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The new Sebi norms are effective from 1 July. **(Photo: Reuters)**

Sebi's move to allow 'defaulted' debt trading a shot in arm for mutual funds

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Industry experts say the move to allow trading of default category debt papers and bonds will allow sellers such as mutual funds to exit exposures faster to return money to investors

MUMBAI : Market regulator Sebi's new framework which enables trading in defaulted debt is likely to create a distressed bond market in India potentially allowing asset management companies among others to return money to investors faster, said industry experts. While there is a market for stressed bank loans in India, where several large global distressed funds and Asset Reconstruction Companies (ARCs) are active, industry experts maintain that the move to allow trading of default category debt papers and bonds will allow sellers such as mutual funds to exit exposures faster to return money to investors.

"This is an attempt to create liquidity for securities that at present would be rendered illiquid in case of a default. All in all, it seems that this new framework will give rise to a distressed bond market in India, where more experienced hands could come and buy these bonds. Sebi is trying to create new avenues to deal with emerging issues in debt, distressed assets and ensure that they do not face legal impediments," said Ajay Shaw, Partner, DSK

Legal. According to a senior executive at a distressed asset fund, the move will be beneficial as it will lead to development of the stressed debt market in India.

"The operational framework is a prompt move by the Sebi to allow secondary sale for trapped debt investors like mutual funds and retail investors to recover whatever they can. Distress investors may buy such heavily discounted bonds, but only through securities receipts (SRs) imposing an unnecessary partnership with and dependence on, ARCs. Funding 15% of such SRs could also be a challenge for ARC. There is a need to operationalize the framework for foreign investors to directly buy non-performing assets. Despite opportunities and interests, foreign investors find it difficult to participate due to regulatory issues," said Ruchir Sinha, co-head, private equity and M&A at law firm Nishith Desai Associates

Sebi's move particularly comes as a shot in the arm for bond holders such as mutual funds which typically have lesser legal remedies for recovering assets that have gone bad. This comes at a time when many issuers are struggling to honour their debt obligations in view of the covid-19 related financial hardships. At present the exchanges suspend trading/reporting of trades on debt securities before the redemption or maturity date. Depositories impose restriction on off-market transfers that restricts tradability on and after the redemption date. Leaving little room for bond holders such as mutual fund to sell these bonds.

"Since there is already a way of trading stressed loans, it is time we have something similar for stressed bonds as well. This facility is available in other countries at the moment and I see buyers like asset reconstruction companies (ARCs) and distressed asset funds showing interest in these bonds," said the executive working at the distressed fund.

According to Sudip Mahapatra, partner at law firm S&R Associates, distressed debt funds, hedge funds and asset reconstruction companies will be the primary buyers of these distressed debt securities. According to a debt fund manager in a mid-sized fund house, this lays the foundation of the new market however it would take some time to develop. Debt funds which have side-pocketed assets to the tune of ₹4000 crore can specially make use of this framework, he said. "Perhaps not all the ARCs, or distressed funds have an appetite for these bonds currently but this lays the foundation for more experienced hands to get into the space of defaulting bond and ensure recoveries," he said declining to be named.

As per the new norms effective 1 July, within 2 working days from the date of intimation of default on payment obligations, the depositories in co-ordination with stock exchanges shall update the ISIN (code for stocks and debt securities) master file and lift restrictions on transactions in such debt securities.

Nirmal Gangwal, founder and chairman of Brescon & Allied Partners LLP, a debt restructuring advisory firm concurs that certain things need to change before this can become effective.

“If a debenture goes for a default, in India there are no takers for it as our market is not mature and liquid enough. Secondly, the security structure and the enforcement of security is very convoluted in India, whether it is the NCLT or the DRT, the investor is at the mercy of the system. This will take some time and until the security enforcement is simplified, no investor would be willing to buy these bonds," he said.