

# Sources of Corporate Funding

## Lesson

## 7

### KEY CONCEPTS

■ Equity Share ■ Preference Share ■ Debentures ■ Bonds ■ Alternative Investment Funds ■ Venture Capital ■ Angel Funds ■ Angel Investor ■ Private Equity ■ Depository Receipts ■ American Depository Receipts (ADR) ■ Global Depository Receipts (GDR) ■ Foreign Currency Convertible Bonds (FCCBs) ■ Foreign Currency Exchangeable Bonds (FCEBs) ■ External Commercial Borrowing (ECB) ■ Foreign Direct Investment ■ Foreign Portfolio Investor ■ Securitization

### Learning Objectives

#### To understand:

- Various sources of Corporate Funding
- Important characteristics of equity shares
- Concept of Preference Shares, Debentures & Bonds and its types
- Governing Regulatory Framework for issuance of Share Capital and Debt Securities
- Concept of Alternative Investment Fund and its Categories
- Bank Financing and credit facilities provided by Banks
- Concept of Foreign Funding and Regulatory Framework in India
- Different sources of international fund available for Indian companies
- Securitization, its Process and Regulatory Framework

### Lesson Outline

- Sources of Corporate Funding
- Share Capital
- Governing Regulatory Framework for Share Capital and Debt Securities
- Equity Shares
- Preference Shares
- Types of Issue
- Debentures
- Types of Debentures
- Bonds
- Alternative Investment Funds (AIFs)
- SEBI (Alternative Investment Funds) Regulations, 2012
- Categories of AIFs
- Venture Capital
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- Real Estate Investment Trusts (REITs)
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- Euro Issue
- American Depository Receipts (ADR) & Global Depository Receipts (GDR)
- Foreign Currency Convertible Bonds (FCCBs)
- Foreign Currency Exchangeable Bonds (FCEBs)
- External Commercial Borrowing (ECB)
- Foreign Direct Investment (FDI)
- Foreign Portfolio Investment
- Securitization and its Process
- Loan against Securities
- Loan against Properties
- Lesson Round-Up
- Glossary
- Test Yourself
- List of Further Readings

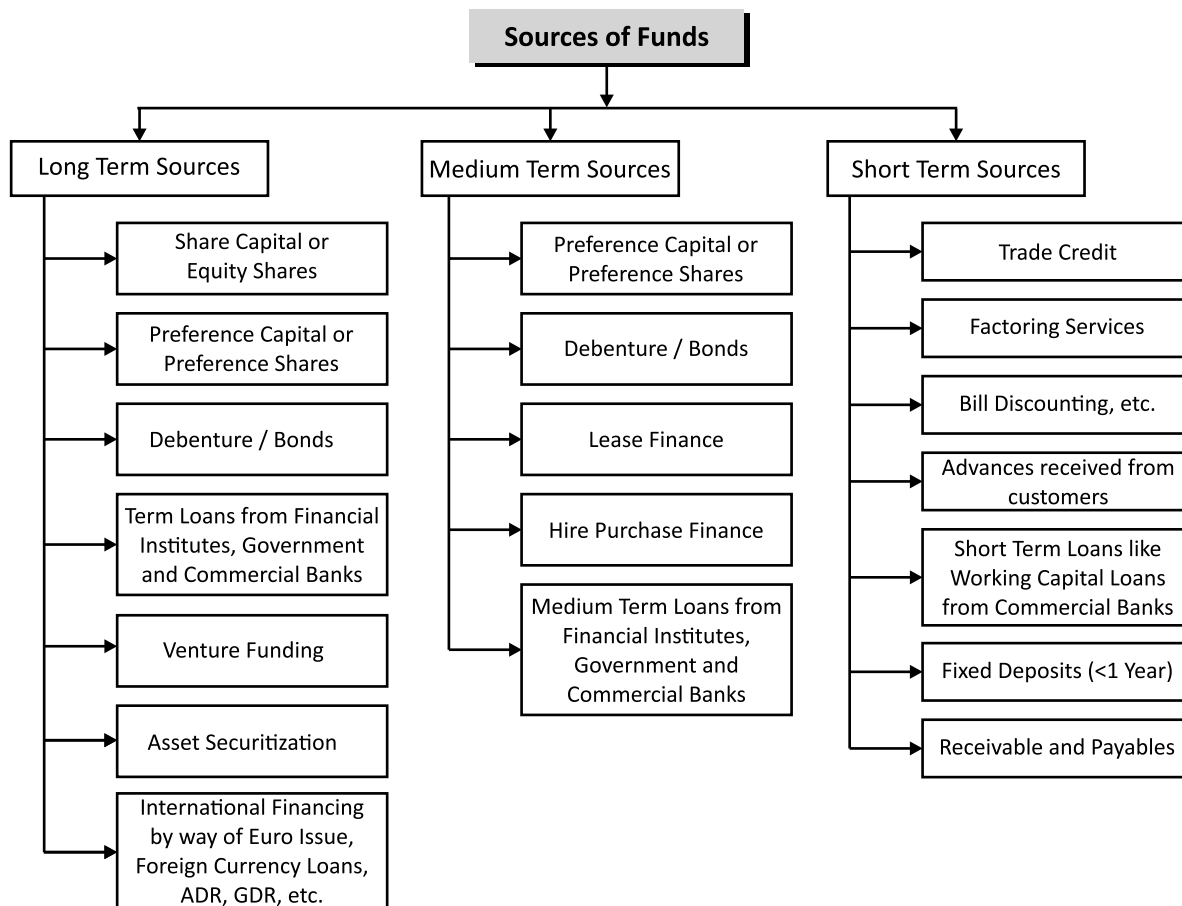
## SOURCES OF CORPORATE FUNDING

Corporate Funding is the area of finance dealing with the sources of funding and the capital structure of corporations, the actions that managers take to increase the value of the firm to the shareholders, and the tools and analysis used to allocate financial resources. The primary goal of corporate finance is to maximize or increase shareholder value.

Capital market of any economy act as a fulcrum of economic development, as it ensures supply of capital from the savers to investors through various forms of financial instruments. Mainly there are two kinds of financial assets through which investors can invest in capital market, i.e. Equity and Debt. Generally, most of the investments happen in equity but gradually debt instruments have also gained steam.

Traditionally, funds could be in the form of equity or debt. Equity would mean the money provided by shareholders, without any repayment clause or charge creation on the assets, whereas debt would come along with repayment clauses, security for the loan and high finance costs. A well-functioning debt and equity markets allow businesses to fund investment flexibly and at a relatively low cost to existing shareholders, thereby contributing to investment and growth. Striking the right mix of debt and equity would help a company to achieve the optimum capital structure. This would enable the company to fund its business requirements with minimum associated costs.

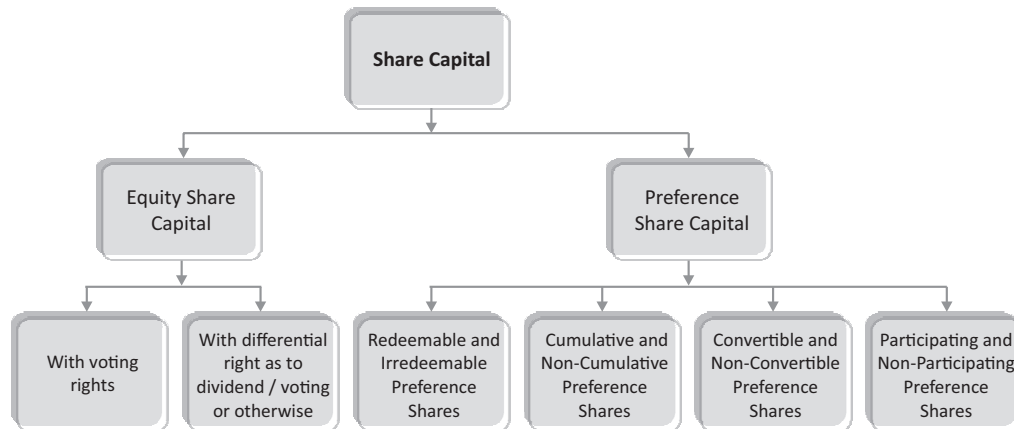
Today majority of corporate houses are espousing the debt financing trajectory to finance their business expansion plans; mergers and acquisitions; setting up of new business etc. Currently, in India the debt market in India comprises mainly of two segments viz., the Government securities market consisting of Central and State Governments securities, Zero Coupon Bonds (ZCBs), Floating Rate Bonds (FRBs), T-Bills and the corporate securities market consisting of FI bonds, PSU bonds, and Debentures/Corporate bonds. Government securities form the major part of the market in terms of outstanding issues, market capitalization and trading value.



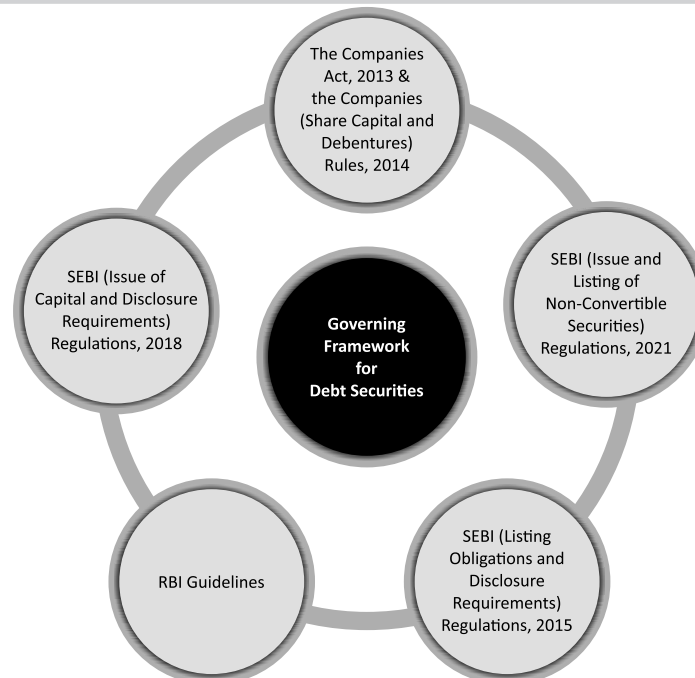
## SHARE CAPITAL

A company can issue two types of shares viz. Equity Shares and Preference Shares. Equity shares are also known as Ordinary Shares. While Preference shareholders enjoy the benefit of receiving their dividend distribution first; the equity shareholders enjoy voting rights in major company decisions, including mergers or acquisitions. Preference shares have the right to receive dividend at a fixed rate before any dividend is paid on the equity shares. Further, when the company is wound up, they have a right to return of the capital before that of equity shares.

The Preference Shares may carry some more rights such as the right to participate in excess profits, which a specified dividend has been paid on the equity shares or the right to receive a premium at the time of redemption. The preference shares are safer investments than the equity shares. In case the company is wound up and its assets (land, buildings, offices, machinery, furniture, etc.) are being sold, the money that comes from this sale is given to the shareholders. After all, shareholders invest in a business and own a portion of it. The preference shares are most commonly issued by companies to institutions. For example, banks and financial institutions may want to invest in a company but do not want to bother with the hassles of fluctuating share prices. In that case, they would prefer to invest in a company's preference shares. Companies, on the other hand, may need money but are unwilling to take a loan. So they will issue preference shares.



## Governing Regulatory Framework for Share Capital and Debt Securities



## 1. The Companies Act, 2013 & the Companies (Share Capital and Debentures) Rules, 2014

- Section 43 of the Companies Act, 2013 recognizes two kinds of share capital –
  - (a) equity share capital –
    - (i) with voting rights; or
    - (ii) with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed; and
  - (b) Preference share capital.
- Section 55 of the Companies Act, 2013 provides that Preference shares can be redeemed only out of the distributable profits of the company or out of the proceeds of a fresh issue of shares made for the purposes of the redemption. This section states that where any such shares are redeemed out of distributable profits, a sum equal to the nominal amount of the shares redeemed shall be transferred out of profits to a reserve fund to be called as the Capital Redemption Reserve Account.

The companies are required to comply Section 55 (Issue and Redemption of Preference Shares) read with Rule 9 and 10 of the Companies (Share Capital and Debentures) Rules 2014.

- Section 71 of the Companies Act, 2013 prescribes the conditions for issue of debentures. A debenture is a legal document that represents a secure means by which a creditor can lend money to the debtor. A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. The company is required to comply with Section 71 read with Rule 18 of the Companies (Share Capital and Debentures) Rules 2014.

## 2. SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 (“NCS Regulations”)

The Securities and Exchange Board of India (“SEBI”) has notified the SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 on August 09, 2021. This regulation provides a framework for:

- (a) issuance and listing of debt securities and non-convertible redeemable preference shares by an issuer by way of public issuance;
- (b) issuance and listing of non-convertible securities by an issuer issued on private placement basis which are proposed to be listed; and
- (c) listing of commercial paper issued by an issuer in compliance with the guidelines framed by the Reserve Bank of India.

## 3. SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (“Listing Regulations”)

The listing of securities is ensured by way of an agreement which is entered into between a stock exchange and the issuing company. This agreement is called listing agreement. All Listed entities shall comply with the listing conditions as stipulated in Listing Regulations to provide substantial information about the company to the stock exchanges within the specified timeline. The Provisions of Chapter IV and V of ‘SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015’ shall apply to a listed entity which has listed its ‘Non-convertible Debt Securities’ and ‘Non-convertible Securities’ on a recognised stock exchange in accordance with SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021.

## 4. RBI Guidelines

### I. Banks

RBI guidelines allow banks to raise capital by issue of non-equity instruments such as Perpetual Non-Cumulative Preference Shares (PNCPS) and innovative Perpetual Debt Instruments (PDI). These

instruments need to be in compliance with the specified criteria for inclusion in Additional Tier I Capital. Further, these instruments *inter-alia* should be able to absorb loss either through: (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism that allocates losses to the instruments at a pre-specified trigger point.

## II. Non-Banking Financial Companies (NBFCs)

Reserve Bank of India has issued detailed directions on prudential and governance norms vide master directions on Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016. These directions are applicable to NBFCs not accepting/holding public deposits which is not systemically important; Factor (NBFC-Factor) registered with the Bank under section 3 of the Factoring Regulation Act, 2011 and having an asset size of below ₹500 crore; Infrastructure Finance Company (NBFC-IFC) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of below ₹500 crore and others as mentioned in clause 2 of the master directions. RBI has also issued detailed directions on prudential and governance norms for Non-Banking Financial Company Systemically Important Non-Deposit Taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

## 5. SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018

Debt securities which are convertible, either partially or fully or optionally into listed or unlisted equity shall be guided by the disclosure norms applicable to equity or other instruments offered on conversion in terms of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018.

