High net worth individuals may ditch market-linked debentures

Post-tax yields of MLDs set to shrink; alternatives like commercial real estate, venture debt may find favour

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HNIs to see yields squeeze in MLDs

How MLDs worked?

MLDS ACTED like debt insturments, where the principal was protected. However, there was slight difference. Coupons were linked to performance of another instrument—Nifty Index or government security. In theory, coupons could be withheld if performance of linked instruments breached certain thresholds, but these were highly unlikely events.

MLD market size* (Outstanding) ₹1 trillion+

Why HNIs preferred MLDs?

REGULAR DEBT instruments were taxed at tax-slab rate of the investor, which in the case of HNIs could be 30%. MLDs were taxed like equity instruments, which meant flat 10% tax-rate on gains if holding period exceeded 12 months. Due to this tax-advantage, MLDs were large chunk of HNIs' debt portfolio.

Crisil estimates MLD issuances to double to ₹20,800 cr in FY23 vs FY21

How were coupons paid?

Coupons are only paid at the time of maturiy along with the principal. This is known as pay-off as these payments are what the investor stands to gain on his or her original investment in an MLD.

*Sourced: Primedatabase.com

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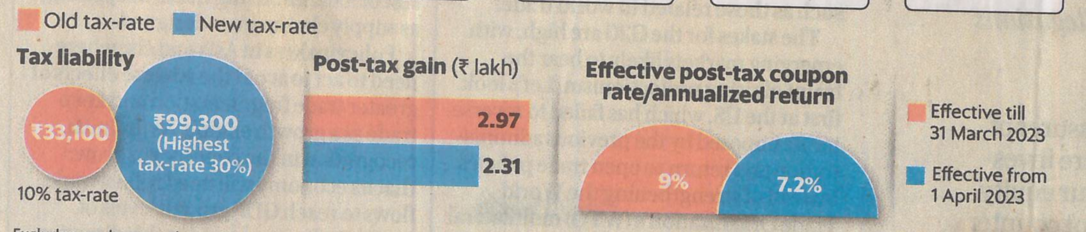
How Budget changed MLD maths

Investment	Coupon rate/return payable (annualized)	Tenure	Maturity value	Capital gains
₹10 lakh	10%	36 month	₹13.31 lakh	₹3.31 lakh



Excludes surcharge and cess, investment, coupon rate, tenure are assumed

Short-term capital loss can be used to set-off short-term capital gains

PARAS JAIN/MINT

Union budget 2023 has taken away the taxation arbitrage hitherto enjoyed by market-linked debentures (MLDs). So far, MLDs attracted just 10% tax if held for more than 12 months and so had become a firm favourite among high net-worth investors (HNIs).

Unlike MLDs, any debt instrument held for less than 36 months attracts short-term capital gains (STCG) tax, wherein such gains are taxed at the income tax slab rate of the investor. In the case of HNIs, this can be 30%—the highest tax slab-rate.

So far, MLDs enjoyed the same tax treatment as that of an equity security, even though these behaved like debt instruments. These were taxed at just 10% rate if held for more than 12 months, which is the holding period required for equity gains to be eligible for long-term capital gains (LTCG) tax. Hence, HNIs looking for a debt instrument preferred to invest in MLDs.

WHAT HAS CHANGED NOW?

The budget proposals effectively mean that regardless of the holding period, MLDs would attract STCG and be taxed at the tax-slab rate of the investor, which can be as high as 30% in the case of HNIs.

The budget also proposed to define MLD as a security which has an underlying principal component in the form of a debt security and the returns are linked to market returns on other underlying securities or indices.

The changes applicable to MLDs make them much less attractive for HNIs (those at highest income tax-slab rate)who had opted for these products for higher post-tax returns.

Earlier, an MLD from a double A-minus issuer would offer post-tax yield of 9% (considering the LTCG tax rate of 10%). Now, the post-tax yield will come down to as low as 7.2% for the same holding period, assuming the highest income tax-slab rate of 30%.

Let's take an example. Suppose you invested ₹10 lakh in an MLD with a maturity of 36 months. You would not only get back your principal of ₹10 lakh, but also additional coupon payments at the time of maturity. This would amount to ₹13.31 lakh after three years, which would translate into capital gains of ₹3.31 lakh. Post-tax, this would come down to ₹2.97 lakh (LTCG tax rate of 10%; tax liability of ₹33,100). Such a gain would now come down to ₹2.31 lakh (STCG tax rate of 30% at highest tax-slab; tax liability of ₹99,300).

The government has not specified any grandfathering clause as yet. This implies that the MLDs issued even before the Budget will be subject to these new rates. Only those MLDs that have been redeemed, sold or have matured before 31 March will not be impacted by the changes. The new rates will be effective 1 April 2023.

