Market Linked Debentures -
Adding Flavour to Plain Vanilla Bonds

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Overview (Executive Summary)

Over the past few years, market-linked debentures have been gaining a lot of popularity against their counterparts. These structured products come with unique features and various benefits, regulatory and otherwise, to issuers and investors as well. However, the concept of these debentures is yet unclear.

The Indian debt market has been showing great interest in these debentures and thus it becomes all the more important to understand the complexity behind these debentures.
Through this article, the author has tried to analyse the concept, features, advantages, regulatory framework and the scenario of the Indian debt market with respect to market-linked debentures.

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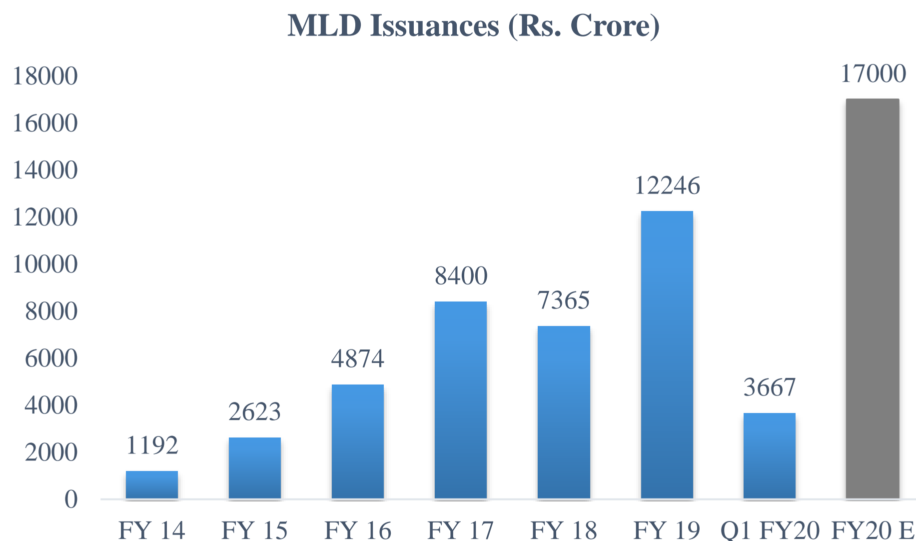
Introduction

Simplicity is the ultimate sophistication until it gets mundane and monotonous. While plain vanilla bonds are a simple and effective way of raising capital, Market-Linked Debentures ('MLDs') are a great way to bring flavour to debt fund raising.

MLDs, as the name suggests, are a type of debt security that take advantage of the performance of an underlying asset/index thereby attracting various issuers and investors to make use of such MLDs. MLDs have been gaining momentum in terms of issuance volumes in the recent past. The following diagram depicts the trend in fund raising through MLD issuances:



Source: CARE report on MLDs

CARE Ratings as per its Report on MLDs[1] ['CARE Report on MLDs'] had expected MLD issuances to increase to Rs.17,000 crore in FY20 led by higher MLD issuances by NBFCs/HFCs/MFIs for fund raising amid continued tight liquidity scenario. Further, as per CARE Ratings, investor's inclination to secure a competitive return on investment and capital protection was expected to continue auguring well for the overall MLD market.

The intriguing question which arises is, why are MLDs getting so popular? What distinguishes them from other kinds of debentures? We try to answer these questions in this write up.

Meaning of MLDs

MLDs fall under the category of 'structured products' or 'hybrid instruments. They are linked/ tied to the performance of an underlying index or security i.e. the return generated from MLDs is dependent on the performance of another instrument. If the underlying performs well, the return on MLDs is higher while the return drops where the underlying faces a slump.