## EQUITY SHARES

Equity capital is also known as “Common Stock” or common share capital that represents ownership in a company. Common share capital is generally divided into units known shares. These unit holders are called equity shareholders. They are the real owners of the company and policy makers of the company. However, they do not have access to the day-to-day affairs of the company. They appoint their representatives called board of directors to look after the affairs of the company.

According to explanation (i) to Section 43 of Companies Act, 2013 “equity share capital”, with reference to any company limited by shares, means all share capital which is not preference share capital.

Important characteristics of equity shares are given below:

- Equity Shares have voting rights at all general meetings of the company. These votes have the effect of the controlling the management of the company.
- Equity Shares have the right to share the profits of the company in the form of dividend and bonus shares. However, even equity shareholders cannot demand declaration of dividend by the company which is left to the discretion of the Board of Directors.
- When the company is wound up, payment towards the equity share capital will be made to the respective shareholders only after payment of the claims of all the creditors and the preference share capital.

## Equity Shares with Differential Voting Rights

While Section 43 enables companies to issue equity shares with differential rights as to dividend, voting rights etc., Rule 4 of the Companies (Share Capital and Debentures) Rules, 2014 states the conditions regarding shares with differential voting rights.

### Conditions for issuing shares with differential rights [Rule 4 of the Companies (Share Capital and Debentures) Rules, 2014]

No company limited by shares can issue equity shares with differential rights as to dividend, voting or otherwise. Such company has to comply with the following conditions, namely:-

- (a) **Authorization in Articles of Association:** The articles of association of the company authorizes the issue of shares with differential rights.
- (b) **Passing of Ordinary Resolution at General Meeting:** The issue of shares is authorized by an ordinary resolution passed at a general meeting of the shareholders. Where the equity shares of a company are listed on a recognized stock exchange, the issue of such shares shall be approved by the shareholders through postal ballot.
- (c) **Limit for voting power not exceeding 74 percent:** The voting power in respect of shares with differential rights of the company shall not exceed seventy four percent of total voting power including voting power in respect of equity shares with differential rights issued at any point of time.
- (d) **No defaults:** The company has not defaulted in the following:
  - the company has not defaulted in filing financial statements and annual returns for three financial years immediately preceding the financial year in which it is decided to issue such shares;
  - the company has no subsisting default in the payment of a declared dividend to its shareholders or repayment of its matured deposits or redemption of its preference shares or debentures that have become due for redemption or payment of interest on such deposits or debentures or payment of dividend;
  - the company has not defaulted in payment of the dividend on preference shares or repayment of any term loan from a public financial institution or State level financial institution or scheduled Bank that has become repayable or interest payable thereon or dues with respect to statutory payments relating to its employees to any authority or default in crediting the amount in Investor Education and Protection Fund to the Central Government.

However, a company may issue equity shares with differential rights upon expiry of five years from the end financial year in which such default was made good.

- (e) The company has not been penalized by Court or Tribunal during the last three years of any offence under the RBI Act, 1934, the SEBI Act, 1992, the Securities Contracts Regulation Act, 1956, the Foreign Exchange Management Act, 1999 or any other Special Act, under which such companies being regulated by sectoral regulators.
- (f) **Conversion of existing equity share capital into differential voting rights and vice-versa not possible:** The company shall not convert its existing equity share capital with voting rights into equity share capital carrying differential voting rights and *vice versa*.
- (g) **Register of Members:** The Register of Members maintained under section 88 shall contain all the relevant particulars of the shares so issued along with details of these.
- (h) The holders of the equity shares with differential rights enjoys all other rights such as bonus shares, rights shares etc., which the holders of equity shares are entitled to, subject to the differential rights with which such shares have been issued.

**Question: The Company ABC Private Limited wants to issue shares with differential voting rights up to 40% of its share capital? Can it do so?**

**Solution:** Rule 4 of the Companies (Share capital and Debentures) Rules, 2014 specifies a condition that the voting power in respect of shares with differential rights of the company shall not exceed 74% of total voting power including voting power in respect of equity shares with differential rights issued at any point of time.

Therefore, a company can issue shares with differential voting rights upto 40 percent of its share capital which is within limit mentioned in Rule 4.

## PREFERENCE SHARES

According to explanation (ii) to Section 43 of Companies Act, 2013, “preference share capital” means that part of the issued share capital of the company which carries or would carry a preferential right with respect to-

- payment of dividend, either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax; and
- repayment, in the case of a winding up or repayment of capital, of the amount of the share capital paid-up or deemed to have been paid-up, whether or not, there is a preferential right to the payment of any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company.

Capital shall be deemed to be preference capital, notwithstanding that it is entitled to either or both of the following rights, namely:—

- (a) that in respect of dividends, in addition to the preferential rights to the amounts specified in sub-clause (a) of clause (ii), it has a right to participate, whether fully or to a limited extent, with capital not entitled to the preferential right aforesaid;
- (b) that in respect of capital, in addition to the preferential right to the repayment, on a winding up, of the amounts specified in sub-clause (b) of clause (ii), it has a right to participate, whether fully or to a limited extent, with capital not entitled to that preferential right in any surplus which may remain after the entire capital has been repaid.

**Question : Who can Issue Redeemable Preference Shares?**

**Answer: The following can issue redeemable preference shares as under:**

- Private Company
- Public Company
- Banks

**Note: NBFCs has to comply with the RBI Guidelines/ Directions in addition to Companies Act, 2013.**

## Types of Preference Shares

| Cumulative and Non-Cumulative  | Convertible and Non-Convertible   | Participating and Non-participating  | Redeemable and Non-Redeemable  |
|--|---|--|--|
| <ul style="list-style-type: none"> <li>● <b>Cumulative preference shares:</b> the dividends are accumulated and therefore paid before anything paid to equity shares.</li> <li>● <b>Non-Cumulative preference shares:</b> if company does not pay dividend in current year, claim of preference shareholder is lost to that extent.</li> </ul> | <ul style="list-style-type: none"> <li>● <b>Convertible preference shares</b> possess an option or right whereby they can be converted into an ordinary equity share at some agreed terms and conditions.</li> <li>● <b>Non-Convertible preference shares</b> do not have the option to convert but has all other normal characteristic of a preference share.</li> </ul> | <ul style="list-style-type: none"> <li>● <b>Participating preferences share</b> has an additional benefit of participating in 'surplus profits' or 'surplus assets' of the company apart from preferential dividend.</li> <li>● <b>The Non-participating preference shares</b> are those which are not entitled to participate in the 'surplus profits' or 'surplus assets' of the company. They are entitled to only a fixed rate of dividend.</li> </ul> | <ul style="list-style-type: none"> <li>● <b>Redeemable preference share</b> has a maturity date on which date the company will repay the capital amount to the preference shareholders. The paying back of capital is called redemption dividend. Preference share shall be redeemed within a period not exceeding 20 years. However infrastructure a company engaged in the setting up and dealing with of infrastructural projects may issue preference shares for a period exceeding 20 years but not exceeding 30 years, subject to the redemption of a minimum ten percent of such preference shares per year from the twenty first year onwards or earlier, on proportionate basis, at the option of the preference shareholders.</li> <li>● <b>Irredeemable Preference Share</b> do not have any maturity date and are repayable only at the time of winding up of the company. However, as per section 55 of the Companies Act, 2013 no company can issue irredeemable preference shares.</li> </ul> |

Non-convertible preference share is another instrument for raising fund from public to Indian companies. With an aim to bring more transparency in raising funds through non-convertible preference shares, the SEBI vide its notification dated August 09, 2021 has notified a new set of Regulations to govern issuance and listing of Non-Convertible Securities, to be called SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 ('NCS Regulations'). The NCS Regulations came into effect from the 7th day from the date of their publication in the official gazette i.e. 16th August, 2021. The NCS Regulations provides for issuance and/or listing of Non-Convertible redeemable preference shares.

As per section 2(1)(w) of SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021, Non-Convertible Redeemable Preference Share means a preference share which is redeemable in accordance with the relevant provisions of the Companies Act, 2013 and does not include a preference share which is convertible into or exchangeable with equity shares of the issuer at a later date, at the option of the holder or not.

## Voting Rights of Members

According to section 47 of the Companies Act, 2013, subject to the provisions of section 43, section 50(2) and section 188(1) –

- (a) every member of a company limited by shares and holding equity share capital therein, shall have a right to vote on every resolution placed before the company; and

- (b) his voting right on a poll shall be in proportion to his share in the paid-up equity share capital of the company.

Every member of a company limited by shares and holding any preference share capital therein shall, in respect of such capital, have a right to vote only on resolutions placed before the company which directly affect the rights attached to his preference shares and, any resolution for the winding up of the company or for the repayment or reduction of its equity or preference share capital and his voting right on a poll shall be in proportion to his share in the paid-up preference share capital of the company.

However, the proportion of the voting rights of equity shareholders to the voting rights of the preference shareholders shall be in the same proportion as the paid-up capital in respect of the equity shares bears to the paid-up capital in respect of the preference shares.

Further, where the dividend in respect of a class of preference shares has not been paid for a period of two years or more, such class of preference shareholders shall have a right to vote on all the resolutions placed before the company.

### Equity Shares and Preference Shares – Comparison

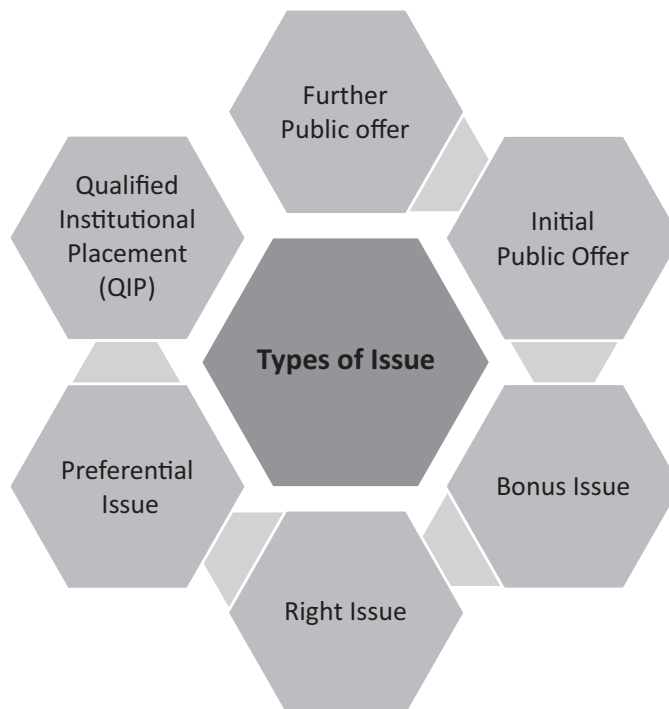
| <i>Basis</i>                         | <i>Preference capital</i>   | <i>Equity share capital</i>   |
|--------------------------------------|---|---|
| <b>Meaning</b>                       | Equity capital is also known as “Common Stock” or common share capital that represents ownership in a company.  | Preference share capital means that part of the issued share capital of the company which carries preferential right with respect to payment of dividend and repayment in the case of a winding up.           |
| <b>Rate of Dividend</b>              | Preference shares are entitled to a fixed rate of dividend.   | The rate of dividend on equity shares depends upon the amount of profit available and the funds requirements of the company for future expansion etc.   |
| <b>Payment of Dividend</b>           | Dividend on the preference shares is paid in preference to the equity shares. Dividend on preference share may be cumulative.   | The dividend on equity shares is paid only after the preference dividend has been paid. The dividend on equity shares is paid only after the preference dividend has been paid and it is not cumulative.      |
| <b>Payment in case of Winding up</b> | In case of winding up, preference share holder get preference over equity Shareholders with regard to the payment of capital.   | In case of winding up, equity share holder get payment of capital after the payment of capital to preference shareholders.  |
| <b>Voting Rights</b>                 | The voting rights of preference shareholders are restricted. A preference shareholder can vote only when his special rights as a preference shareholder are being varied, or on any resolution for the winding up of the company or for the repayment or reduction of its equity or preference share capital or their dividend has not been paid for a period of two years or more [section 47(2)]. | An equity shareholder can vote on all matters affecting the company. Voting right of an Equity Shareholders on a poll shall be in proportion to his share in the paid-up equity share capital of the company. |

| <i>Basis</i>        | <i>Preference capital</i>   | <i>Equity share capital</i>  |
|---------------------|---|--|
|                     | Voting right of a Preference Shareholders on a poll shall be in proportion to his share in the paid-up preference share capital of the company. |  |
| <b>Entitlements</b> | No bonus shares/right shares are issued to preference shareholders.   | A company may issue rights shares or bonus shares to the company’s existing equity shareholders.                     |
| <b>Redemption</b>   | Redeemable preference shares may be redeemed by the company.  | Equity shares cannot be redeemed except under a scheme involving reduction of capital or buy back of its own shares. |

**TYPES OF ISSUES**

The primary market is the avenue for resource mobilization and capital formation in the country as it deals with the issue of new instruments by the corporate sector such as equity shares, preference shares and debt instruments. Central and State Governments, various Public Sector Undertakings (PSUs), statutory and other authorities such as state electricity boards and port trusts also issue bonds/debt instruments. Primary Market provides an opportunity to issuers of securities, Government as well as Corporates, to raise financial resources to meet their requirements of investment and/or discharge their obligations. SEBI has issued SEBI (Issue of Capital and Disclosure Requirements) Regulations [‘ICDR Regulations’] for regulation several types of issue.

The following are the various types of issues in the capital market -



**Initial Public Offer:** It means an offer of specified securities by an unlisted issuer to the public for subscription and includes an offer for sale of specified securities to the public by any existing holder of such securities in an unlisted issuer. In order to qualify as an Initial public offer, the offer of securities must be by an unlisted issuer

company and such an issue shall be made to the public and not to the existing shareholders of the unlisted issuer company.

**Further Public Offer (FPO):** It is an offer of specified securities by a listed issuer company to the public for subscription. In other words, another issue to the public other than its existing shareholders or to a select group of persons by the listed persons is referred to as a Further Public offer. It also includes an offer for sale of specified securities to the public by any existing holder of such specified securities in a listed issuer.

**Rights Issue:** Rights issue of securities is an issue of specified securities by a company to its existing shareholders as on a record date in a predetermined ratio.

**Preferential Allotment:** It refers to an issue, where a listed issuer issues shares or convertible securities, to a select group of persons on a private placement basis it is called a preferential issue. It does not include an offer of specified securities made through employee stock option scheme, employee stock purchase scheme and issue of sweat equity shares or depository receipts issue in a country outside India or foreign securities. The issuer is required to comply with various provisions which inter alia include pricing, disclosures in the notice, lock in etc., in addition to the requirements specified in the Companies Act, 2013.

