

6. Masala Bond- Economy

The Enforcement Directorate (ED) has issued show-cause notices to the Kerala Infrastructure Investment Fund Board (KIIFB) for alleged FEMA violations, specifically investigating the use of Masala Bond proceeds for land acquisition, which is a prohibited end-use under RBI regulations. While KIIFB asserts compliance and has fully repaid the bonds, the ED contends that diverting funds for "land purchase" breaches the External Commercial Borrowing (ECB) norms.

Context and Background- The KIIFB Case

The Current Issue- The Enforcement Directorate (ED) has issued show-cause notices (November 2025) to the Kerala Infrastructure Investment Fund Board (KIIFB).

Allegation- Potential violations of the Foreign Exchange Management Act (FEMA) and RBI regulations.

Transaction Details- In 2019, KIIFB raised ₹2,150 crore via Masala Bonds listed abroad to fund state infrastructure.

Repayment Status- The entire amount was repaid by March 2024.

Specific Areas of Scrutiny

Prohibited Usage- The ED is investigating the alleged use of ₹466.91 crore for land purchases.

Regulation- Under External Commercial Borrowing (ECB) and Masala Bond norms, using proceeds for real estate/land purchase is generally prohibited.

Institutional & Political Concerns-

CAG Flag- The Comptroller and Auditor General (CAG) had previously questioned the validity of the RBI approval and flagged these bonds as "off-budget borrowings," raising concerns about the state's fiscal transparency.

Political Timing- With local body elections approaching in 2025, the issue has sparked accusations between the LDF government and the Opposition.

Masala Bond

Definition- Masala bonds are rupee-denominated debt instruments. They are issued in foreign markets (overseas) by Indian entities.

Core Distinction- Unlike traditional External Commercial Borrowings (ECBs) where loans are raised in dollars or euros, Masala bonds allow borrowers to raise money in Indian Rupees (INR).

Historical Origin- The first Masala bond was issued in October 2013.

Issuer- The International Finance Corporation (IFC) (a World Bank Group institution).

Program- It was part of a USD 2-billion offshore rupee programme.

Key Features of Masala Bonds

Rupee-Denominated Nature- The bonds are issued overseas, but they are priced and repaid in Indian Rupees.

Currency Risk Transfer

Crucial Benefit- The exchange rate risk (fluctuation of the Rupee) is borne by the foreign investor, not the Indian issuer. If the Rupee weakens, the issuer still pays the agreed Rupee amount, protecting their balance sheet.

Jurisdiction and Listing- Issued in international financial markets. Commonly listed on exchanges like the London Stock Exchange (LSE) or Singapore Stock Exchange.

Eligibility

Issuers- Both government bodies (like KIIFB) and private companies (like HDFC) can issue them (subject to RBI approval).

Investors- Must be from FATF-compliant (Financial Action Task Force) countries and IOSCO-regulated markets (International Organization of Securities Commissions). Multilateral agencies are also eligible.

Interest Rate Dynamics- These bonds typically carry higher yields (interest rates) compared to bonds in the investors' home markets.

Reason- The higher rate compensates the investor for taking on the currency risk.

Current Status and Decline

Growth Trajectory- 2013–2017- Rapid growth, peaking at over USD 5 billion in issuances by 2017. 2018–

Present- Steep decline. 2021–2024- Annual issuances fell to near-zero, with only isolated transactions.

Currency Impact- The Indian Rupee depreciated nearly 30% between 2013 and 2022, making returns volatile for investors and reducing the attractiveness of the instrument

Reasons for the Decline of Masala Bonds

The fading popularity of Masala bonds is attributed to a combination of market dynamics and regulatory changes-

Depreciating Rupee (Investor Risk)- Since the bonds are rupee-denominated, foreign investors bear the full loss if the currency falls.

Data- The ₹ depreciated by nearly 18% between 2018 and 2020, eroding investor confidence.

Higher Cost of Borrowing (Issuer Disinterest)- Global interest rates hardened between 2022–24. To attract investors, issuers had to offer high coupon rates (often 9–10%). Comparison- Domestic bond markets offered cheaper rates of 7–8%, making overseas borrowing expensive.

Tighter RBI Regulations- The RBI strengthened guidelines for ECBs and Masala Bonds.

Restrictions- Stricter end-use norms (e.g., prohibition on land purchase, which affects KIIIFB) and a mandatory minimum maturity of 3–5 years.

Stronger Domestic Bond Market- India's corporate bond market has deepened significantly.

Growth- Annual corporate bond issuance crossed ₹40 lakh crore by 2023.

Shift- Major issuers like HDFC (an early adopter of Masala bonds in 2016) shifted entirely to domestic bonds due to simpler regulations and competitive yields.

Global Risk Aversion- Post-COVID-19 and global monetary tightening led to foreign investors exiting Emerging Market (EM) local-currency debt.

Impact of Rupee Internationalisation on Masala Bonds

The push to internationalise the INR has paradoxically reduced the immediate need for Masala bonds-

Alternative Avenues for INR Exposure- Mechanisms like Vostro accounts and bilateral currency arrangements allow foreigners to hold INR directly. Countries like Russia, UAE, and Sri Lanka now settle trade in Rupees, giving them "natural" INR exposure without needing to buy bonds.

Reduced Need for Risk Transfer- Masala bonds were designed to transfer currency risk. As internationalisation stabilizes the Rupee (via stronger forex buffers and global demand), the *desperation* to offload currency risk diminishes.

The Liquidity Constraint- Masala bonds require a deep offshore INR market, which has not fully developed.

Example- The London Stock Exchange masala bond market saw almost no large new issuances after 2020 because offshore INR liquidity remains thin compared to the USD or EUR.

Conclusion

Masala bonds started as a promising tool to attract global capital without currency risk for Indian issuers. However, they have transitioned from a mainstream borrowing avenue to a niche instrument.

Primary Drivers of Decline- High currency volatility, rising borrowing costs, regulatory tightening on end-use (like land), and the maturation of India's domestic bond market.

Source- <https://www.thehindu.com/news/national/kerala/what-is-the-kerala-masala-bond-probe-explained/article70345495.ece>