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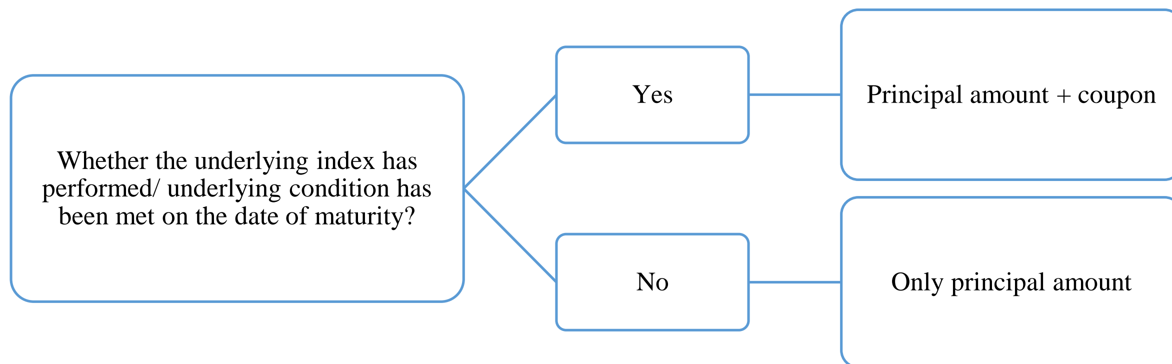
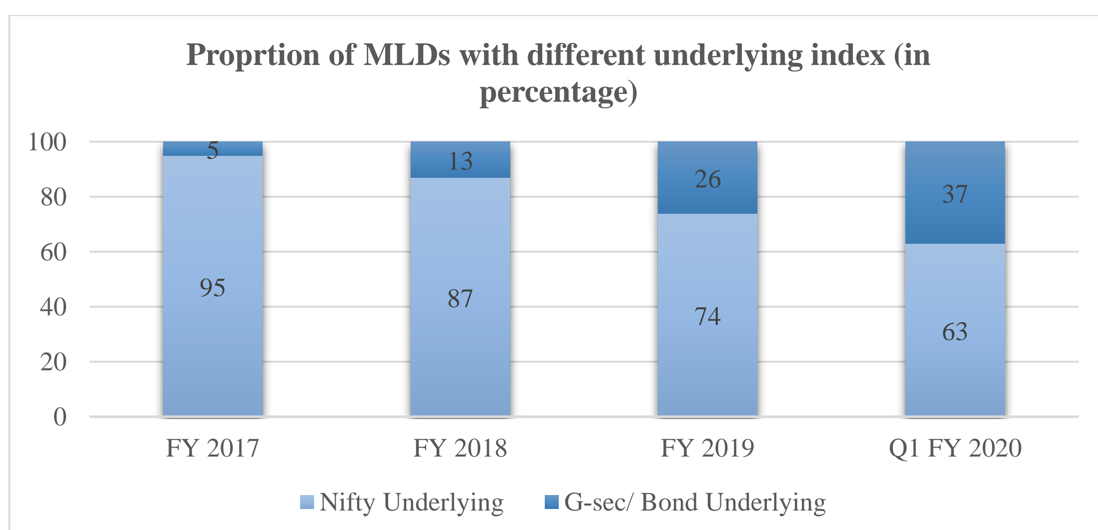
1 https://www.careratings.com/upload/MLDFiles/Article/Market%20Linked%20Debentures_Heading%20for%20a%20new%20high%20in%20FY20.pdf

Thus, MLDs usually offer positive returns at the time of redemption, based on the performance of an underlying asset/ index or condition, while guaranteeing principal/ investment amount back, even if there is a downside in the performance of the underlying asset/index such as NIFTY, equity, bonds, fixed-income securities etc. This makes MLDs a safer option than directly investing in such indexes which may cause loss on investment as well.



Type of underlying

There is no specific guideline on the type of underlying that MLDs should be linked to and is generally at the discretion of respective issuers. Thus, the underlying may range from an equity instrument to a government security ('G-sec') to an index such as Nifty. Also, a single or a pool of securities may be used as well. However, market practice reveals that the most common underlying used are G-secs and Nifty. As per CARE Report on MLDs, the number of issuances with underlying G-sec have continued to grow during Q1 of FY 2020 while Nifty has been the preferred underlying reference index for majority (63%) of the issuances in Q1 of FY20. The following diagram shows a trend in the underlying security since 2017.



Source: CARE report on MLDs

Can the underlying to be any condition?