**Qualified Institutional Placement (QIP):** It refers to an issue by a listed entity to only qualified institutional buyers in accordance of Chapter VI of the SEBI (ICDR) Regulations, 2018. It also includes an offer for sale by promoters/promoter group on a private placement basis.

**Bonus Issue:** Bonus issue of shares means additional shares issued by the Company to its existing shareholders to reward for their royalty and is an opportunity to enhance the shareholders wealth. The bonus shares are issued without any cost to the Company by capitalizing the available reserves.

***For more information about raising funds from equity, the students may refer Lesson 8 of this study.***

## Debt Market

Debt markets are markets for the issuance, trading and settlement of various types and features of fixed income securities. Fixed income securities can be issued by any legal entity like central and state governments, public bodies, statutory corporations, banks and institutions and corporate bodies.

The debt market in India comprises mainly of two segments viz., the Government securities market consisting of Central and State Governments securities, Zero Coupon Bonds (ZCBs), Floating Rate Bonds (FRBs), T-Bills and the corporate securities market consisting of FI bonds, PSU bonds, and Debentures/Corporate bonds. Government securities form the major part of the market in terms of outstanding issues, market capitalization and trading value.

The trading of government securities on the Stock exchanges is currently through Negotiated Dealing System using members of Bombay Stock Exchange (BSE) / National Stock Exchange (NSE) and these trades are required to be reported to the exchange. The bulk of the corporate bonds, being privately placed, were, however, not listed on the stock exchanges and the trend is changing now. Most of the debt securities which are privately placed are now listed either on both the exchanges or on one of the exchange. Two Depositories, National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL) maintain records of holding of securities in a dematerialized form. Records of holding of Government securities for wholesale dealers like banks/Primary Dealers (PDs) and other financial institutions are maintained by the RBI.

Negotiated Dealing System (NDS) is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments. NDS Facilitated electronic submission of bids/application by members for primary issuance of Government Securities by RBI through auction and floatation. It will provide an interface to the Securities Settlement System.

## DEBENTURES

A vibrant securities market, both equity and bond, has to play an increasingly pivotal role to facilitate fund mobilization for sustaining India's projected economic growth momentum. A debenture being an attractive source of funding, is a long-term debt instrument issued by corporates and Government to secure fresh funds or capital. Coupons or interest rates are offered as compensation to the lender. Company issues non-convertible debentures to attract lenders and investors, these come with higher interest rates.

Keeping in view the larger complementary role that corporate bonds have to play along-side bank credit for financing economic activities and promoting ease of doing business in India, several policy measures have been taken by the Government and the Regulators to develop a vibrant corporate bond market.

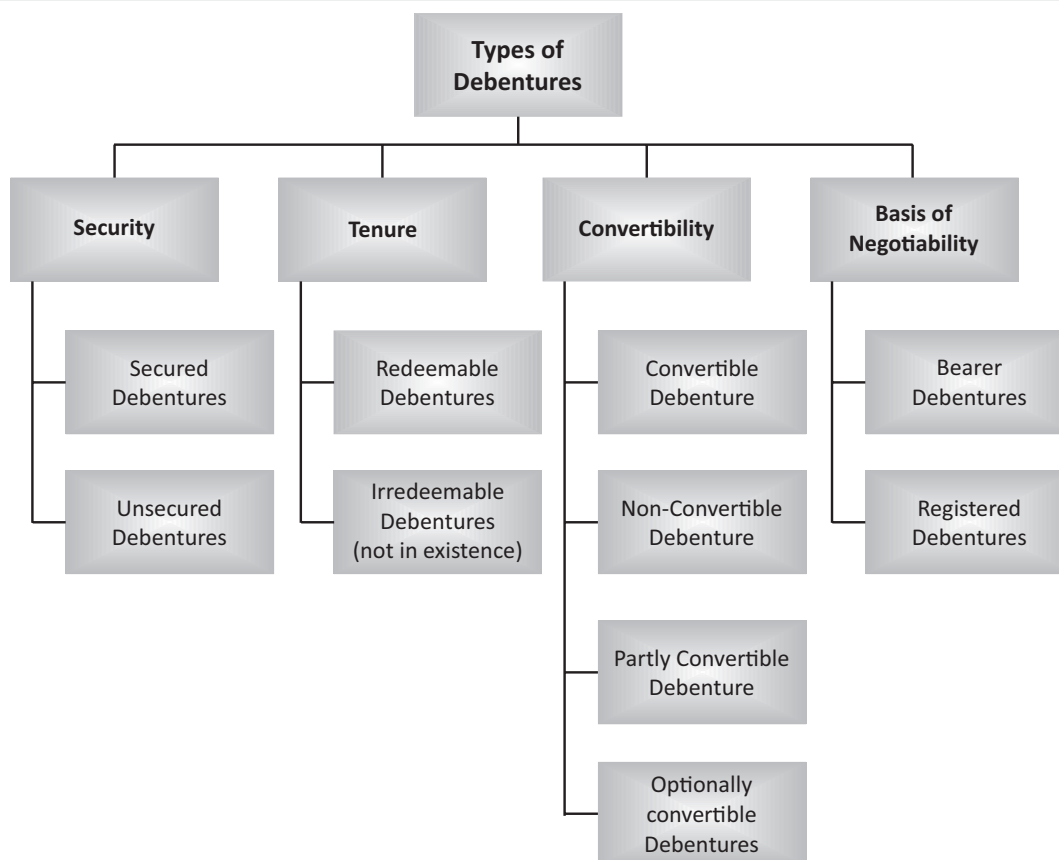
Debenture is a document evidencing a debt or acknowledging it and any document which fulfills either of these conditions is a debenture. They can be either convertible or non-convertible into equity shares at a later point in time. Debenture is a written instrument acknowledging a debt to the Company. It contains a contract for repayment of principal after a specified period or at intervals or at the option of the company and for payment of interest at a fixed rate payable usually either half-yearly or yearly on fixed dates.

In essence, it represents a loan taken by the issuer who pays an agreed rate of interest (decided at the time of issue only) during the life time of the instrument and repays the principal normally, unless otherwise agreed, on maturity.

Section 2(30) of the Companies Act, 2013 defines a debenture which includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

The SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 ('NCS Regulations') provides for issuance and/or listing of Debt securities.

### Types of Debentures



## Security

### (a) Secured Debentures

Secured debentures refer to those debentures where a charge is created on the assets of the company (mostly immovable) for the purpose of payment in case of default.

The secured debenture holders have greater protection. Holders of secured debentures remain convinced about the payment of interest and payment of principal in the event of redemption.

### (b) Unsecured Debentures

These debentures are also known as naked debentures. These debentures are not secured by way of charge on the company's assets. Interest rate payable on unsecured debentures is generally higher than that which is payable on secured debentures but the risk is comparatively high too.

## Tenure

### Redeemable Debentures

Redeemable debentures are those which are payable on the expiry of the specific period (Maximum period 10 years from the date of issue) or upto 30 years in case the company is engaged in infrastructure project or is an infrastructure finance company either in lump sum or in Instalments during the life time of the company. Debentures can be redeemed either at par or at premium.

## Convertibility

On the basis of convertibility, a debenture may be classified under the following categories:-

### a. Convertible Debenture

These debentures are fully converted into equity shares of the company on the expiry of a specified period.

### b. Non- Convertible Debenture

Non-convertible debentures do not have any option to be converted into equity shares and are redeemed at the expiry of specified period(s).

### c. Partly Convertible Debenture

Partly convertible debentures are divided into two portions, viz., convertible and non-convertible portion. The convertible portion is converted into equity shares of the company at the expiry of specified period. The non- convertible portion is redeemed at the expiry of the specified period in terms of the issue.

### d. Optionally convertible Debentures

An option is provided to the debenture holders at the maturity to get them converted into equity shares of the company or get them redeemed.

## Basis of Negotiability

Debentures issued by a company may be negotiable or non-negotiable. There are following two types of debentures:-

### Bearer Debentures

These debentures are payable to bearer of the debentures and transferable by mere delivery. These debentures are also known as unregistered debentures.

### *Registered Debentures*

These debentures are not transferable by mere delivery of debenture certificate and shall be transferred as per the provisions of the Companies Act, by executing transfer deeds and the transfer registered by the company. Registered debentures are not negotiable instruments. A registered holder of a debenture means a person whose name appears both in the debenture certificate and in the register of debenture holders. Principal and interest amount, when due in respect of these debentures are payable to the registered holders thereof only.

## **Green Debt Securities**

### **Meaning of Green Debt Securities**

A Debt Security shall be considered as “Green or Green Debt Securities”, if the funds raised through issuance of the debt securities are to be utilised for project(s) and/or asset(s) falling under any of the following broad categories:

- a) renewable and sustainable energy including wind, bioenergy, other sources of energy which use clean technology;
- b) clean transportation including mass/public transportation;
- c) climate change adaptation including efforts to make infrastructure more resilient to impacts of climate change and information support systems such as climate observation and early warning systems;
- d) energy efficiency including efficient and green buildings;
- e) sustainable waste management including recycling, waste to energy, efficient disposal of wastage;
- f) sustainable land use including sustainable forestry and agriculture, afforestation;
- g) biodiversity conservation;
- h) pollution prevention and control (including reduction of air emissions, greenhouse gas control, soil remediation, waste prevention, waste reduction, waste recycling and energy efficient or emission efficient waste to energy) and sectors mentioned under the India Cooling Action Plan launched by the Ministry of Environment, Forest and Climate Change;
- i) circular economy adapted products, production technologies and processes (such as the design and introduction of reusable, recyclable and refurbished materials, components and products, circular tools and services) and/or eco efficient products;
- j) blue bonds which comprise of funds raised for sustainable water management including clean water and water recycling, and sustainable maritime sector including sustainable shipping, sustainable fishing, fully traceable sustainable seafood, ocean energy and ocean mapping;
- k) yellow bonds which comprise of funds raised for solar energy generation and the upstream industries and downstream industries associated with it;

- l) transition bonds which comprise of funds raised for transitioning to a more sustainable form of operations, in line with India's Intended Nationally Determined Contributions, and Explanation: Intended Nationally Determined Contributions (INDCs) refer to the climate targets determined by India under the Paris Agreement at the Conference of Parties 21 in 2015, and at the Conference of Parties 26 in 2021, as revised from time to time;
- m) any other category, as may be specified by the Board from time to time.

For more information about raising of funds from debentures, the students may refer lesson 14 of this study.

## BONDS

A bond is a debt instrument in which an investor loans money to an entity (typically corporate or government) which borrows the funds for a defined period of time at a variable or fixed interest rate. Bonds are used by companies, municipalities, states and sovereign governments to raise money to finance a variety of projects and activities. Owners of bonds are debt holders, or creditors, of the issuer.

**The bond holders are generally like a creditor where a company is obliged to pay the amount. The amount is paid on the maturity of the bond period. Generally, these bonds duration would be for 5 to 10 years.**

Based on the maturity period, bonds are referred to as bills or short-term bonds and long-term bonds. Bonds have a fixed face value, which is the amount to be returned to the investor upon maturity of the bond. During this period, the investors receive a regular payment of interest, semi-annually or annually, which is calculated as a certain percentage of the face value and known as a 'coupon payment.' There are various types of bonds issued in India like:

- **Government Bonds:** These are the bonds issued either directly by Government of India or by the Public Sector Units (PSU's) in India. These bonds are secured as they are backed up with security from Government. These are generally offered with low rate of interest compared to other types of bonds.
- **Corporate Bonds:** These are the bonds issued by the private sector corporate. Indian corporates have issued secured as well as non-secured bonds. e.g. IIFL bonds issued in Sep-2012 were unsecured bonds whereas Shriram city union bond issue in Sep-2012 itself was a secured bond issue. They generally offer high interest rates than Government Bonds.
- **Banks and other Financial Institutions Bonds:** These bonds are issued by banks or any financial institution. The financial market is well regulated and the majority of the bond markets are from this segment. However, the investor is expected to take care and to consider the credit rating given by Credit Rating Agencies before investing in these bonds. In case of poor credit rating, better to stay away from such bonds.
- **Tax Saving Bonds:** In India, the tax saving bonds are issued by the Government of India for providing benefit to investors in the form of tax savings. Along with getting normal interest, the bond holder would also get tax benefit.

All these bonds are listed on National Stock Exchange and Bombay Stock Exchange of India, hence can be easily liquidated and sold in the open market.

## Masala Bonds

With a unique name, Masala Bonds are rupee denominated borrowings by Indian companies in the overseas markets. This is different from the other overseas borrowings in the sense that in the other borrowings, the currency is normally dollar, euro, yen etc. whereas Masala Bonds are Rupee denominated.

The advantage of issuing masala bonds is that the company does not have to worry about the depreciation in the rupee in comparison to the other bonds/ instruments that are denominated in foreign currencies. This is normally a big worry for corporates while raising money in the overseas markets. If the rupee weakens at the time of the redemption of the bonds, the company will have to pay more rupees to repay the dollars. Many companies which had raised funds via the Foreign Currency Convertible Bonds in 2007 found themselves in a great difficulty as the rupee had depreciated very sharply during the global financial crisis.

In order to compensate the risk of currency depreciation, the buyer of the Masala Bond will get a higher coupon rate and therefore earns a higher yield.

The masala bonds were reckoned under both corporate debt and external commercial borrowings for Foreign Portfolio investment. The Reserve Bank of India recently amended the Regulations and currently treats Masala Bonds under the ECB category only, where a borrower just needs to seek the RBI's approval to sell those securities.

The provisions in respect of maturity period, all-in-cost ceiling and recognized lenders (investors) of Masala Bonds as under:

- i. **Maturity period:** Minimum original maturity period for Masala Bonds raised upto USD 50 million equivalent in INR per financial year should be 3 years and for bonds raised above USD 50 million equivalent in INR per financial year should be 5 years.
- ii. **All-in-cost ceiling:** The all-in-cost ceiling for such bonds will be 300 basis points over the prevailing yield of the Government of India securities of corresponding maturity.
- iii. **Recognised investors:** Entities permitted as investors under the provisions of paragraph 3.3.3 of the Master Direction No.5 dated January 1, 2016 but should not be related party within the meaning as given in Ind-AS 24.

#### Normal Bonds *vis-a-vis* Masala Bonds

As against Normal Bonds, Masala Bonds are considered a safer way of raising funds from international investors by Indian Corporates as they are rupee denominated bonds. Whereas the investor gets the benefit of a slightly high rate of interest as against normal bonds, issuer enjoys safety in terms of decrement in the rupee value against foreign currencies.

