Reversal on rupee-denominated debt

Determining the interest at which Indian firms will be able to borrow in the foreign market is an unwarranted intervention, given that the currency risk in such borrowings is borne by the foreigners

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The Reserve Bank of India (RBI) has, since 2015, been liberalising foreign investment in offshore rupee-denominated debt raised by Indian firms. In September 2015, it allowed Indian companies to issue rupee-denominated bonds that could be traded offshore (popularly called masala bonds). Before this, foreigners could subscribe to onshore rupee-denominated bonds through Sebi-registered foreign portfolio investors (FPIs) only. In November 2015, the RBI issued a more liberal external commercial borrowings (ECB) framework, governing Indian firms raising foreign debt. The RBI has also been gradually increasing the limit on FPI investment in onshore rupee-denominated debt. However, on June 7, the RBI announced three changes in the framework governing masala bonds that reverse this progressive trend. One, it capped the coupon rate that Indian issuers can offer on masala bonds. Two, it raised the minimum maturity period for such bonds, where the issue size exceeds USD 50 million. Three, it declared that proposals for the issuance of masala bonds will be cleared by the foreign exchange department of the RBI. These changes are inimical to Indian firms, many of which are already starved of capital as Indian banks become increasingly averse to corporate lending.

First, the circular does not achieve the stated objective of aligning the masala bond framework with the ECB framework. To achieve a coherent alignment, the same rules that apply to rupee-denominated bonds issued offshore under the masala bond framework, should govern the rupee-denominated loans under the ECB framework. However, the circular caps the coupon rate on masala bonds at 300 basis points over the yield of government securities of corresponding maturity. This is a new element of control and goes against the stated objective of alignment. There is no cap on the rupee-denominated loans under the ECB framework, which simply requires that the interest on such loans must be in line with market conditions.

The rationale for imposing a cap, linked to G-sec yield, on the coupon rate is unclear. One could argue that a cap of 300 bps over G-sec yield gives sufficient leeway to Indian firms to raise offshore debt. However, this is not borne out from the average interest rate offered on foreign currency loans. In the last three years, fixed rate foreign currency loans have offered an average annualised interest rate between 13 and 14 per cent. If the cap of 300 bps over G-sec yield were applied, then offering an interest rate of 13-14 per cent would be possible only if the G-sec yields were above 10 per cent. However, on average, the G-sec yields over the last three years have been in the range of six-eight per cent. This, at best, allows an Indian firm to offer a coupon rate in the range of 10-11 per cent. Moreover, the 13-14 per cent interest rate does not factor in the currency risk that the borrower takes. Rupee-denominated debt would presumably need to offer a higher yield as the lender bears the currency risk.

LENDING TERMS

Minimum maturity period for rupee-denominated instruments issued to non-residents

Type of instrument	Issue size of $50 million	Issue size exceeding $50 million
Onshore rupee-denominated bonds	3 years	3 years
Offshore rupee-denominated loans	3 years	5 years
Offshore rupee-denominated bonds	3 years	5 years

Determining the interest that Indian firms will be able to borrow at in the foreign market is an unwarranted intervention, given that the currency risk in such borrowings is borne by the foreigners. With the exception of South Africa, none of the similarly placed economies such as Brazil, South Korea or Turkey impose restrictions on interest rate on foreign currency borrowing. Attempting to control debt flows through interest rate caps is a rather blunt policy tool because it effectively means that smaller Indian firms would find it difficult to access the masala bond route to raise local currency debt. At a time when bank lending to such firms is likely to stagnate and the Indian bond market struggles to find its feet, a cap on the coupon rate virtually strangulates such firms from going abroad and raising debt that they are in a position to service.

Second, increasing the minimum maturity period from three years to five years for issues exceeding USD 50 million, aligns the masala bond framework to the ECB framework for rupee-denominated loans. However, the overall inconsistency between the rules governing similarly placed rupee-denominated instruments persist, as shown in the table.

The table shows that while the minimum maturity period for onshore bonds that can be issued to non-residents is three years, irrespective of the issue size, the minimum maturity period for offshore rupee-denominated debt varies depending on the issue size. This approach is incoherent for two reasons. First, it treats similarly placed rupee-denominated instruments differently. Two, it penalises large issuances by imposing differential minimum maturity requirements on them. The rationale for imposing differential maturity requirements depending on issue size for one class of rupee-denominated instruments and not another, is unclear.

An enhanced minimum maturity requirement of five years for large issuances implies that Indian firms wanting to make large issuances of under-five years maturity, will be restricted to the Indian market. With Sebi's simultaneous proposal to tighten foreign investments though P-notes, such a proposal may be detrimental to foreign inflows in local currency debt, an outcome that is neither intended nor desirable.

Finally, the circular states that "any proposal of borrowing by eligible Indian entities by issuance of these bonds will be examined at the Foreign Exchange Department, Central Office, Mumbai". This is the most damaging intervention in the framework for local currency borrowing. While the circular has carefully avoided the words "approval route", the addition of an "examination" requirement means that such issuances are subject to RBI approval. It is unclear if the Foreign Exchange Department has the authority to stall proposals for masala bond issuances if they do not satisfy the notional requirements of the Foreign Exchange Department (notional, because the circular does not list them). The period for clearance and the manner of application are also unclear.

The regulatory framework for masala bonds had just begun to show results with Indian issuers showing increasing interest in issuing such bonds. Trading in these bonds could potentially be a first major step towards rupee internationalisation. We must not clip its wings with interventions that are not rooted in sound economic logic.

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