It is to be noted, that MLDs are market-linked. This means that the underlying is required to be related to the market and not anything else. Thus, the issuer cannot link MLDs based on conditions that have no connection with the market, for instance, MLDs will earn interest rate of 10% if Mumbai has a rainfall of more than 250 mm between 4th August and 12th August, or if India wins the world cup in 2022.

Return on MLDs

Unlike their other counterparts, usually, MLDs do not fetch any regular and fixed coupon payoff and investors are directly paid at the time of redemption as one single bullet payment. Redemption amount consists of principal amount and coupon amount (return on MLDs) without any payments during the tenure of MLDs.

Now, such return portion at the time of redemption, depends on the performance of the underlying, which can vary depending on the final performance on the date of redemption. The gain from an MLD is ascertained at the time of its maturity and is dependent on how its underlying asset has moved.

Therefore, while the performance of the underlying at the end of tenure is most important as far as return on MLDs is concerned, we cannot say that the tenure during the MLDs have no impact, as the same will depend on the product features. For instance, there are MLDs with put option as well.

Types of MLDs

MLDs can either be principal-protected ('PP-MLDs') or non-principal protected ('NPP' MLDs'). The difference between the two is that in the case of the former, the principal amount of the MLDs is 'protected' while in case of the latter the principal is 'not protected'. Under PP-MLDs, the downside to the principal amount is protected. This means that the investor will enjoy the upward movement in the return on MLDs indefinitely but will have downside protection. Thus, whether or not there is a return on the security in terms of coupon pay off, the investor shall certainly receive the principal amount back. Thus, in case of downgrading of underlying, the investor shall be at break-even. However, in case of NPP-MLDs, the investors face a risk of losing even the principal amount. According to CARE Report on MLDs, PPMLDs accounted for 95% of the total issuances in Q1FY20.

It is also interesting to note that SEBI Circular on MLDs[2] ('MLD Circular') *(as discussed later)* only recognise PP-MLDs. This is because debentures are always principal protected while equity is latched with a risk of loss on investment. The moment the principal/ investment amount of any security is at risk, an equity element gets attached to such security. Since, PP-MLDs are pure debt, only such MLDs are recognised by the MLD Circular.

How do issuers manage to pay off PP-MLDs?

In order to be able to pay off at least the principal amount in case of PP-MLDs, issuers invest the portion of the principal amount in fixed income securities so that such securities yield the principal amount at the time of their maturity. The remaining portion is invested in call options which provide exposure to returns of equity index.

Tenure of MLDs

As per CARE, the tenure of MLDs ranges between 13 to 60 months depending upon issuers funding requirement. The average maturity of MLDs issued has been 2.89 years in FY19 as against average maturity of 2.92 years in FY18.

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[2] https://www.sebi.gov.in/legal/circulars/sep-2011/guidelines-for-issue-and-listing-of-structured-products-market-linked-debentures_20742.html

Manner of issue of MLDs

MLDs, like debentures, can be issued through public issue as well as by private placement. No restriction has been specified in this aspect. However, MLDs are majorly issued on a private placement basis.

Security creation with respect to MLDs

Usually, MLDs are secured by fixed or floating charge on the assets of the issuer.

Example of MLDs

Variable Coupon Rate

An issuer issues PP-MLDs linked to the performance of the underlying i.e. the return on MLD will be 40% of the upward movement in Nifty. At the time of maturity of such MLDs, if Nifty has moved 30% upward, then the rate of return on MLDs will be 40% of 30% i.e. 12%.

However, if the Nifty moves in a downward direction, there will be no return earned by the investor, but the principal amount of MLDs will be returned.

This is also known as variable coupon rate since the coupon rate varies as per the performance of the underlying. Variable coupon rate is also known as participation rate. Participation rate indicates the how much of the performance of the underlying will form part of the return to the investor. Thus, under variable coupon, there is a real and direct linkage of the return on MLDs to the performance of the underlying.

Fixed Coupon Rate

Another example is where the return on the MLDs will be based on an underlying condition i.e. in case Nifty rises by more than 50%, the rate of return will be 15%. However, if the rise in Nifty is up to 50%, then no return will be given and the investor will only receive his principal amount back.