"Issuers may call back the MLDs for early redemption, if the covenants allow, before 31 March. This will be particularly possible where the bonds have already had a vintage of at least 12 months to qualify for LTCG rate of 10% before new rates come into play," says Aanchal Kaur Nagpal, manager (non-banking regulations and corporate laws) at Vinod Kothari consultants.

MLDs that have been redeemed, sold or have matured before 31 March will not be impacted by the new changes

HOW MLDS WORK

Most MLDs issued in India are principal-protected MLDs—the principal is protected just like any other debt instrument and coupon payment (payable at the time of maturity) is linked to performance of another market index or another instrument.

The latter gives the impression that MLDs are slightly different than regular debt investments. In reality, however, the chances of the additional coupon payment being suspended is contingent on events that are extremely unlikely over the short term.

For example, an MLD could be issued on the condition that there would not be any additional coupon payment at the time of maturity if the Nifty index corrects over 75% or G-Sec bond price was to rise by 25%.

Usually, MLDs have maturities of anywhere between 13 months and 36 months. The final observation date of the linked instruments (Nifty or G-sec) would usually be two-three months before the maturity date.

As these events—the Nifty index correcting over 75% or G-Sec bond price rising by 25%—are highly unlikely, MLDs in effect functioned like any other coupon-bearing debt instrument with usually fixed rates.

The coupon rate or yield is essentially the return payable to the investor at the time of maturity, which is called pay-off.

Several non-bank financial companies (NBFCs) issue MLDs to raise debt capital. "For NBFCs that were not able to raise capital from banks, these instruments had become a sizeable source of funding. For some NBFCs, raising capital through MLDs would be a challenge now, unless they are willing to raise their MLD rates," points out Sanjay Agarwal, senior director, CARE Ratings.

MLDs also offered flexibility to NBFCs. Regulations stipulated by the Securities and Exchange Board of India (Sebi) say that companies issuing non-convertible debentures (NCDs) can only have nine securities maturing in a given financial year. However, if the NBFCs also issue MLDs, they can have an additional five securities maturing in a financial year.

WHAT INVESTORS CAN DO

According to data sourced from primedatabase.com, the MLD market is worth over ₹1 trillion (in terms of outstanding debt).

"CRISIL Ratings estimates total MLD issuances almost doubling to ₹20,800 crore in FY23, from ₹11,000 crore in FY21. More significantly, the number of unique issuers is estimated to have increased to 70 from 50 in FY21," says Krishnan Sitaraman, senior director and deputy chief ratings officer, CRISIL Ratings.

"HNIs had concentrated exposure to MLDs within their fixed income portfolio due to the tax-advantage these instruments enjoyed," says Manish Jeloka, co-head products and solutions, Sanctum Wealth.

"On post-tax basis, MLDs earlier offered 8-8.5% returns. Now, to get same kind of returns, HNIs will have to shift to bonds that are offering 11-11.5% returns on pre-tax basis," Jeloka adds. These high-risk, high-return bond segment could find some allocation in the debt portfolio of the HNIs, following this change in taxation.

On the other hand, HNIs with low-risk appetite could still stick to MLDs despite the change. If MLD issuers are willing to raise their rates, MLDs could continue to be one of the alternative investment vehicles for HNIs, particularly because these instruments still offer principal protection on the investments.

"Income arising out of listed MLDs will be short-term capital gain. One will not need to find buyer before maturity to deal with interest income. Family of four with upto ₹5 crore in listed MLD will pay about 15-20% in new tax regime," says Feroze Azeez, deputy CEO, Anand Rathi Wealth.

Investors looking for higher post-tax returns from debt investments may even look at certain credit risk strategies. Certain debt MF categories may seem more tax-efficient. If the holding period is more than 36 months, the investor is eligible for LTCG tax-rate of 20%, which comes with an indexation benefit.

Wealth managers may also come up with new alternative products to offer better post-tax yields to HNI clients. "Asset-classes like venture debt and commercial real estate can potentially offer better post-tax yield to HNIs," says Anshu Kapoor, head and president of Nuvama Asset Management.

Commercial real estate products can potentially offer 14-15% pre-tax post-fee (asset management fee) yields.

HNIs can also invest in venture capital debt, which is essentially funding startups by extending loans instead of equity infusion, and can also offer 12% pre-tax yields.

HNIs, who fully understand the risks, can also consider additional tier-I (AT-1) bonds of larger banks like State Bank of India (SBI), where yields are slightly higher than regular bonds issued by the banks.

Structured and alternative investment products are suitable for sophisticated investors like HNIs, who have enough corpus to adequately diversify their risks across different asset-classes. Post-this change, HNIs would need to review their investment portfolios and make appropriate changes if they still want similar yields.