### Municipal Bonds

Municipal bonds are also referred to as 'muni bonds'. The urban local government and agencies issue these bonds. Municipal bonds are issued when a government body wants to raise funds for projects such as infra-related, roads, airports, railway stations, schools, and so on. SEBI issued guidelines in 2015 for the urban local bodies to raise funds by issuing municipal bonds. Municipal bonds exist in India since the year 1997. Bangalore Municipal Corporation is the first urban local body to issue municipal bonds in India. Ahmedabad followed Bangalore in the succeeding years. The municipal bonds lost the ground after the initial investors' attraction it received and failed to raise the desired amount of funds. To revive the municipal bonds, SEBI came up with guidelines for the issue of municipal bonds in 2015.

***For more information about Bonds, students may refer lesson 14 of this study.***

### ALTERNATIVE INVESTMENT FUNDS

Indian entrepreneurs need private equity and debt products to meet the capital needs of their growth, restructuring, turn around or start-up plans. The main providers of this form of capital are private equity and venture capital funds which are channelled through Alternative Investment Funds (AIFs). Given that such capital is in short supply in India, a favourable policy and regulatory environment is essential. AIFs in India are regulated

by the Securities and Exchange Board of India (SEBI). Other government agencies which play an important role are the Ministry of Finance and sector regulators in the pension and insurance areas as well as the Reserve Bank of India.

SEBI had earlier framed the SEBI (Venture Capital Funds) Regulations, 1996 (“VCF Regulations”) to encourage investments into start-ups and mid-size companies. Since the introduction of the VCF Regulations, it was observed by SEBI that the venture capital route was being used by several other categories of funds such as private equity funds, real estate funds etc. Further, since registration as a Venture Capital Fund (“VCF”) was not mandatory under the VCF Regulations, not all private equity or other categories of funds were registering with the SEBI.

While these funds did not enjoy certain exemptions that were available to VCFs, they were not subjected to any investment restrictions. SEBI noted the need for comprehensive regulations to deal with investments that are sourced from diverse parts of the private pool of capital. Accordingly, SEBI notified the Alternative Investment Fund (AIF) Regulations to govern unregulated entities and create a level playing ground for existing venture capital investors.

The Securities and Exchange Board of India (“SEBI”) has notified the SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations) on 21 May, 2012 - a comprehensive regulatory framework for regulating private pools of capital or Alternative Investment Funds, thus bringing various funds investing in Indian securities under a unified regulatory umbrella.

The AIF Regulations aim to regulate funds involved in the pooling or raising of private capital from Institutional Investors or High Networth Investors (“HNI”) with a view to invest such funds in accordance with a defined investment policy for benefit of the investors and the manager of such fund, irrespective of their legal domicile. These regulations provide that an entity, seeking to pool and manage such private pool of capital for investing in securities or acting as an Alternative Investment Fund (“AIF”), should be registered with the SEBI under these regulations.

#### **What is an Alternate Investment Fund (“AIF”)?**

Alternative Investment Fund or AIF means any fund established or incorporated in India which is a privately pooled investment vehicle which collects funds from sophisticated investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors.

#### **SEBI (Alternative Investment Fund) Regulations, 2012**

According to Section 2(1)(b), “Alternative Investment Fund” (AIF) means any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which-

- (i) is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and
- (ii) is not covered under the SEBI (Mutual Funds) Regulations, 1996, SEBI (Collective Investment Schemes) Regulations, 1999 or any other regulations of the SEBI to regulate fund management activities.

The following shall not be considered as Alternative Investment Fund for the purpose of these regulations, -

- (i) family trusts set up for the benefit of ‘relatives’ as defined under Companies Act, 2013;
- (ii) ESOP Trusts set up under the Securities and Exchange Board of India (Share Based Employee Benefits) Regulations, 2014 or as permitted under Companies Act, 2013;
- (iii) employee welfare trusts or gratuity trusts set up for the benefit of employees;

- (iv) 'holding companies' as defined under sub-section 46 of section 2 of Companies Act, 2013;
- (v) other special purpose vehicles not established by fund managers, including securitization trusts, regulated under a specific regulatory framework;
- (vi) funds managed by securitisation company or reconstruction company which is registered with the Reserve Bank of India under Section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002; and
- (vii) any such pool of funds which is directly regulated by any other Regulator in India.

#### Key Aspects pertaining to AIFs under SEBI (Alternative Investment Funds) Regulations, 2012

- All AIFs must state its **investment strategy, investment purpose and its investment methodology** in its placement memorandum to the investors. In case the AIF decides to **alter the fund strategy**, it shall be made only **with the consent of at least 2/3rd of the unit holders** by value of their investment in the AIF.
- The AIF, in all categories, may raise funds from any investor whether Indian, foreign or non-resident Indians only by way of issue of **units**.
- **Minimum Corpus of an AIF- ₹ 20 crores.**
- **Minimum Investment from an Individual - ₹ 1 crore (₹ 25 lakhs in case of employees or directors of the AIF fund/Manager).**
- Corpus of Manager/Sponsor- 2.5% or ₹ 5 Crore whichever is lower. (In case of Category I and II) Double in case of Category –III.
- Not more than **1000 investors**.
- Raise funds only by way of **Private Placement**.

#### Categories of AIFs

| <i>Basis</i>                                 | <i>Category I</i>  | <i>Category II</i>   | <i>Category III</i>  |
|--|--|--|--|
| <b>Introduction</b>                          | Invest in <b>Start ups, SMEs and such projects</b> which are <b>economically and socially desirable</b> .  | Which are not covered under Category –I and III.   | Employ <b>diverse and complex trading strategies</b> .   |
| <b>Investment in securities of companies</b> | Yes, generally unlisted companies.   | Yes, primarily unlisted company.   | Yes, both listed and unlisted.   |
| <b>Investment in units of other AIF</b>      | Yes, but not more than 25% of the investable funds in an Investee Company directly or through investment in the units of other Alternative Investment Funds. | Yes, but not more than 25% of the investable funds in an Investee Company directly or through investment in the units of other Alternative Investment Funds. | Yes, not more than ten per cent of the investable funds in an Investee Company, directly or through investment in units of other Alternative Investment Funds. |

| <b>Basis</b>        | <b>Category I</b>  | <b>Category II</b>      | <b>Category III</b>   |
|---------------------|--|-------------------------|---|
| <b>Borrow funds</b> | No, except for temporary fund requirements.<br>Max 30 days.<br>Max. 4 times in a year.<br>Max 10 % of the investible funds.  | Same as of Category -I. | Yes, with the consent of investors.   |
| <b>Tenure</b>       | Minimum tenure of 3 years closed ended fund<br>Tenure can be extended for 2 years by approval from investors (2/3 in value). | Same as of Category -I. | No minimum Tenure<br>Open ended or close ended<br>Tenure can be extended for 2 years by approval from investors (2/3 in value). |

Special Alternate Investment Fund under Regulation 19 of SEBI (AIF) Regulations is added. Regulation 19 prescribed that SEBI may lay down framework for AIFs other than the funds falling in the categories specified in SEBI (AIF) Regulations, 2012.

**For more details about AIFs, the students may refer lesson 11 of this study.**

## VENTURE CAPITAL

Venture Capital is one of the innovative financing resource for a company in which the promoter has to give up some level of ownership and control of business in exchange for capital for a limited period, say, 3-5 years.

Venture Capital is generally equity investments made by venture capital funds, at an early stage in privately held companies, having potential to provide a high rate of return on their investments. It is a resource for supporting innovation, knowledge based ideas and technology and human capital intensive enterprises.

According to Section 2(1)(z), “venture capital fund” means an Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model and shall include an angel fund as defined under Chapter III-A and migrated venture capital fund as defined under Chapter III-D of the SEBI (AIF) Regulations, 2012.

A venture capital company is a group of investors who pool investments focused within certain parameters. The participants in venture capital firms can be institutional investors like pension funds, insurance companies, foundations, corporations or individuals.

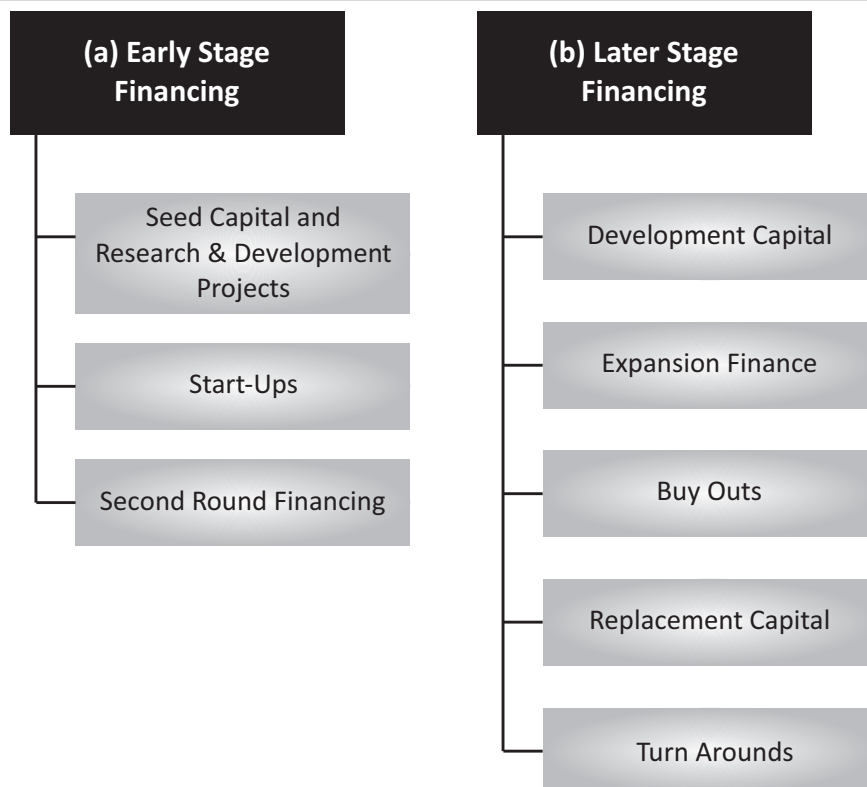
Unlike banks, which seek their return through interest payments, venture firms seek for capital appreciation. Generally, venture capital firms look for a return of five to ten times the original investment.

### Areas of Investment

Different venture groups prefer different types of investments. Some specialize in seed capital and early expansion while others focus on exit financing. Biotechnology, medical services, communications, electronic components and software companies seem to be the most likely attraction of many venture firms and receiving the most financing. Venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability.

In India, software sector has been attracting a lot of venture finance. Besides media, health and pharmaceuticals, agri-business and retailing are the other areas that are favored by a lot of venture companies.

## Stages of Investment Financing



## Early Stage Financing

- **Seed Capital and R&D Projects:** Venture capitalists are more often interested in providing seed finance i. e. making provision of very small amounts for finance needed to turn into a business. Research and Development activities are required to be undertaken before a product is to be launched.
- **Start-Ups:** The most risky aspect of venture capital is the launch of a new business after the Research and Development activities are over. Start-ups may include new industries/businesses set up by the experienced persons in the area in which they have knowledge, specialization and proficiency.
- **Second Round Financing:** It refers to the stage when product has already been launched in the market but has not earned enough profits to attract new investors.

## Later Stage Financing

- **Development Capital:** It refers to the financing of an enterprise which has overcome the highly risky stage and have recorded profits but cannot go public, thus needs financial support.
- **Expansion Finance:** Venture capitalists perceive low risk in ventures requiring finance for expansion purposes either by growth implying bigger factory, large warehouse, new factories, new products or new markets or through purchase of existing businesses.
- **Buy Outs:** It refers to the transfer of management control by creating a separate business by separating it from their existing owners.
- **Turnarounds:** Such form of venture capital financing involves medium to high risk on a time scale of

three to five years. It involves buying the control of a sick company which requires specialized skills in finance.

## ANGEL FUNDS

As per SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations), Angel Fund means a sub-category of Venture Capital Fund under Category I - Alternative Investment Fund that raises funds from angel investors and invests in accordance with the provisions of Chapter III-A of the AIF Regulations.

### Angel Investor

'Angel Investor' means any person who proposes to invest in an angel fund and satisfies one of the following conditions, namely-

- an individual investor who has net tangible assets of at least **two crore rupees excluding value of his principal residence**, and who:
  - has **early stage investment experience**, or
  - has **experience as a serial entrepreneur**, or
  - is a **senior management professional with at least ten years of experience**.
- a body corporate with a net worth of at least ten crore rupees; or
- an Alternative Investment Fund registered under SEBI AIF Regulations or a Venture Capital Fund registered under the SEBI (Venture Capital Funds) Regulations, 1996.

*Early stage investment experience shall mean prior experience in investing in start-up or emerging or early-stage ventures and 'serial entrepreneur' shall mean a person who has promoted or co-promoted more than one start-up venture.*

### Regulatory Framework

The provisions of Chapter III-A of the AIF Regulations, 2012 and all other provisions of the AIF Regulations, except clauses (a), (b), (c), (d) and (f) of regulation 10, regulation 12, regulation 14, clauses (a), (c) and (e) of sub-regulation (1) of regulation 15, clause (b) of sub-regulation (1) of regulation 16 and sub-regulation (2) of regulation 16 of the AIF Regulations, and the guidelines and circulars issued under the AIF Regulations unless specifically excluded, shall apply to angel funds, their sponsors and managers and angel investors.

## PRIVATE EQUITY

Private equity is a type of equity (finance) and one of the asset classes that are not publicly traded on a stock exchange. Private equity is essentially a way to invest in some assets that is not publicly traded, or to invest in a publicly traded asset with the intention of taking it private. Unlike stocks, mutual funds, and bonds, private equity funds usually invest in more illiquid assets, i.e. companies. By purchasing companies, the firms gain access to those assets and revenue sources of the company, which can lead to very high returns on investments. Another feature of private equity transactions is their extensive use of debt in the form of high-yield bonds. By using debt to finance acquisitions, private equity firms can substantially increase their financial returns.

Private equity consists of investors and funds that make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity. Capital for private equity is

raised from retail and institutional investors, and can be used to fund new technologies, expand working capital within an owned company, make acquisitions, or to strengthen a balance sheet. The major of private equity consists of institutional investors and accredited investors who can commit large sums of money for long periods of time.

Private equity investments often demand long holding periods to allow for a turnaround of a distressed company or a liquidity event such as IPO or sale to a public company. Generally, the private equity fund raise money from investors like Angel investors, Institutions with diversified investment portfolio like – pension funds, insurance companies, banks, funds of funds etc.

