have already discussed whether or not, the private placement market needs to be regulated. However, what can be presumed to be *not* a private placement still needs clear definition. Such a presumptive definition is necessary, considering the applicable issues of non-disclosure to investors, etc. There are deep concerns which arise when private placements are, in reality, public issues in the garb of private placements. A practical way is to include a provision in the Companies Act specifying that if :

1. The issue results in an offer, or an application, by more than 100 investors for less than the prescribed minimum amount, it will be presumed to be *not* a private placement; and,
2. There must be a minimum amount per investor, which must be invested for it to be categorised as a private placement. To begin with, this figure can be in the region of Rs. 1,00,000. We must begin with some such solution, since the heart of the problem really lies in how to distinguish *public* versus *private*.

Section 76 of the Companies Act

Section 76 in the Companies Act says that a company cannot issue a corporate debt instrument for discount of less than 2½ %. We take a legally different view for discount bonds on the premise that, for them the discount offered is in lieu of interest, and therefore this regimen does not apply. This is an archaic provision and does not contemplate the kind of scenario we are actually in. I think this is a hidden risk which issuers are exposing themselves to if they really are issuing interest-rate bond products today at a discount higher than what is contemplated under this provision. It is extremely important that this archaic provision is actually corrected. Ultimately, all that happens in issuing an interest bearing instrument at a discount, is that the instrument gets re-priced to fetch the investor a higher yield and a consequentially higher cost of funds to the Issuer. As long as the pricing is clear in the offer document, and the discount is not given by way

of a one-to-one incentive to a chosen few investors in an otherwise non-discounted public offer, this regimen ought to go.

Need to Eliminate Differential Transaction and Stamp Duty Costs amidst Competing Debt Funding Alternatives

In the overall perspective of the market microstructure, there is a significant difference in the transaction costs of raising debt finance under various options. These options include bonds, loans, lease, structured finance, etc. But there is little economic rationale of having vastly differentiating costs of transactions for raising debt finance under different alternatives. For instance, I don't see any economic rationale for having vastly differential stamp duties between and across these various options. Therefore, we need to view transaction costs on a much broader perspective, and harmonise them across the various types of debt funding structures.