This is also known as fixed coupon rate since the coupon rate is fixed and is dependent on the fulfilment of the underlying condition.

There are also various instances of MLD issuances where issuers combine fixed and variable coupon rates.

Difference between Vanilla Debentures and MLDs

Plain Vanilla Debentures	MLDs
Return	
Fixed and regular rate of return- monthly, quarterly, annually etc.	No regular return. Return paid at the time of maturity along with principal amount
Risk	
No additional risk apart from risk of default.	Higher and additional risk as no return maybe received (in case of PP-MLDs) or loss on investment/ principal amount (in case of NPP-MLDs) if the underlying moves downward.

Thus, MLDs consist of significant risks that are not included in a traditional debt security. Such risks include changes in the value of the underlying security/ index and the investor faces the risk of receiving less or no return and in some cases, loss on the investment amount as well.

Advantages of MLDs over other debentures

For issuers

- No fixed regular payment of coupon during the tenure of MLDs thereby not affecting liquidity.

Regulatory benefits for issuers

- Issuers are allowed to issue 5 additional ISINs over and above the limit of 12 ISINs in a financial year in case of non-convertible debenture. *[Pursuant to SEBI ISIN Circular[3]];*
- MLDs help issuers comply with SEBI guidelines[4] on fund raising by issuance of Debt Securities by Large Entities (25% of borrowing via Capital market).
- Exemption from Electronic book mechanism for issuance of securities on private placement basis. This is one of the major reasons that issuers choose MLDs for fund raising.

For investors

- Potential to earn higher returns than fixed income debt securities with a certain amount of risk involved;
- Exposure to various types of assets as underlying along with capital protection (in case of PP-MLDs).

MLDs- whether issued in their true sense or just a façade for regulatory arbitrage?

To understand the market of MLDs, we have collated information on various issuances (from the offer document available on stock exchange/ company's websites) and the same have been analysed below:

Instances	Underlying	Basis for coupon payoff*[5]	Likely/unlikely conditions (in terms of downside)
Case A	NIFTY 50	If final fixing level > 25% of initial level, coupon - 8.1767% (XIRR 8.000%) Suppose, Initial level (NIFTY 50) index = 11400 25% of initial level (NIFTY 50) = 2850 So, if final fixing level is above a value of 2850, then coupon pay off will be	**Conclusion -** This condition is highly **unlikely** to happen. Looking at past trends, the probability that NIFTY 50 would fall below the level of 2850 is very low.

[3] https://www.sebi.gov.in/legal/circulars/jun-2017/specifications-related-to-international-securities-identification-number-isins-for-debt-securities-issued-under-the-sebi-issue-and-listing-of-debt-securities-regulations-2008_35215.html

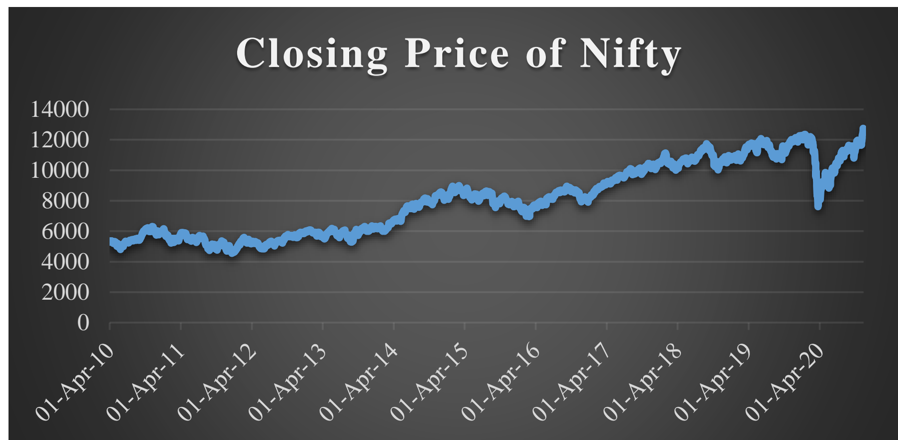
[4] https://www.sebi.gov.in/legal/circulars/nov-2018/fund-raising-by-issuance-of-debt-securities-by-large-entities_41071.html

[5] Here, companies observe the value of the underlying at the start i.e. initial date/ initial fixing level and compare the same with the performance of the underlying at the end of the tenure i.e. final date/ final fixing level. This determines the return on MLDs. Some companies calculate the performance by averaging values on various dates.

