Reform, do not rationalise

It is time we shed India's complex foreign debt policy framework in favour of a coherent one that addresses the potential market failures arising from unhedged foreign currency debt

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On April 27, 2018, the Reserve Bank of India (RBI) published two circulars purporting to rationalise and liberalise the regulatory framework governing foreign borrowings by Indian residents. Briefly summarised, these circulars make four important changes. First, they re-allow foreign investors to invest in Indian debt with a maturity period of less than three years. Second, they impose a uniform all-in-cost ceiling (cap) on the return that Indian entities may promise to foreign lenders. Third, they expand the list of 'eligible' borrowers permitted to raise foreign currency debt. Fourth, they prescribe a uniform list of end-uses that foreign debt must not be deployed towards.

In this article, we argue that while these circulars incrementally rationalise a complex regulatory framework, they yet again miss an opportunity for fundamentally reforming the manner in which Indian businesses may avail of foreign debt. Currently, India's regulatory framework governing foreign debt flows follows a prescriptive approach that dictates who can raise foreign capital, who can lend such capital, the purposes for which it can be used, the security that can be offered and the return that can be offered. The result is a fragmented and complex regulatory architecture that is difficult to administer. These circulars continue this approach, and in some instances, exacerbate its complexity. We highlight three specific problems with these circulars.

First, they reverse a significantly progressive step taken by the RBI with respect to rupee-denominated corporate debt by capping the return on such debt to 450 basis points over G-sec yield of corresponding maturity. The reason for such reversal is unclear, given that foreign capital flows in local currency debt are not associated with systemic risk. Systemic risk is associated from borrowings denominated in foreign currency. Where an Indian borrower borrows in foreign currency, she bears the exchange risk. If the rupee excessively depreciates, she will have to pay much more than what she borrowed. Unless the Indian borrower hedges such risk or has natural hedges in the form of foreign currency earnings, it may result in disproportionate balance sheet exposures. Where an entire sector relies on unhedged foreign currency borrowings, it can lead to a systemic collapse of the sector as well as financial institutions which are exposed to the sector.

In line with this rationale, the RBI had hitherto refrained from imposing interest rate caps on rupee-loans raised from non-residents. However, these circulars reverse this logic in the garb of 'harmonising the extant provisions of foreign currency and rupee ECBs and RDBs'. The introduction of an interest rate cap on rupee borrowings must be supported by a first principles-based sound economic rationale.

CHALLENGING The recent circulars that purport to "rationalise and liberalise" the framework, in fact, complicate it further

Second, the circulars create differential standards for allowing foreign debt in the short-term debt market by allowing foreign investors to invest in G-secs with a residual maturity of less than one year, but disallowing such investment in corporate debt of similar maturity. In 2015, RBI had, disallowed foreign investors from investing in corporate bonds with less than three-year maturity. This step was seemingly taken to harmonise the conditions of allowing foreign debt in government bonds and corporate bonds, as at that time, foreign capital was not allowed in G-secs of less than three-year maturity. Now that foreign investment in G-secs of less than one-year maturity is permitted, it is unclear why the liberalised policy change was not extended to corporate bonds. Doing so would have ensured true harmonisation of the framework governing foreign debt in government securities and corporate bonds.

Finally, these circulars exacerbate the complexity of the regulatory framework. While these circulars have capped the return on offshore rupee-debt (bonds issued outside India), the return on foreign portfolio investment (FPI) in onshore rupee-debt (bonds issued in India) is not capped. Foreign investment in rupee-denominated onshore bonds is governed differently from that in offshore rupee-denominated bonds and loans, although the nature of these transactions is substantially the same, namely raising foreign capital in local currency. While onshore rupee debt is not subject to end-use restrictions, offshore rupee debt is subject to restrictions on end-use, eligible borrowers and eligible lenders etc.

Similarly, even for debt raised in foreign currency, different conditions on hedging and caps apply, depending on who is availing the loan. Such sector-wise caps and dispensations illustrate a centrally planned approach and undue discretion.

The recent circulars that purport to "rationalise and liberalise" the framework, in fact, complicate the framework further. For instance, they prefer long term FPIs over other FPIs for investment in Indian debt. Classifying portfolio investors into 'long-term' and 'others' again tantamounts to central planning, without addressing the primary issue of systemic risk that unhedged foreign currency loans may pose. Similarly, they limit the participation by a foreign investor in a single company's bonds to 20 per cent of the investor's aggregate bond portfolio. Such prudential measures are generally applied towards funds that retail consumers invest in, such as mutual funds, to avoid risk concentration. The rationale for imposing such requirements on FPIs has not been explained. Moreover, such requirements raise the compliance burden and hinder the development of a liquid and deep bond market.

It is time that we shed India's over-prescriptive and complex foreign debt policy framework in favour of a coherent single framework that addresses the potential market failures arising from unhedged foreign currency debt. These issues assume greater significance in times when credit uptake from banks is weak, and the importance of a deep bond market is being felt more than ever before.

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