### Types of Private Equity

Private equity investments can be divided into the following categories:

*Leveraged Buyout (LBO):* This refers to a strategy of making equity investments as part of a transaction in which a company, business unit or business assets is acquired from the current shareholders typically with the use of financial leverage. The companies involved in these type of transactions that are typically more mature and generate operating cash flows.

*Venture Capital:* It is a broad sub-category of private equity that refers to equity investments made, typically in less mature companies, for the launch, early development, or expansion of a business.

*Growth Capital:* This refers to equity investments, mostly minority investments, in the companies that are looking for capital to expand or restructure operations, enter new markets or finance a major acquisition without a change of control of the business.

***For more details about Venture Capital, Angel Funds and raising of funds from Private Equity, students may refer Lesson 11 of this study.***

### REAL ESTATE INVESTMENT TRUSTS (REITs)

A real estate investment trust (“REIT”) is a collective investment scheme that owns, operates or finances income producing real estate. REITs provide all investors the chance to own valuable real estate, present the opportunity to access dividend-based income and total returns, and help communities grow, thrive, and revitalize. REITs allow anyone to invest in portfolios of real estate assets the same way they invest in other industries – through the purchase of individual company stock or through a mutual fund or exchange traded fund (ETF). The stockholders of a REIT earn a share of the income produced through real estate investment – without buying any finance property.

REITs are similar to mutual funds and shares and they provide income by way of Dividend to its shareholders and Capital Appreciation as REIT stocks are listed in BSE and NSE. Recently, the SEBI has notified Small and medium REIT framework to facilitate greater growth of the real estate sector and all related sectors of the economy.

***For more details about REITs, students may refer Lesson 9 of this study.***

### INFRASTRUCTURE INVESTMENT TRUSTS (InvITs)

Considering the importance of infrastructure sector with an aim to provide a suitable platform for financing / refinancing infrastructure projects and allow the investors to participate in the growth story of infrastructure, the Government introduced a new investment vehicle named Infrastructure Investment Trusts (‘InvITs’) in 2014.

The primary objective of InvITs is to promote the infrastructure sector of India by encouraging more individuals to invest in it. Typically, such a tool is designed to pool money from several investors to be invested in income-generating assets. The cash flow thus generated is distributed among investors as dividend income. When compared to Real Estate Investment Trust or REITs, the structure and operation of both are quite similar.

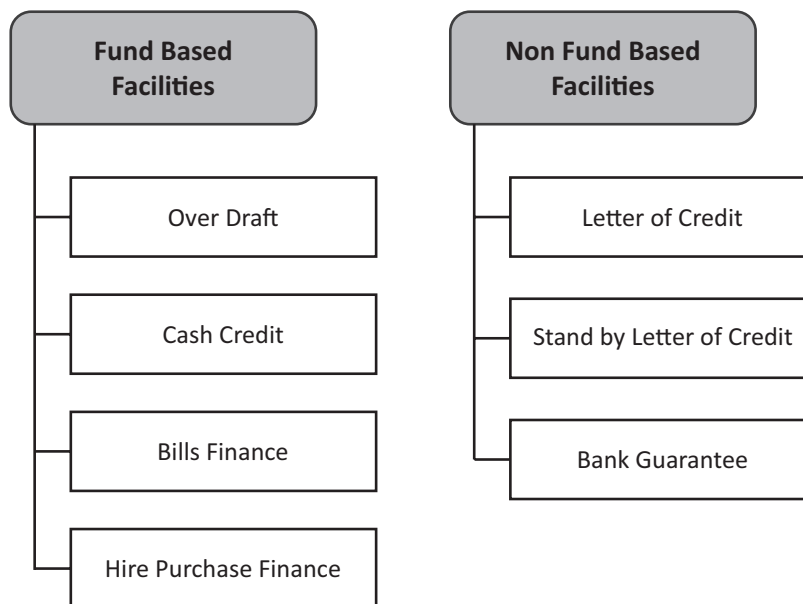
*For more details about InvITs, students may refer Lesson 10 of this study.*

### BANK FINANCE - MOST COMMON WAY OF FUNDING FOR CORPORATES

Banking Regulation Act, 1949 classifies bank finance into secured loans and unsecured loans. Secured loan means loans granted by the banks on the backing of some tangible security, while Unsecured loan is one for which the banker has to rely upon the personal security of the borrower. Unsecured advances are not popular in India as they impose a huge risk of money loss in case of default by the borrower. Most of the bank advances are secured ones. Only a small portion of about 11% to 15% of the total bank advance is unsecured that usually take form of Overdrafts and Cash Credit Facilities.

Bank's finance their customers not only in the form of loans, but through other types of credit facilities also. The other types of bank finance are tailor made to suit the needs of customers. The loans and advances wherein immediate flow of funds is available to borrowers, are called funds based facility. In non-fund based facilities like issuance of letter of guarantee, letter of credit etc., banks get income in the form of fee for making available the facility and there is no immediate outflow of funds from bank. Some of the credit facilities which are different from loans are described here-under.

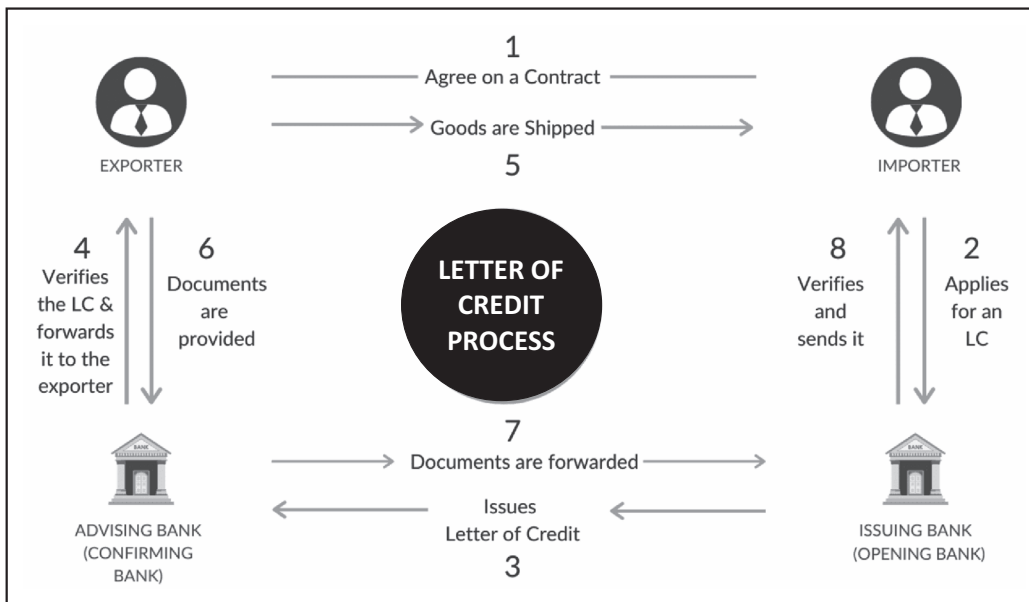
#### Credit Facilities Provided by the Banks



#### Letter of Credit

A letter of credit is a document from a bank that guarantees payment. It is an undertaking/ commitment by the bank, advising/informing the beneficiary that the documents under a letter of credit would be honoured, if the beneficiary (exporter) submits all the required documents as per the terms and conditions of the letter of credit.

**A Letter of Credit is issued by a bank at the request of its customer (importer / buyer) in favour of the beneficiary (exporter / seller).**

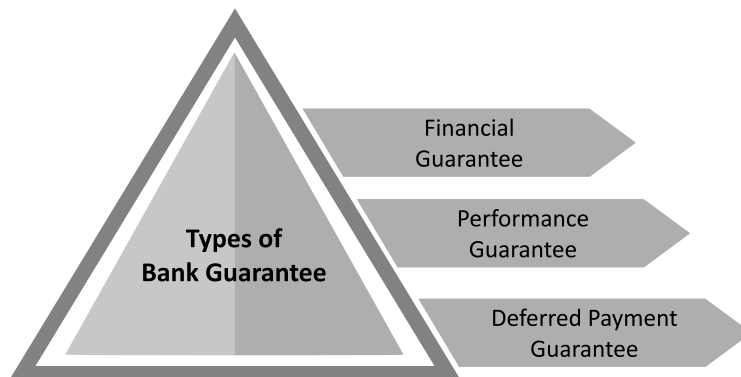


### Bank Guarantee

A Bank Guarantee is a legal contract which can be imposed by law. The banker as guarantor assures the third party (beneficiary) to pay him a certain sum of money on behalf of his customer, in case the customer fails to fulfill his commitment to the beneficiary.

Bank guarantees are part of non-fund based credit facilities provided by the bank to the customers. Bank issue bank guarantee on behalf of his client as a commitment to third party assuring her/ him to honour the claim against the guarantee in the event of the non- performance by the bank’s customer. A Bank Guarantee is a legal contract which can be imposed by law. The banker as guarantor assures the third party (beneficiary) to pay him a certain sum of money on behalf of his customer, in case the customer fails to fulfill his commitment to the beneficiary.

Banks issue different types of guarantees, on behalf of their customers, as illustrated below:



- Financial Guarantee:** A financial guarantee is an agreement that guarantees a debt will be repaid to a lender by another party if the borrower defaults. The banker issues guarantee in favour of a government department against caution deposit or earnest money to be deposited by bank’s client. At the request of his customer, in lieu of a caution deposit/ earnest money, the banker issues a guarantee in favour of the government department. This is an example of a Financial Guarantee. This type of guarantee helps the bank’s customer to bid for the contract without depositing actual money. In case,

the contractor does not take up the awarded contract, then the government department would invoke the guarantee and claim the money from the bank.

- **Performance Guarantee:** Performance Guarantees are issued by banks on behalf of their clients. In performance guarantee bank issue on behalf of his client to assure the third party to complete some work on time or as per the terms of contract between the parties. If the work is not completed as per the term of contract then the third party can request the bank to invoke the bank guarantee and make payment for default.
- **Deferred Payment Guarantee:** It is clear from the name of the Bank guarantee that under this guarantee, the banker guarantees payments of installments spread over a period of time.

Here, the banks undertake to make payment of instalments payable by the buyer of capital goods such as machinery, on long term credit given by the supplier. Normally advance payment of 10% to 15% of the price of the capital goods is made by the borrower (margin). The balance amount with interest is payable in installments spread over may be 1 to 5 years. The supplier accordingly draws bills due on different dates which are accepted by the borrower and further co-accepted by the banker or bank issues DPG. On every due date the buyer's bank makes payment of the bill to the supplier irrespective of there being balance in the buyer's (borrower's) account or not. Banks secure such guarantees by creating charge over the assets purchased.

A bank guarantee and a letter of credit are similar in many ways but they are two different things. Letters of credit ensure a transaction proceeds as planned, while bank guarantees reduce the loss if the transaction does not go as planned.

### Difference between Letter of Guarantee and Bank Guarantee

A letter of credit, sometimes referred to as a documentary credit, acts as a promissory note from a bank. It represents an obligation taken on by a bank to make a payment once certain criteria are met. Once these terms are completed and confirmed, the bank will transfer the funds. The letter of credit ensures the payment will be made as long as the services are performed.

#### **Illustration**

An Indian wholesaler receives an order from a US company. The wholesaler has no way of knowing whether the buyer can fulfill his payment obligations, and requests a letter of credit be provided in their contract. The purchasing company applies for a letter of credit at a bank where it already has funds (LOC). After the goods have been shipped, the bank would pay the wholesaler its due as long as the terms of the sales contract are met, such as delivery before a certain time or confirmation from the buyer that the goods were received undamaged. The letter of credit substitutes the bank's credit for that of its client, ensuring correct and timely payment.

Letters of credit are especially important in international trade due to the distance involved and potentially differing laws in the countries of the businesses involved. In these transactions, it is not always possible for the parties to meet in person. The bank issuing the letter of credit holds payment on behalf of the buyer until it receives confirmation that the goods in the transaction have been shipped.

While letters of credit are used mostly in international trade agreements, bank guarantees are often used in real estate contracts and infrastructure projects.

Bank guarantees represent a more significant contractual obligation for banks than letters of credit do. A bank guarantee, like a letter of credit, guarantees a sum of money to a beneficiary; however, unlike a letter of credit, the sum is only paid if the opposing party does not fulfill the stipulated obligations under the contract. This can be used to essentially insure a buyer or seller from loss or damage due to nonperformance by the other party in a contract.

Bank guarantees insure both parties in a contractual agreement from credit risk. For instance, a construction company and its cement supplier may enter into a new contract to build a mall. Both parties may have to issue bank guarantees to prove their financial stance and capability. In a case where the supplier fails to deliver cement within a specified time, the construction company would notify the bank, which then pays the company the amount specified in the bank guarantee.

Both bank guarantees and letters of credit work to reduce financial risk. The seller takes on less risk when a letter of credit or bank guarantee is active, and would be more likely to agree to the transaction. These agreements are particularly important and useful in what would otherwise be risky transactions for the seller, such as certain real estate and international trade contracts. Banks, since they are agreeing to take on risk, thoroughly screen buyers interested in one of these transactions. After the bank has determined that the buyer is a reasonable risk, a monetary limit is placed on the agreement. The bank agrees to be obligated up to, but not exceeding, the limit. This protects the bank by providing a specific threshold of risk.

***For more information about Letter of Credit and Bank Guarantee, students may refer Lesson 14 (Section II) of this study.***

## FOREIGN FUNDING

Globalisation has opened doors and opportunities that were never explored before. International Financing is also known as International Macroeconomics as it deals with finance on a global level. International finance helps organizations engage in cross-border transactions with foreign business partners, such as customers, investors, suppliers and lenders. Various international sources from where funds may be raised include the following:

- (i) Commercial Banks;
- (ii) International Agencies and Development Banks;
- (iii) International Capital Markets.

With economies and the operations of the business organizations going global, Indian companies have an access to funds in the global capital market.

**The Government of India has taken various policies initiatives to allow India companies to raised funds from International Market. These policy initiatives have led to the introduction of International Instruments like American Depository Receipts (ADR), Global Depository Receipts (GDR), Foreign Currency Convertible Bonds (FCCBs) and Foreign Currency Exchangeable Bonds (FCEBs) etc.**

Increased globalization and investor appetite for investing in India, offer unique opportunity to companies looking to tap a new investor base, awareness or raise capital.

