Market Linked Debentures:
Motivations & Mechanisms

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Learning Scope

- Basic Overview
- Motivation & Risks
- Statistics
- Regulatory Framework
- Issue Mechanism
- Practical scenario
- Conclusion

Basic Overview

Meaning of Market Linked Debentures

- A type of Debt Security as defined in Reg. 2(1)(k) of NCS Regulations, 2021.
- Falls under the category of ‘Hybrid Securities’ that combines the features of plain vanilla debt securities and exchange traded derivatives.
- Coupon on MLDs is linked to the performance of an underlying security.

- What is a Debt Security?

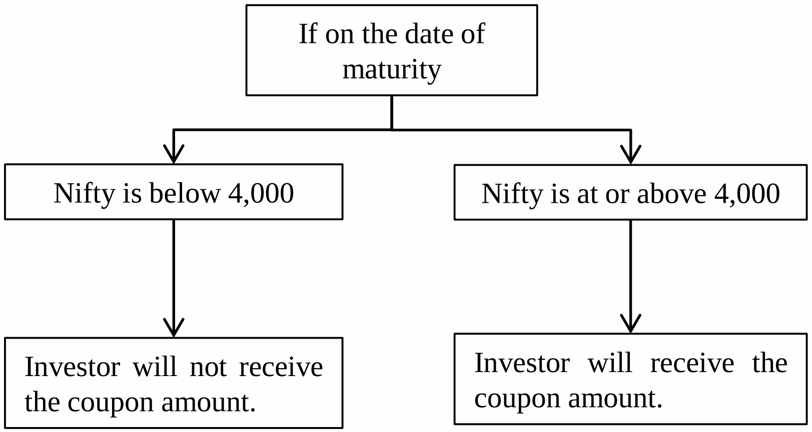
  Means non-convertible debt securities with a fixed maturity period which create or acknowledge the indebtedness.
- Other types of Debt Securities are: Green Bonds, Infrastructure Bonds, Fixed Deposits etc.

Understanding the difference

Basis of difference	**Plain Vanilla Debt Securities**	**Market Linked Debentures**
Risk	Issuer may default in payment, otherwise no risk.	Apart from risk of default, additional risk that in case the underlying underperforms, then no return maybe received.
Coupon certainty	Payment of coupon is certain	Coupon payment depends upon the performance of the underlying asset.
Payment frequency	Payment at regular intervals say monthly, quarterly, yearly etc.	Payment of interest + principal at the time of maturity

Illustration

- Sun Ltd. (“Company”) intends to raise 15 crores worth of capital through issuance of MLDs.
- The Company offered to pay an interest of 7.5% P.A. on the condition that the level of Nifty-50 will not fall below 25% of the level, it stood on the date of entering this covenant (‘initial fixing date’).
- Suppose, Nifty is at the level of 16000 on initial fixing date.



Types | Modes of Issuance | Tenure

MLDs are of two types:

Principal-protected: Principal amount is always protected, no matter whatever the condition maybe.

Non-principal protected: In case of non-fulfillment of certain conditions, principal amount may be lost. (excluded by the SEBI)

MLDs can be issued through:

- **Public issue**; or
- **Private placement**

However, private placement is the most preferred method of issuing the MLDs.

According to section 71 of CA, 13 **Maximum** tenure for which a debenture may be issued is **10 years.**

(Usually the tenure of MLDs ranges from 13 to 60 months)

Motivations & Risks

Motivation for the issuance of MLDs

Exemption from EBP mechanism

No liquidity crunch to the issuer

Allowed to issue 5 additional ISINs

Help issuer comply with SEBI guidelines of Min. 25% of fund raising through debt securities by large entities

Returns earned are taxed as LTCG @ 10%, if sold after holding for at least one year

Risks Associated

Complexity Risk:

Extremely complex to decode and won't be understood easily by the amateur investors.

Credit risk:

Issuer may default on either its interest payments or principal repayment.

Regulatory Risk:

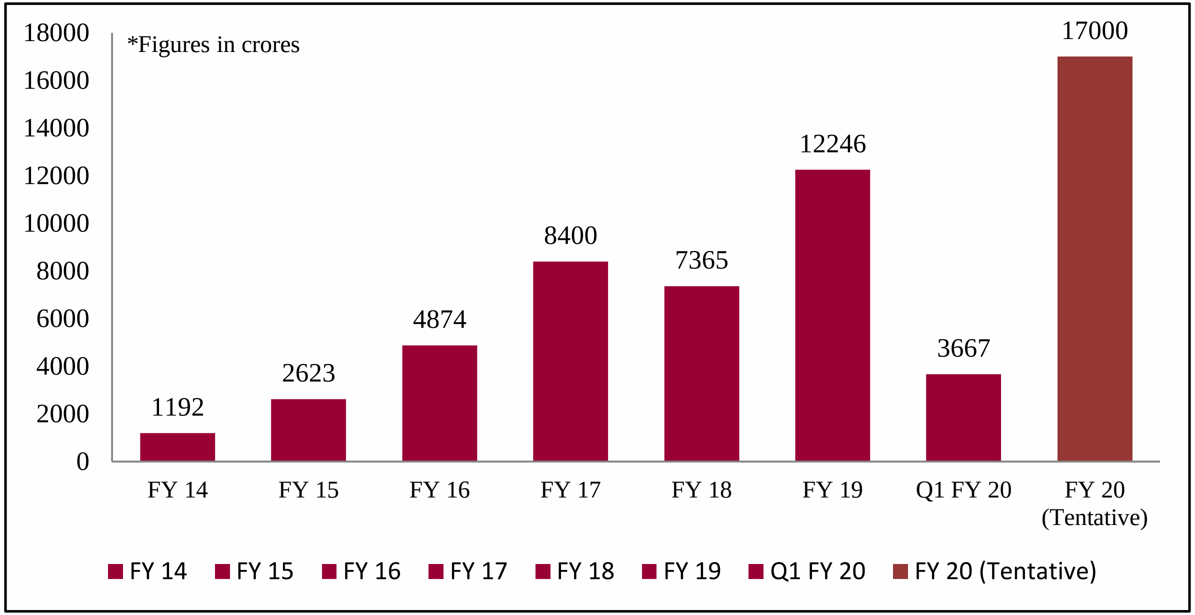
laws and rules may change and so the benefits available may be lapsed.

Liquidity Risk:

These instruments are traded less on SEs, hence quick liquidity may be difficult for the investor.

Statistics

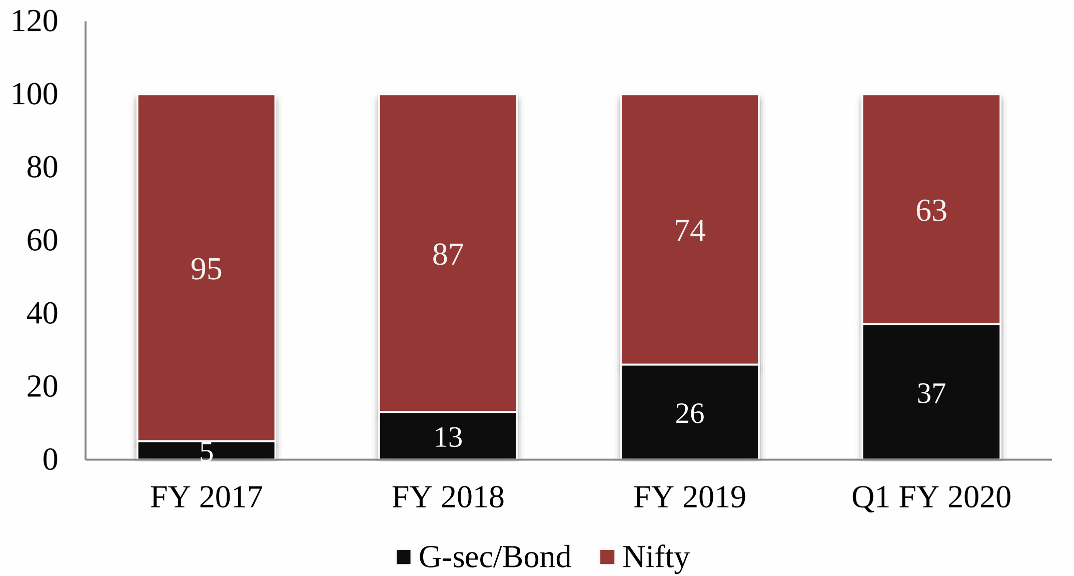
Issue Volume



Source: CARE Rating report on MLDs

The surge in the volume of issuance, that the MLDs have shown is evident above

Proportion of ‘G-sec’ and ‘Nifty’ as an underlying asset



Source: CARE Rating report on MLDs

Other type of common underlying assets preferred in the issuance of MLDs are:

- Currency like USD;
- Group of equity shares;
- Indices like S&P 500 index.

G-sec bond have shown a consistent surge as an underlying asset in the issuance of MLDs

Regulatory Framework

Laws governing the functioning of MLDs

- The Companies Act, 2013;
- SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021;
- The Depositories Act, 1996;
- SEBI (Depositories and Participant) Regulations, 2018
- Circulars issued by SEBI/NSE/BSE

- SEBI (Listing Obligation and Disclosure Requirements) Regulations, 2015
- SEBI (Debenture Trustees) Regulations, 1993;
- Income Tax Act, 1961;
- Indian Stamp Act, 1899;
- Regulator specific laws;

Issue Mechanism

Pre-issue Requisites

Issuer’s Eligibility

The issuer should have a minimum net worth of at least INR 100 Crores (SEBI circular).

Nature of the MLDs

- Must be principal protected;
- Minimum ticket size- Rs. 10 lakhs. (SEBI circular).

No Pending offers/Invitations

The Company should ensure that it has first completed the allotment of any previous issue. (Sec. 42 CA,13).