Instances	Underlying	Basis for coupon payoff*[5]	Likely/unlikely conditions (in terms of downside)
		8%. If final fixing level is below 2850, coupon will be 0%.	
Case B	NIFTY 50	If Final >= Initial, Coupon =Principal Amount * 20.50% If Final < Initial, Coupon = Principal Amount * 19.65%	**Conclusion-** • This is a likely condition. However, in all cases, the investor is going to receive coupon payoff, even if the underlying performs negatively, there is a payoff. • The level of rise in Nifty is not related to the return that the investor will receive. i.e. if the initial level is 10,000 and Nifty either rises to 20,000 or 10, 200, the return will be the same. • Difference between the coupon rates in both the cases i.e. if the underlying performs or not, is less than 1%.
Case C	G-sec	Initial fixing level is 105.94 (which is the price of G-sec on initial fixing date) **Conditions are summarized hereunder with illustration -** If final fixing level is >=79.455 - then coupon will be 8% If final fixing level is <79.455 but >= 26.485 then coupon will be 7.95% If final fixing level is <26.485 then coupon will be 0%	**Conclusion -** The downside condition is highly **unlikely** to happen. **The probability that the price of the G-sec on final fixing date will fall below 26.485 from a level of 105.94 is very low**. In fact, we have also seen that on final fixing date the price of the G-sec was actually **108.17** which is higher than the initial fixing level.
Case D	NIFTY 50	Intial level- average of 6 observations Final level- average of 6 observations Nifty performance- final level/initial level - 1 Fixed coupon- 26.70% Participation rate (variable component)- 85% Coupon payoff- If Final Level >= Initial Level, Principal + Max (Fixed Coupon, Participation rate * Nifty Performance) Else, If Final Level < Initial Level; Principal + Fixed Coupon	Conclusion- This is a likely condition. Here the coupon payoff is a combination of fixed and variable part (Directly depending on the performance of nifty) Even if the underlying preforms negatively, the investor will still earn the fixed component along with principal.

Instances	**Underlying**	**Basis for coupon payoff***[5]	**Likely/unlikely conditions (in terms of downside)**
Case E	NIFTY 50	If Final Fixing Level <= 25% of Initial Fixing Level: 0.000% If Final Fixing Level > 25% of Initial Fixing Level: 7.4273% p.a. (XIRR 6.95% p.a.) Suppose, Initial level (NIFTY 50) index = 9106.25 25% of initial level (NIFTY 50) = 2276.56 So, if final fixing level is above a value of 2276.56, then coupon pay off will be 6.95%. If final fixing level is below 2276.56, coupon will be 0%.	**Conclusion -** This condition is highly **unlikely** to happen. Looking at past trends, the probability that NIFTY 50 would fall below the level of 2376.56 is very low.
Case F	G-sec	If Final Fixing Level >=25% of the Initial Fixing level, then coupon+ principal If Final Fixing Level < 25% of the Initial Fixing level, then only principal	**Conclusion -** This condition is highly **unlikely** to happen. Looking at past trends, the probability that the G-sec would fall below 25% of the initial level is low.
Case G	10 year G-sec	Underlying performance- FL/ IL * 100 Coupon payoff- If UP >= 75% of IL- 8.45% If UP < 75% but >= 25% of IL , then 8.40% If UP < 25%, then 0	**Conclusion-** This condition is highly unlikely to happen. Looking at past trends, the probability that G-secs would fall below 25% of the IL is low. Also, difference between the two coupon rates is 0.5%.

The above issuances are either linked to NIFTY or G-secs. Many of these consist of conditions where no coupon will be paid if the Nifty or G-sec falls below 25% of the rates prevailing on the initial dates. However, market trends show that the likelihood for Nifty to see such a massive downfall is very low.