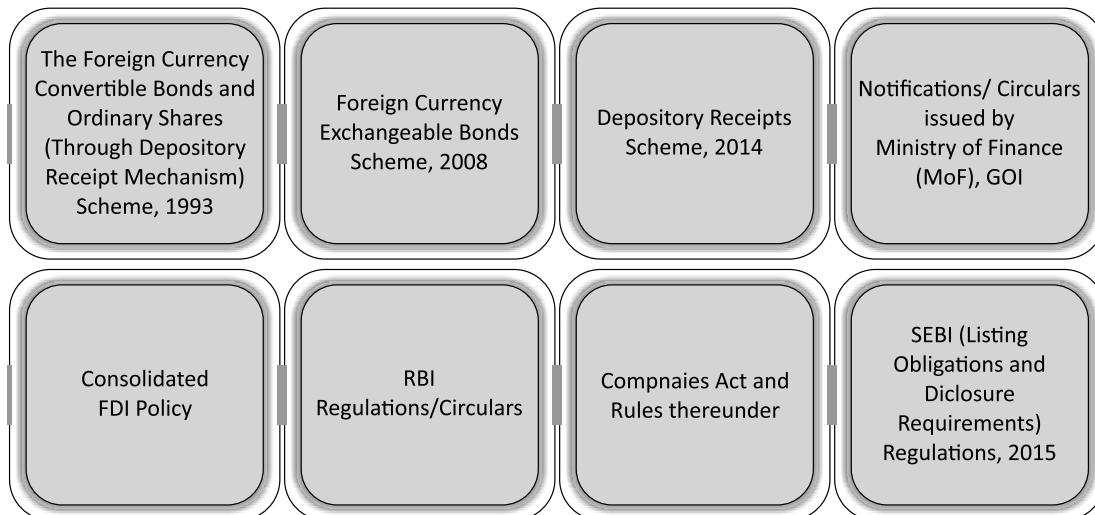
Capital can be raised from international capital market in foreign currency by accessing foreign capital market. Funds raised through foreign currency are called as euro equity or debt.

- **Euro Equity:** Euro equity represents shares denominated in dollar terms, issued by non-American and non-European companies to list their shares on American and European stock exchanges by complying the regulations of respective stock exchanges where the shares are intended to be listed. The euro equity issue can be made in different forms like American Depository Receipts and Global Depository Receipts.
- **Euro Debt:** Debts raised from international capital market by complying regulations of the respective country of which the capital market is accessed is called as euro debt. Euro debt can be issued in the form of ECB/FCCB/FCEB etc.

**Indian companies are allowed to raise capital in the international market through the issue of GDR/ADR/ FCCB/ FCEB and through External Commercial Borrowings.**

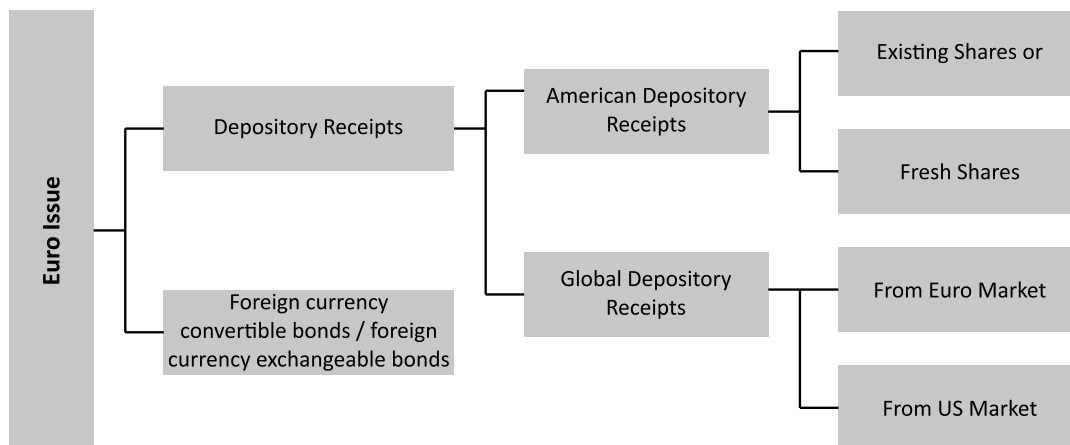
## Regulatory Framework in India

Issue of ADR/GDR/FCCBs/FCEBs are regulated by the following regulations in India:



## Euro issue

Euro issue means modes of raising funds by an Indian company outside India in foreign currency. There are different modes of Euro issue which is as follows:



## Depository Receipts Scheme, 2014

The issuance of depository receipt is one of the mechanisms used by Indian companies to get an access to foreign investors. In simple terms, a depository receipt is a foreign currency denominated instrument which is issued by an overseas depository to non-residents against securities of the Indian company.

On October 21, 2014, the Ministry of Finance (“MoF”) notified (“Notification”), the Depository Receipts Scheme, 2014 (“DR Scheme”) by virtue of which issuance of DRs has been taken out of the 1993 Scheme and is now regulated by the DR Scheme.

Hitherto, instruments issued by Indian companies to tap global capital markets, viz. American depository receipts (ADRs) or global depository receipts (GDRs) or convertible debt instruments in the form of foreign currency convertible bonds (FCCBs) were governed by the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipts Mechanism) Scheme, 1993, which had been amended from time to time.

The issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 stands repealed to the extent that it applies to Depository Receipts ('DRs'). It will, however, continue to apply to FCCBs. The DR Scheme came into effect from December 15, 2014.

The DR Scheme is based on the recommendations of the Sahoo Committee, which under the chairmanship of Mr. M.S. Sahoo undertook a comprehensive review of the 1993 Scheme and proposed significant deregulation and rationalisation of the manner in which Indian companies could tap global capital markets.

### American Depository Receipts (ADR) & Global Depository Receipts (GDR)

Typically, companies in India issue securities in the form of depository receipts (DR) viz American Depository Receipts (ADR), Global Depository Receipts (GDR) or Foreign Currency Convertible Bonds (FCCB). While ADR and GDR are equity instruments, FCCB is a convertible debt instrument.

The DR Scheme 2014 is solely applicable to ADR and GDR. The Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 continues to govern FCCB.

Regulation 2(c) of the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 defines ADR as under:

"American Depository Receipt (ADR)" means a security issued by a bank or a depository in United States of America (USA) against underlying rupee shares of a company incorporated in India."

Regulation 2(i) of the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004, defines GDR as under:

"Global Depository Receipt (GDR)" means a security issued by a bank or a depository outside India against underlying rupee shares of a company incorporated in India.

#### Difference between American Depository Receipts (ADR) and Global Depository Receipts (GDR)

- ADR are US \$ denominated and traded only in US.
- GDRs are traded in various places such as New York Stock Exchange, London Stock Exchange, etc.

### Provisions under the Companies Act, 2013

The Companies Act, 2013 has laid down provisions for issue of GDRs under Section 41 and prescribed the Companies (Issue of Global Depository Receipts) Rules, 2014.

According to Section 2(44) of Companies Act, 2013, "Global Depository Receipt" means any instrument in the form of a depository receipt, by whatever name called, created by a foreign depository outside India and authorised by a company making an issue of such depository receipts.

Section 41 provides that a company may, after passing a special resolution in its general meeting, issue depository receipts in any foreign country in such manner, and subject to such conditions, as may be prescribed.

### Foreign Currency Convertible Bonds (FCCBs)

Foreign Currency Convertible Bonds (FCCBs) are optionally convertible bonds issued in a currency other than Indian Rupees. A convertible bond is a mix between a debt and equity instruments. It acts like a bond by making regular coupon and principal payments, but these bonds also give the bondholders the option to convert the bond into shares at the expiry the term of the Bond.

The FCCBs are unsecured, carry a fixed rate of interest and an option for conversion into a fixed number of equity shares of the issuer company. Interest and redemption price (if conversion option is not exercised) is payable in dollars. FCCBs shall be denominated in any freely convertible Foreign Currency. However, it must be kept in mind that FCCB issue proceeds need to conform to ECB end use requirements.

Apart from the policy of ECB, issue of FCCB is also required to adhere to FEMA Regulations and in accordance with the scheme viz., "Issue of Foreign Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993.

Foreign investors also prefer FCCBs because of the dollar denominated servicing, the conversion option and, the arbitrage opportunities presented by conversion of the FCCBs into equity at a discount on prevailing Indian market price.

In addition, 25% of the FCCB proceeds can be used for general corporate restructuring.

#### Difference between Foreign Current Convertible Bonds (FCCBs) and Global Depository Receipts (GDR)

- FCCB is a type of Eurobond which can be exchanged for equity shares at some later date after issue of the Bond.
- GDR is a negotiable instrument in the form of depository receipts or certificate created by the overseas depository bank outside India and issued to non-resident investor against the issue of ordinary shares of foreign currency convertible bonds of the issuing company.

The major drawbacks of FCCBs are that the issuing company cannot plan its capital structure as it is not assured of conversion of FCCBs. Moreover, the projections for cash outflow at the time of maturity cannot be made.

#### Benefits to the Issuer Company

- Being Hybrid instrument, the coupon rate on FCCB is particularly lower than pure debt instrument there by reducing the debt financing cost.
- FCCBs are book value accretive on conversion. It saves risks of immediate equity dilution as in the case of public shares. Unlike debt, FCCB does not require any rating nor any covenant like securities, cover etc.
- It can be raised within a month while pure debt takes a longer period to raise. Because the coupon is low and usually payable at the time of redeeming the instrument, the cost of withholding tax is also lower for FCCBs compared with other ECB instruments.

#### Benefits to the Investor

- It has advantage of both equity and debt.
- It gives the investor much of the upside of investment in equity, and the debt portion protects the downside.
- Assured return on bond in the form of fixed coupon rate payments.

- Ability to take advantage of price appreciation in the stock by means of warrants attached to the bonds, which are activated when price of a stock reaches a certain point.
- Significant Yield to maturity (YTM) is guaranteed at maturity.
- Lower tax liability as compared to pure debt instruments due to lower coupon rate.

### FCCB and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993

FCCBs are governed by the 'Issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993' as amended from time to time and Notification FEMA No.120/RB-2004 dated July 7, 2004.

The issuance of FCCBs was brought under the ECB guidelines in August 2005. In addition to the requirements of:

- having the maturity of the FCCB not less than 5 years,
- the call & put option, if any, shall not be exercisable prior to 5 years,
- issuance of FCCBs only without any warrants attached,
- the issue related expenses not exceeding 4% of issue size and in case of private placement, shall not exceed 2% of the issue size, etc.

as required in terms of Notification FEMA No. 120/RB-2004 dated July 7, 2004, FCCBs are also subject to all the regulations which are applicable to ECBs.

### Foreign Currency Exchangeable Bonds (FCEBs)

Indian promoters can now raise money abroad by issuing foreign currency bonds against the value of their investments in shares of listed group company, termed as Foreign Currency Exchangeable Bonds (FCEB). The issue of these bonds helps the promoter to meet the financing requirements within the group. Issue of Foreign Currency Exchangeable Bonds (FCEB) are governed by Foreign Currency Exchangeable Bonds Scheme, 2008 issued by Ministry of Finance, Department of Economic Affairs.

#### What is FCEB?

According to the "Issue of Foreign Currency Exchangeable Bonds (FCEBs) Scheme, 2018, FCEB means a bond expressed in foreign currency, the principal and the interest in respect of which is payable in foreign currency, issued by an issuing company, subscribed to by a person resident outside India, exchangeable into equity shares of another company, being Offered company in any manner either wholly or partly or on the basis of any equity related warrants attached to debt instruments. The FCEB may be denominated in any freely convertible foreign company.

#### Parties of FCEB



Under this option, an issuer company may issue FCEBs in foreign currency, and these FCEBs are convertible

into shares of another company (offered company) that forms part of the same promoter group as the issuer company.

*Example-* Company ABC Ltd. issues FCEBs, then the FCEBs will be convertible into shares of company XYZ Ltd. that are held by company ABC Ltd. and where companies ABC Ltd. and XYZ Ltd. form part of the same promoter group. Unlike FCCBs that convert into shares of issuer itself, FCEBs are exchangeable into shares of OC. Also, relatively, FCEB has an inherent advantage that it does not result in dilution of shareholding at the OC level.

### External Commercial Borrowing (ECB)

ECBs are commercial loans raised by eligible resident entities from recognised non-resident entities and should conform to parameters such as minimum maturity, permitted and non-permitted end-uses, maximum all-in-cost ceiling, etc. The parameters apply in totality and not on a standalone basis.

**Merging of Tracks I and II as “Foreign Currency denominated ECB” and merging of Track III and Rupee Denominated Bonds framework as “Rupee Denominated ECB”.**

### ECB Framework

The framework for raising loans through ECB comprises the following two options:

| <b>Parameters</b>            | <b>FCY denominated ECB</b>  | <b>INR denominated ECB</b>  |
|------------------------------|---|---|
| <b>Currency of borrowing</b> | Any freely convertible Foreign Currency.  | Indian Rupee (INR)  |
| <b>Forms of ECB</b>          | Loans including bank loans; floating/ fixed rate notes/ bonds/ debentures (other than fully and compulsorily convertible instruments); Trade credits beyond 3 years; FCCBs; FCEBs and Financial Lease.  | Loans including bank loans; floating/ fixed rate notes/ bonds/ debentures/ preference shares (other than fully and compulsorily convertible instruments); Trade credits beyond 3 years; and Financial Lease. Also, plain vanilla Rupee denominated bonds issued overseas (RDBs), which can be either placed privately or listed on exchanges as per host country regulations. |
| <b>Eligible borrowers</b>    | All entities eligible to receive FDI. Further, the following entities are also eligible to raise ECB: <ul style="list-style-type: none"> <li>a) Port Trusts;</li> <li>b) Units in SEZ;</li> <li>c) SIDBI; and</li> <li>d) EXIM Bank.</li> </ul> | <ul style="list-style-type: none"> <li>a) All entities eligible to raise FCY ECB; and</li> <li>a) Registered entities engaged in micro-finance activities, viz., registered Not for Profit companies, registered societies/ trusts/cooperatives and Non- Government Organisations (permitted only to raise INR ECB).</li> </ul>   |

### Foreign Direct Investment (FDI)

Foreign Direct Investment is one of the important drivers of economic growth and a source of non-debt finance for the economic development of India. FDI complements and supplements domestic investment. Domestic companies are benefited through FDI by way of enhanced access to supplementary capital and state-of-art-technologies, as also exposure to global managerial practices resulting into employment generation and

accelerated growth of the sectors. Foreign investment through routes of Foreign Direct Investment (FDI) inflow and Foreign Portfolio Investment (FPI) inflows (net).

To promote FDI, the Government has put in place an investor-friendly policy, wherein except for a small negative list, most sectors are open for 100% FDI under the Automatic route. Further, the policy on FDI is reviewed on an ongoing basis, to ensure that India remains attractive & investor friendly destination. Changes are made in the policy after having intensive consultations with stakeholders including apex industry chambers, Associations, representatives of industries/groups and other organizations taking into consideration their views/comments.