Security Cover for debentures

Ensure a security cover of hundred percent or higher to discharge the principal and interest thereon.

Dematerialised Issue

The Company is required to apply to the depository for the allotment of ISIN and issue of securities in the demat form.

Intermediaries identification

Issuer shall identify in advance the intermediaries like DT, CRA, Depository and Valuation agency.

Issue Roadmap

Step 1

Convene meeting of Board of Directors

Step 2

Obtain approval of:

- Shareholders- Increasing borrowing limits (Sec.180)
- Creditors- Creation of subsequent charge (Reg. 44)

Step 3

Enter into arrangement with:

- Depository (Reg. 7);
- Debenture Trustee (Reg. 8);
- Registrar (Reg. 9);
- Credit Rating Agency (Reg.10);
- Valuation Agency; (SEBI Circular)

Step 4

Simultaneously, application should be made for ISIN and DLT on boarding

Step 5

Creation of Recovery Expense Fund (Reg. 11)

Step 6

Application for In-principle approval (Reg. 6)

Step 7

Circulation of Letter of Offer

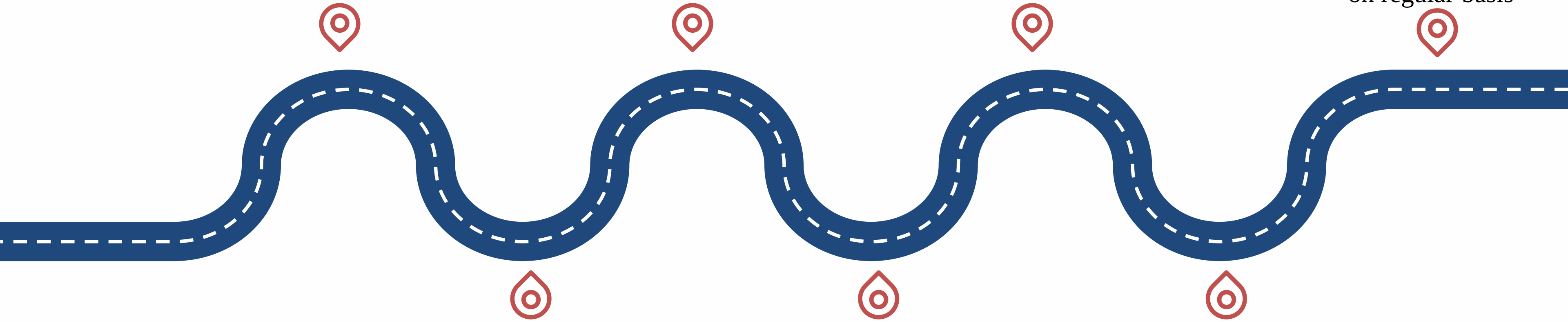
Step 8

Receipt of application money in the designated bank A/c and closure of the issue

Step 9

Convene Board Meeting for the allotment of securities

Post-issue Compliances



Filing of return of allotment

Utilization of Money

Payment of Stamp Duty

Execution of Debenture Trust Deed

Return of creation of charge

Application for Listing and payment of listing fees

Valuation of securities on regular basis

Practical Scenario

Case Studies

Case 1- 10 yr. G-sec. bond as underlying asset

Scenario	Redemption Value
If Final Fixing Level >= 25% of the Initial Fixing level	11,44,900
If Final Fixing Level < 25% of the Initial Fixing level	10,00,000

In this case, the first condition under which the coupon will be paid to the investor, is very likely to happen.

Case 2- Nifty 10 yr benchmark G-sec (clean price) Index as underlying asset

Scenario	Coupon
If Final Fixing Level > 50% of Initial Fixing Level	13.59%
If Final Fixing Level >10% and <= 50% of Initial Fixing Level	13.45%
If Final Fixing Level <= 10% of Initial Fixing Level	0%

In this case, the first two conditions are very likely to occur. Nevertheless, the difference between the coupons is less than even 1%.

Case Studies

Case 3- 10 yr. G-sec. bond as underlying asset

Scenario	Coupon
If Final Fixing Level>25% of the Initial Fixing level	6.65%
If Final Fixing Level<=25% of the Initial Fixing level	0.000%

The possibility that the G-sec will fall upto 25% of its initial level is highly inconsiderable. Hence, the investor will get the coupon amount at the redemption.

Case 4- Nifty-50 index as underlying asset

Coupon Amount	**A) If Final > 25%* Initial** **Principal Amount * 13.10%** **Or** **B) If Final <= 25% * Initial** **Nil**

Not even in the rarest case, Nifty will fall by 75% of its initial levels. Hence, the coupon payment is almost certain.

Conclusion

MLDs: A tool to gain regulatory arbitrage

- MLDs were meant to be an innovative type of instruments.
- Nevertheless, Indian bond market players have considered MLDs a way out of regulatory limitations.
- One can easily interpret that the conditions of the coupon rate, are far away from the reality.
- In India, the Market Linked Debentures are not actually linked to the market, but just a sophisticated charade of old-school plain vanilla bonds.

Thank you