Our observation:

On an analysis of the above issuances, we observe that most of the MLDs in the market are laden with downsides that are highly unlikely to take place. This means that the chance that the investor will not receive any coupon is dependent on a condition that is almost impossible to happen and thus in most cases, the investor is bound to receive the interest. Such MLDs, except their name, do not differ much from plain debentures as far as coupon payoff is concerned.

Thus, MLDs may be used issuers a tool to attain regulatory arbitrage (in the form of relaxations from EBP, ISIN norms, etc.), by using structures where the debentures might 'appear' to be 'market-linked', but in effect, are not so, as the link itself is illusory.

The question that then arises is that, what are the difficulties that issuers face with the EBP, that drive them to shift towards MLDs.

Difficulties faced under EBP

SEBI introduced the EBP with a view to make participation in the privately-placed bond market more inclusive. The private placement market in India is completely bespoke in nature, and issuances are almost completely OTC negotiations. In order to bring more transparency and allow larger participation, the EBP mechanism was introduced.

However, most of the issuers have been strongly critical of the EBP. There are various contentions put forth by the stakeholders:

- Most issuers confided that irrespective of the EBP, the practice of the market being bespoke in nature, continues. The issuers still negotiate the private placement on OTC basis, and then place the offer on the EBP.
- Frequent issuers say that including all elements of the process – the time for uploading of the offer documents, minimum time to be allowed to the investors, etc., between the time the company has done informal book-building to the actual date of subscription, a time period of 6-7 days may elapse. Debt markets may be sensitive; situation may change in the meantime. Hence, there have been situations where firm intent to subscribe has been stuck due to the procedural time on EBP.

Further, electronic bidding platforms are there in several other markets – however, in most cases, these are private bidding engines, and are optional.

Thus, due to the above reasons, the mandatory nature of the EBP has made certain issuers skeptical of the platform.

Regulatory framework governing MLDs

- MLDs, being a type of debt security, issue and listing of MLDs is governed by the same regulatory framework for issuing and listing any other debenture such as plain vanilla NCDs. The issuer of MLDs, will have to thus comply with the provisions of the Companies Act, 2013 and rules framed thereunder as well as, SEBI (Issue and Listing of Debt Securities) Regulations, 2008 ('ILDS Regulations') in case the MLDs are to be listed on a stock exchange.

- An additional requirement in case of MLD issuances arises from the MLD Circular dated 28th September, 2011, which lays down the 'Guidelines for issue and listing of structured products/ Market Linked Debentures.

MLD Circular

It was observed by SEBI that hybrid instruments are issued that combine features of plain vanilla debt securities and exchange traded derivatives issued through private placements and listed on stock exchanges. These instruments differed from debentures in their nature and risk-return relationship and thus **additional** disclosures and other requirements for issue of such instruments that sought listing on stock exchanges were prescribed by SEBI through these guidelines. *[The MLD Circular provides additional requirements over and above all other requirements as per various laws on debentures]* Requirements in relation to MLDs through the circular have been listed in Annexure 1:

Conclusion

Although MLDs come with many feathers in the hat, investors are required to be cautious while investing in these securities due to additional exposure. Therefore, such instruments are usually favourable to HNI and UNHI who are capable of investing in and understanding high risk instruments. Thus, MLDs seem to be an attractive leeway for issuers from traditional debentures and an appealing investing opportunity for investors.

However, the Indian bond market has seen MLDs as an escape route from regulatory requirements. MLDs are issued not in their true sense but only as a disguise so as to gain regulatory advantage as compared to plain debentures.