Government has also taken various steps to improve the overall business regulatory environment in the country and create a conducive business environment by streamlining the existing regulations and processes and eliminating unnecessary requirements and procedures.

Government has taken various steps in addition to ongoing schemes to boost domestic investments in India. These include the National Infrastructure Pipeline, Reduction in Corporate Tax, easing liquidity problems of NBFCs and Banks, trade policy measures to boost domestic manufacturing. Government of India has also promoted domestic manufacturing of goods through the public procurement order, Phased Manufacturing Programme (PMP), Schemes for Production Linked Incentives of various Ministries.

It may be noted that Foreign Direct Investment ('FDI') means investment through capital instruments by a person resident outside India in an unlisted Indian company; or in 10% or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company. In case an existing investment by a person resident outside India in equity instruments of a listed Indian company falls to a level below 10% of the post issue paid-up equity capital on a fully diluted basis, the investment shall continue to be treated as FDI. 'Fully diluted basis' means the total number of shares that would be outstanding if all possible sources of conversion are exercised.

### Entry Routes for Investment

Investments can be made by non-residents in the equity shares/fully, compulsorily and mandatorily convertible debentures/fully, compulsorily and mandatorily convertible preference shares of an Indian company, through the Automatic Route or the Government Route. Permissible FDI can be made under "Automatic route" or "Government route".

**Automatic Route:** It means the entry route through which investment by a person resident outside India does not require the prior approval of the Reserve Bank of India or the Central Government.

**Government Route:** It means the entry route through which investment by person resident outside India requires prior Government approval and foreign investment received under this route shall be in accordance with the conditions stipulated by the Government in its approval.

### Foreign Portfolio Investment

'Foreign Portfolio Investment' means any investment made by a person resident outside India through capital instruments where such investment is less than 10 percent of the post issue paid-up share capital on a fully diluted basis of a listed Indian company or less than 10 percent of the paid up value of each series of capital instruments of a listed Indian company.

*Explanation: The 10 percent limit for foreign portfolio investors shall be applicable to each foreign portfolio investor or an investor group as referred in Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014.*

According to section 2(1)(j) of the SEBI (Foreign Portfolio Investors) Regulations, 2019, "Foreign Portfolio Investor" means a person who has been registered under Chapter II - Registration of Foreign Portfolio Investors of these regulations and shall be deemed to be an intermediary in terms of the provisions of the SEBI Act, 1992.

**Categories of Foreign Portfolio Investor**

| <i>FPI Category</i> | <i>Investors</i>   |
|---------------------|--|
| <b>Category I</b>   | <ul style="list-style-type: none"> <li>● Government and Government related investors such as central banks, sovereign wealth funds, international or multilateral organizations or agencies including entities controlled or at least 75% directly or indirectly owned by such Government and Government related investor(s).</li> <li>● Pension funds and university funds.</li> <li>● Appropriately regulated entities such as insurance or reinsurance entities, banks, asset management companies, investment managers, investment advisors, portfolio managers, broker dealers and swap dealers.</li> <li>● Entities from the Financial Action Task Force member countries, or from any country specified by the Central Government by an order or by way of an agreement or treaty with other sovereign Governments, which are – <ul style="list-style-type: none"> <li>I. appropriately regulated funds;</li> <li>II. unregulated funds whose investment manager is appropriately regulated and registered as a Category I foreign portfolio investor. However, the investment manager undertakes the responsibility of all the acts of commission or omission of such unregulated fund;</li> <li>III. university related endowments of such universities that have been in existence for more than five years.</li> </ul> </li> <li>● An entity (A) whose investment manager is from the Financial Action Task Force member country and such an investment manager is registered as a Category I foreign portfolio investor; or (B) which is at least seventy-five per cent owned, directly or indirectly by another entity and such an eligible entity is from a Financial Action Task Force member country. However such an investment manager or eligible entity undertakes the responsibility of all the acts of commission or omission of the applicants seeking registration under this sub-clause.</li> </ul> |
| <b>Category II</b>  | <p>"Category II foreign portfolio investor" shall include all the investors not eligible under Category I foreign portfolio investors such as –</p> <ul style="list-style-type: none"> <li>● appropriately regulated funds not eligible as Category-I foreign portfolio investor</li> <li>● endowments and foundations</li> <li>● charitable organisations</li> <li>● corporate bodies</li> <li>● family offices</li> <li>● Individuals</li> <li>● appropriately regulated entities investing on behalf of their client, as per conditions specified by the Board from time to time</li> <li>● Unregulated funds in the form of limited partnership and trusts.</li> </ul>   |

***For more details about Foreign Funding – Institutions, Instruments, Laws & Procedure, the students may refer Lesson 15 & 16 of this study.***

**SECURITIZATION**

**Introduction**

Securitization is the transformation of financial assets into securities. Securitization is used by financial entities to raise funding other than what is available via the traditional methods of on-balance-sheet funding.

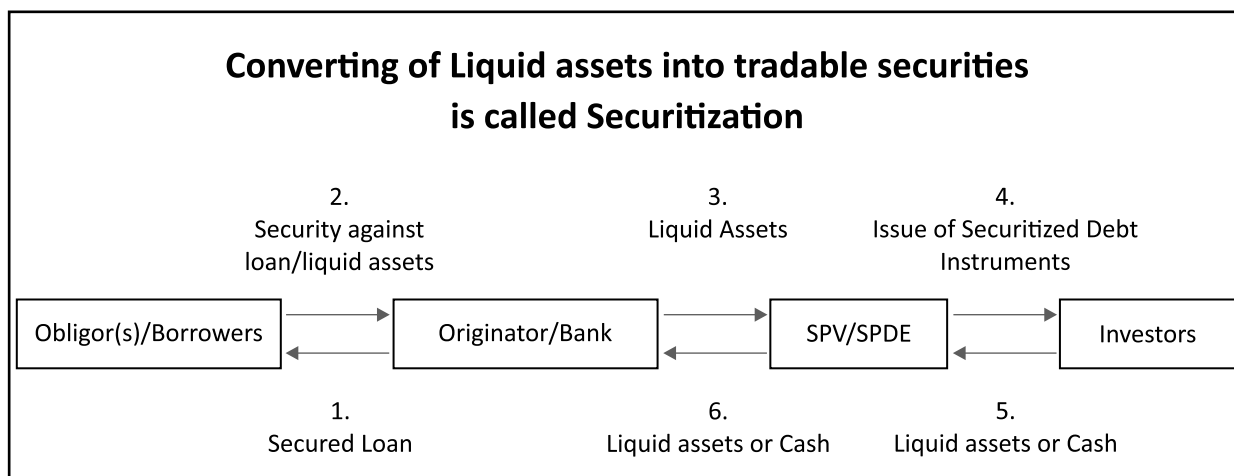
**Securitization is a technique used to convert illiquid assets/claims in to tradable securities.**

In other words, Securitization is the process of pooling and repackaging of homogenous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing asset or pool of assets. The pool of assets collateralizes securities.

These assets are generally secured by personal or real property (e.g. automobiles, real estate, or equipment loans), but in some cases are unsecured (e.g. credit card debt, consumer loans). There are four steps in a securitization:

- (i) Special Purpose Distinct Entity (SPDE) is created to hold title to assets underlying securities; Securitisation as a structured finance mechanism has several commercial advantages, including balance sheet and risk management, increased liquidity, cost-efficient financing, marketability of the resulting securities and an opportunity for portfolio diversification, which has remained an attractive option for banks, NBFCs and financial institutions in India.
- (ii) the originator or holder of assets sells the assets (existing or future) to the SPDE;
- (iii) the SPDE with the help of an investment banker, issues securities which are distributed to investors; and
- (iv) the SPDE pays the originator for the assets with the proceeds from the sale of securities.

**Securitization Process**



**Steps in securitisation**

- (i) Acquisition of Financial Assets by Securitisation Company or reconstruction Company (i.e. SPVs) from the originator. Here financial assets are loans backed by properties. The originator is banks or FIs who has lent money to the original borrower.

- (ii) the SPV, with the help of an investment banker, issues security receipts which are distributed to investors; and
- (iii) the SPV pays the originator for the financial assets purchased with the proceeds from the sale of securities.

### Parties involved in Securitisation

#### Primary Parties

- The Originator (Banks/FIs who has lent loan against properties)
- SPVs (Securitisation Company or reconstruction Company)
- Investors (To whom securities are issued, which is a participative interest against the pool of receivables which is bought by the SPVs from the originator). Few examples of assets that can be securitized :
  1. Residential mortgage loans
  2. Commercial mortgage loans
  3. Bank loans to businesses
  4. Commercial debt
  5. Student loans (Generally in US)
  6. Credit-card debt
  7. Automobile loans etc.

#### Besides above parties the following are involved in the Process of securitizations.

- The obligator (i.e. original borrower of the loan)
- Rating agency
- Administrator etc.

**The industry was born in 1970 in the United States with the securitization of U.S. government-guaranteed residential home mortgages by the Government National Mortgage Association.**

### Securitized Debt Instruments

Securitized debt instruments are regulated by the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, SEBI (Issue and Listing of Securitized Debt Instruments and Security Receipts) Regulations, 2008 for listing on stock exchanges and the RBI Guidelines on Securitisation of Assets issued in 2012. (Revisions to the Guidelines on Securitisation Transactions - <https://rbidocs.rbi.org.in/rdocs/notification/PDFs/FIGUSE070512.pdyj>)

**First securitization deal in India between Citi Bank and GIC Mutual Fund in 1991 for Rs. 160 million**

Initially, SEBI (Issue and Listing of Securitized Debt Instruments) Regulations, 2008 ('SDI Regulations) was applicable to:

- (a) public offers of securitised debt instruments;
- (b) to listing of securitised debt instruments issued to public or any person(s), on a recognised stock exchange.

'Securitized debt instruments' has been defined to mean 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 acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be.

The SRFAESI Act, 2002 has empowered the Banks and Financial Institutions with vast power to enforce the securities charged to them. The Banks can now issue notices to the defaulters to pay up the dues and if they fail to do so within 60 days of the date of the notice, the banks can take over the possession of assets like factory, land and building, plant and machinery etc. charged to them including the right to transfer by way of lease, assignment or sale and realize the secured assets. In case the borrower refuses peaceful handing over of the secured assets, the bank can also file an application before the relevant Magistrate for taking possession of assets. The banks can also take over the management of business of the borrower. The bank in addition can appoint any person to manage the secured assets the possession of which has been taken over by the bank. Banks can package and sell loans via "Securitisation" and the same can be traded in the market like bonds and shares.

**Announcement made by Hon'ble Finance Minister in budget speech 2021-22**

To improve credit discipline while continuing to protect the interest of small borrowers, for NBFCs with minimum asset size of Rs. 100 crores, the minimum loan size eligible for debt recovery under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 has been reduced to Rs. 20 lakhs from the level of Rs. 50 lakhs.

SEBI notified SEBI (Issue and Listing of Securitized Debt Instruments and Security Receipts) Regulations, 2008 on May 26, 2008 taking into account the market needs, cost of the transactions, competition policy, the professional expertise of credit rating agencies, disclosures and obligations of the parties involved in the transaction and the interest of investors in such instruments.

### Applicability

- 01 Public offers of securitised debt instruments;
- 02 To listing of securitised debt instruments issued to public or any person(s), on a recognised stock exchange; or
- 03 To listing of security receipts issued to qualified buyer(s) on a recognized stock exchange in terms of Chapter VIIA, Chapter VIII and Chapter X.

### Eligibility

A person cannot make a public offer of securitized debt instruments or seek listing for such securitized debt instruments unless –

- (a) it is constituted as a special purpose distinct entity;
- (b) all its trustees are registered with the SEBI under the SEBI (Issue and Listing of Securitized Debt Instruments and Security Receipts) Regulations, 2008; and
- (c) it complies with all the applicable provisions of these regulations and the SEBI Act.

The requirement of obtaining registration is not applicable for the following persons, who may act as trustees of special purpose distinct entities:

- (a) any person registered as a debenture trustee with SEBI;

- (b) any person registered as a securitization company or a reconstruction company with the RBI under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
- (c) the National Housing Bank established by the National Housing Bank Act, 1987;
- (d) the National Bank for Agriculture and Rural Development established by the National Bank for Agriculture and Rural Development Act, 1981;
- (e) any scheduled commercial bank other than a regional rural bank;
- (f) any public financial Institution as defined under clause (72) of section 2 of the Companies Act, 2013; and
- (g) any other person as may be specified by SEBI.

However, these persons and special purpose distinct entities of which they are trustees are required to comply with all the other provisions of the SEBI (Public Offer and Listing of Securitized Debt Instruments and Security Receipts) Regulations, 2008.

An applicant seeking registration to act as a trustee shall:-

**The networth requirement for registration to act as a trustee is at least Rs. 2 crore.**

- (a) have a networth of not less than two crore rupees.
- (b) have in its employment, a minimum of two persons who, between them, have atleast five years.

## PUBLIC OFFER OF SECURITIZED DEBT INSTRUMENTS

### Offer to the Public

No offer shall be treated as made to the public, if the offer can properly be regarded, in all the circumstances—

- (a) as not being likely to result, directly or indirectly, in the securitised debt instruments becoming available for subscription or purchase by persons other than those receiving the offer;
- (b) otherwise as being the domestic concern of the persons making and receiving the offer.

However, above mentioned conditions apply only in respect of securitized debt instruments which belong to the same tranche and which are *pari passu* in all respects.

**Any offer of securitized debt instruments made to fifty or more persons in a financial year shall be deemed to have been made to the public.**

## LISTING OF SECURITIZED DEBT INSTRUMENTS

### Mandatory Listing

A SPDE desirous of making an offer of securitized debt instruments to the public shall make an application for listing to one or more recognized stock exchanges.

### Application for listing

A SPDE to get the securitized debt instruments issued by it listed on a recognised stock exchange or otherwise desirous of getting the securitized debt instruments issued by it so listed shall make an application to the stock exchange in the form specified by it along with the requisite documents and particulars.

### Listing Agreement

Every SPDE desirous of listing securitized debt instruments on a recognised stock exchange, shall execute an agreement with such stock exchange.

Every SPDE which has previously entered into agreements with a recognised stock exchange to list securitized debt instruments shall execute a fresh listing agreement with such stock exchange in line with SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

### Minimum public offering for listing

In respect of public offer of securitized debt instruments, the SPDE or trustee thereof shall satisfy the recognised stock exchange to which a listing application is made that each scheme of securitized debt instruments was offered to the public for subscription through advertisements in newspapers for a period of not less than two days and that applications received in pursuance of the offer were allotted in accordance with these regulations and the disclosures made in the offer document.