Annexure 1

Sr. No	Particulars	Requirement
	Applicability of the MLD Circular	Applicable to structured products/ MLDs by whatever name called including all securities where: - Underlying principal component is in the form of debt securities *[as defined under regulation 2(d) of ILDS Regulations]* and - Returns are linked to market returns on other underlying securities/ indices. Thus, all securities that fulfil the above conditions will be covered under the MLD Circular irrespective of the name used.
	Type of MLDs Covered	PP-MLDs NPP-MLDs are not considered as debt securities under regulation 2(d) of ILDS Regulations.
	Eligibility criteria for issuers	Minimum net worth of at least 100cr Such net worth will be calculated as per definition under ILDS Regulations which further refers to definition of net worth under Companies Act, 2013. Due to absence of any express requirement and counterintuition for requirement of maintenance of net worth beyond the time of listing, it is to be understood that the requirement of net worth will be applicable only at the time of listing.
	Minimum Ticket Size	Minimum subscription/ allotment - Rs. 10 lakhs Face value to be determined at the discretion of the issuer.
	Additional Disclosure Requirements in Offer Document:	i. Credit rating by any registered CRA bearing the prefix 'PP-MLD' denoting Principal Protected Market Linked Debentures followed by the standardized rating symbols for long/ short term debt. ii. A detailed scenario analysis/ valuation matrix showing value of the security under different market conditions such as rising, stable and falling market conditions are to be disclosed in a table along with a suitable graphic representation. iii. A risk factor should be prominently displayed, stating that such securities are subject to model risk, i.e., the securities are created on the basis of complex mathematical models involving multiple derivative exposures which may or may not be hedged and the actual behavior of the securities selected for hedging may significantly differ from the returns predicted by the mathematical models. iv. A risk factor should be prominently displayed stating that in case of PP-MLD, the principal amount is subject to the credit risk of the issuer whereby the investor may

Sr. No	Particulars	Requirement
		or may not recover all or part of the funds in case of default by the issuer. Wherever indicative returns/ interest rates are mentioned in the IM in percentage terms, such figures are to be shown only on annualized basis. v. A disclosure that the latest and historical valuation for such securities will be available on the websites of the issuer and of the valuer appointed for the purpose. vi. All commissions by whatever name called, if any, paid by issuer to distributor for selling/ distribution of such securities to end investors are to be disclosed in the offer document. vii. Conditions for premature redemption of such securities, if any, are to be clearly disclosed in the offer document.
	Safeguards for primary issuance and sale of securities to retail investors	i. The intermediary that sells the security to the retail investor should be a SEBI regulated entity. ii. The intermediary should ensure that investor understands the risks involved and is capable of taking the risk posed by the MLDs and should also satisfy itself that securities are suitable to the risk profile of the investor. iii. The intermediary has to provide to the investor the offer document, whether or not the investor has made a specific request for the same. iv. The intermediary has to provide the investor guidance on obtaining valuation for the securities, i.e., the locations where such information would be available (issuer or the third party). v. The intermediary should provide the investor with guidance on exit loads/ exit options/ liquidity support, if any, etc., being provided by the issuer or through the secondary market.
	Valuation of MLDs	i. It is mandatory for an issuer of MLDs to appoint a third party valuation agency which should be an agency appointed by Association of Mutual Funds in India (AMFI) for the purpose of carrying out valuation[6]. ii. The valuer has to publish on its website and also provide to the issuer, value of the securities at a frequency of not less than once in a calendar week. The issuer is also required to provide to an investor the valuation, whenever investor asks for it.

[6] Earlier the same was required to be done by a CRA. However, since CRAs have been prohibited to carry out any activity other than rating of securities post 30th May, 2020, amendment made by SEBI vide Circular dated July 13, 2020.
https://www.sebi.gov.in/legal/circulars/jul-2020/guidelines-for-issue-and-listing-of-structured-products-market-linked-debentures-amendments_47053.html

Sr. No	Particulars	Requirement
		iii. The cost incurred for valuation is to be disclosed in the offer document. The issuer cannot charge the investor for such services. iv. The issuer is also required to make the valuations available on its website

Other relevant articles-

1) Listing of equity linked/market linked securities – SEBI tightens it a bit more – http://vinodkothari.com/wp-content/uploads/2017/04/Note-on-guidelines-on-issue-and-listing-of-equity-linked-debt-securities.pdf

2) COVID- 19 and Debenture Restructuring http://vinodkothari.com/2020/04/covid-19-and-debenture-restructuring/

3) Report on Corporate Bonds in India http://vinodkothari.com/wp-content/uploads/2020/01/Final-Presentation_world-bank_corporate-bonds.pdf