In case of a private placement of securitized debt instruments, the SPDE shall ensure that it has obtained credit rating from a registered credit rating agency in respect of its securitized debt instruments.

In case of a private placement of securitized debt instruments, the special purpose distinct entity shall file listing particulars with the recognised stock exchange, along with the application, containing such information as may be necessary for any investor in the secondary market to make an informed investment decision in respect of its securitized debt instruments and the SPDE shall promptly disseminate such information, as prescribed, in such manner as the recognised stock exchange(s) may determine from time to time. All credit ratings obtained including unaccepted ratings, if any, shall be disclosed in the listing particulars filed with the recognized stock exchange.

### Continuous listing conditions

The SPDE or trustee thereof shall submit such information, including financial information relating to the schemes, to the stock exchanges and investors and comply with such other continuing obligations as may be stipulated in the listing agreement.

### Trading of securitized debt instruments

The securitized debt instruments issued to the public or on a private placement basis, which are listed in recognised stock exchanges, shall be traded and such trades shall be cleared and settled in recognised stock exchanges subject to conditions specified by SEBI.

## ISSUANCE AND LISTING OF SECURITY RECEIPTS

### Eligibility

An issuer proposing to issue and list security receipts or only list its already issued security receipts shall comply with the provisions of chapter VIIA of SEBI (Issue and Listing of Securitized Debt Instruments and Security Receipts) Regulations, 2008.

Security receipts proposed to be listed shall:

- i. be issued in compliance with the applicable rules and guidelines, as framed by the Reserve Bank of India, from time to time;
- ii. be issued on a private placement basis;
- iii. comply with the provisions pertaining to issue of security receipts.

### Sale of security receipts by the existing holder

- Any existing holder of security receipts, who proposes to sell, whole or part of, its holding of security receipts to the qualified buyers on private placement basis, where such security receipts are proposed to be listed, may do so, in accordance with the provisions of Chapter VIIA of these regulations.

However, such sale by any holder of security receipts shall be permitted only if the holding is not less than fifty percent of the outstanding security receipts.

- A sale of security receipts by any existing holder of such security receipts under these regulations, shall be subject to the issuer compulsorily listing the security receipts before complying with the provisions of this chapter.

### Conditions for Listing of Security Receipts

An issuer may list its security receipts on a recognized stock exchange subject to the following conditions:

- (a) the security receipts have been issued on a private placement basis;
- (b) the issuer has issued such security receipts in compliance with the applicable laws;
- (c) the offer or invitation to subscribe to security receipts shall be made to such number of persons not exceeding two hundred or such other number, in a financial year, as may be prescribed from time to time;
- (d) the security receipts proposed to be listed are in dematerialized form;
- (e) the disclosures as provided in Regulation 38E of SEBI (Issue and Listing of Securitised Debt Instruments and Security Receipts) Regulations, 2008 have been made in the offer document;
- (f) the minimum allotment made to the qualified buyers is Rs. 10 lakhs;
- (g) such security receipts have been valued prior to listing;

However, such valuation shall not be more than three months old from the date of listing and shall be done by an independent valuer;

- (h) the security receipts have been rated by a credit rating agency registered with SEBI. However, such rating shall not be more than three months old from the date of listing.

The issuer shall comply with the conditions of listing of such security receipts as specified in SEBI Listing Regulations, 2015.

### Offer Document

- An issuer seeking listing of security receipts on a recognized stock exchange shall make such disclosures in the offer document as specified by the Reserve Bank of India from time to time, and as specified in Schedule VA of SEBI (Issue and Listing of Securitised Debt Instruments and Security Receipts) Regulations, 2008.

However, the offer document shall not contain any false or misleading statement and shall disclose all material facts.

- The offer document shall be made available for download on the web sites of stock exchanges where such securities are listed.
- In exercise of the powers conferred by sub-rule (7) of rule 19 of the Securities Contracts (Regulation) Rules, 1957, SEBI shall waive the strict enforcement of sub-rules (1) to (3) of the said rule in relation to listing of security receipts issued in terms of these regulations, subject to compliance with these regulations.

### Trading of security receipts

- The security receipts issued on a private placement basis, which are listed on recognised stock exchanges, shall be traded and such trades shall be cleared and settled in recognised stock exchanges subject to conditions specified by SEBI.
- The trading lot of the security receipts shall not be less than Rs 10 lakh.
- The trades of security receipts which have been made over the counter, shall be reported on a recognized stock exchange having a nation-wide trading terminal or such other platform as may be specified by SEBI.
- SEBI may specify conditions for reporting of trades on the recognized stock exchange or other platform.

### LOAN AGAINST SECURITIES

Banks and financial institutions come up with innovative ways to fulfill the monetary requirements of every individual as per their credit worthiness and paying capacity. One step in this direction has been Loan against Securities, popularly referred to as LAS. Under “Loan against Securities”, loan is advanced to a customer against pledge of securities or simply put loan against insurance policy, mutual funds, NSC and other securities. The list of approved securities against which LAS can be advanced varies from bank to bank, but primarily the following are considered to be approved securities against which LAS could be given.

1. Non-Convertible Debentures
2. Mutual Fund Units
3. NABARD Bonds
4. Dematerialised Shares
5. National Saving Certificates/Kissan Vikas Patra (Accepted only in Demat form)
6. Insurance Policies.

By pledging the securities held by the borrower, a loan against Securities is provided by a bank or a financial institution as an overdraft facility. The value of the overdraft limit that is advanced is determined on the basis of the securities that are pledged. The rate of interest is calculated only on the amount withdrawn and only for the period of utilization.

The advantageous part of pledging your securities is one that the borrower is able to get steady cash easily at the time of need and secondly the borrower need not be devoid of the benefits as a shareholder. This means that the borrower enjoys the rights of receiving dividends and bonuses along with gaining from the price movements in the shares. This facility is ideal to meet short- term financial needs and the interest rates are lesser than that in a personal loan.

#### **Illustration**

Zen Limited is in need of funds for its upcoming project and wishes to consider the facility of LAS. The company approaches the bank and pledges shares worth Rs. 10,00,000 held by it in Ten Limited, with the help of its Depository.

*Depository creates a pledge on said shares in the favor of the bank and the bank disburses the payment to Zen Ltd.*

*The pledge was created for 1 year. At the end of this tenure Zen Ltd. will repay the loan to the bank along with the interest, at the rate as decided and intimated by the bank at the time of disbursement, and the bank will release the shares to Zen Ltd.*

### Features of Loan against Securities

1. **Secured Loan** - Loan against securities is a secured loan as the bonds, shares, debentures or mutual funds owned by the borrower are kept as collateral security when this loan is advanced.
2. **Tenure** - The tenure of loan against securities is generally one year.
3. **Rate of Interest** - Generally, interest rates at which loan against securities is advanced varies from 12%-15% per annum.
4. **Processing Fees** - Banks and financial institutions usually charge approximately 2 % as processing fees.
5. **Loan Amount** - The loan amount for which the borrower may be eligible depends upon the type of security that is being offered. For example, in case equity shares are offered then the amount that is eligible would be 50% of the value of such shares.
6. **Prepayment Charges** - There are generally no prepayment charges.

### LOAN AGAINST PROPERTIES

Similar to loans against securities, this is a loan, banks grant against property owned by the prospective borrower. Banks take the property as security and based on the valuation of the property, they extend a loan, net of the margin fixed by them.

The types of Property against which LAP can be availed can range from owned residential properties g, self-occupied property, owned and rented property, owned land, owned commercial property, owned but rented out commercial property. The proceeds from these are used by borrowers for personal, business and consumption purposes. After due appraisal Banks sanction generally anywhere between 50% to 65% of the value of borrower's property. Banks offer repayment period of 10 to 15 years at competitive interest rates. For sanctioning loans against properties banks insist on creating a mortgage in their favour.

#### LESSON ROUND-UP

- Section 43 of the Companies Act, 2013 recognizes two kinds of share capital i.e. equity share capital and Preference share capital.
- A debenture being an attractive source of funding, is a long-term debt instrument issued by corporates and Government to secure fresh funds or capital.
- A bond is a debt instrument in which an investor loans money to an entity (typically corporate or government) which borrows the funds for a defined period of time at a variable or fixed interest rate.
- Indian entrepreneurs need private equity and debt products to meet the capital needs of their growth, restructuring, turn around or start-up plans. The main providers of this form of capital are private equity and venture capital funds which are channelled through Alternative Investment Funds (AIFs).
- According to Section 2(1)(z), "venture capital fund" means an Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model and shall include an angel fund as defined under Chapter III-A.

- ‘Angel Investor’ means any person who proposes to invest in an angel fund.
- A letter of credit is a document from a bank that guarantees payment and Bank Guarantee is a legal contract which can be imposed by law.
- Capital can be raised from international capital market in foreign currency by accessing foreign capital market. Funds raised through foreign currency are called as euro equity or debt.
- Indian companies are allowed to raise equity capital in the international market through the issue of GDR/ ADR/FCCB/FCEB.
- ECBs are commercial loans raised by eligible resident entities from recognised non-resident entities and should conform to parameters such as minimum maturity, permitted and non-permitted end-uses, maximum all-in-cost ceiling, etc.
- FCCBs/DRs may be issued in accordance with the Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 and Depository Receipts Scheme, 2014 respectively, as per the guidelines issued by the Government of India thereunder from time to time.
- “FDI” or “Foreign Direct Investment” means investment through capital instruments by a person resident outside India in an unlisted Indian company; or in ten per cent or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company.
- ‘Foreign Portfolio Investment’ means any investment made by a person resident outside India through capital instruments where such investment is less than 10 percent of the post issue paid-up share capital on a fully diluted basis of a listed Indian company or less than 10 percent of the paid up value of each series of capital instruments of a listed Indian company.
- Securitization is the transformation of financial assets into securities. Securitization is used by financial entities to raise funding other than what is available via the traditional methods of on-balance-sheet funding.

### GLOSSARY

**Bond:** A negotiable certificate evidencing indebtedness a debt security or IOU, issued by a company, municipality or government agency. A bond investor lends money to the issuer and, in exchange, the issuer promises to repay the loan amount on a specified maturity date. The issuer usually pays the bondholder periodic interest payments over the life of the loan.

**Eurobond:** Eurobonds are issued in a specific currency outside the currency’s domicile. They are not subject to withholding tax and fall outside the jurisdiction of any one country. The Eurobond market is based in London. Not to be confused with euro-denominated bonds.

**Foreign Currency Convertible Bonds:** It means bonds issued in accordance with this scheme and subscribed by a non- resident in foreign currency and convertible into ordinary shares of the issuing company in any manner, either in whole, or in part, on the basis of any equity related warrants attached to debt instruments.

**Equity Linked Instruments:** Equity Linked Instruments includes instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily or optionally convertible into equity.

**Infrastructure Fund:** Infrastructure fund means an Alternative Investment Fund which invests primarily in unlisted securities or partnership interest or listed debt or securitized debt instruments of investee companies or special purpose vehicles engaged in or formed for the purpose of operating, developing or holding infrastructure projects.

**Investable Funds:** Investable Funds means corpus of the scheme of Alternative Investment Fund net of expenditure for administration and management of the fund estimated for the tenure of the fund.

**Social Impact Fund:** Social Impact Fund means an Alternative Investment Fund which invests primarily in securities, units or partnership interest of social ventures or securities of social enterprises and which satisfies the social performance norms laid down by the fund.

**Unit:** Unit means beneficial interest of the investors in the Alternative Investment Fund or a scheme of the Alternative Investment Fund and may be fully or partly paid up.

**Non-resident Indian and Overseas Citizen of India:** Non-resident Indian and Overseas Citizen of India shall have the same meaning as assigned to such terms under rule 2 of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 made under the Foreign Exchange Management Act, 1999.

**Securitisation:** Securitisation means acquisition of debt or receivables by any special purpose distinct entity from any originator or originators for the purpose of issuance of securitised debt instruments to investors based on such debt or receivables and such issuance.

**Asset Pool:** Asset Pool in relation to a scheme of a special purpose distinct entity, means the total debt or receivables, assigned to such entity and in which investors of such scheme have beneficial interest.

**Credit Enhancement:** Credit Enhancement means any arrangement intended to decrease the likelihood of default on the securitised debt instruments, including subordination, insurance, letter of credit, over-collateralisation, undertakings and guarantees.

**Liquidity Provider:** Liquidity Provider means a person who agrees to provide funds to the special purpose distinct entity for settlement of payments due to investors in accordance with the schedule of payments contained in the terms of issue of the securitised debt instruments issued to them, in the event of any short term cash flow shortfalls of the special purpose distinct entity.

**Obligor:** Obligor means a person who is liable, whether under a contract or otherwise.

### TEST YOURSELF

*(These are meant for recapitulation only. Answer to these questions are not to be submitted for evaluation.)*

1. How is the Masala Bond more advantageous to the conventional source of funding from overseas sources?
2. Distinguish between REITs and InvITs.
3. What is an Alternative Investment Fund? Explain the different categories of an Alternative Investment Fund.
4. What do you understand by private equity? Discuss about different categories of private equity.
5. What do you mean by 'Green Debt Securities'? Explain.
6. What are the Non-based credit facilities provided by the bank?

7. ECBs are commercial loans raised by eligible resident entities from recognised non-resident entities. Comment.
8. What do you mean by Foreign Currency Exchangeable Bonds (FCEBs)? Distinguish between Foreign Currency Convertible Bonds (FCCBs) and FCEB.
9. Define Foreign Direct Investment.
10. Write short notes on: (i) Automatic Route (ii) Government Route.
11. What do you mean by securitization? Explain the securitization structure.

**LIST OF FURTHER READINGS**

- FAQs on External Commercial Borrowings available at <https://m.rbi.org.in/Scripts/FAQView.aspx?id=120>
- Master Direction - External Commercial Borrowings, Trade Credits and Structured Obligations [https://m.rbi.org.in/Scripts/BS\\_ViewMasDirections.aspx?id=11510](https://m.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510)
- FAQs on Funding Option available at <https://www.investindia.gov.in/faq-pdf/27/en>
- Bare Act - Foreign Exchange Management Act, 1999 (FEMA), Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 and other rules and regulations made thereunder
- SEBI Manual
- Premier on Companies Act, 2013
- Regulations/Rules/Guidelines/Circulars issued by SEBI, RBI, MCA etc. from time to time
- SEBI Annual Reports
- SEBI Monthly Bulletin
- Foreign Exchange Management Manual – Snow White
- SEBI (Foreign Portfolio Investors) Regulations, 2019
- SEBI (Issue and Listing of Securitised Debt Instruments and Security Receipts) Regulations, 2008.

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