A new foreign commercial debt policy

It is a sincere effort to simplify the governing regulation. But an explanation about the economic rationale underlying the restrictions is overdue

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On January 16, 2019, the Reserve Bank of India (RBI) issued a circular re-hauling the regulatory framework governing the raising of foreign credit by Indian firms. This is the 13th time in a span of three years that the framework has been revised. The revised framework simplifies the hitherto complex regulatory maze that governed the terms on which Indian firms could access credit from foreign lenders. It expands the range of lenders that may lend to Indian firms, the range of Indian firms that may borrow from offshore lenders and the purposes for which such borrowing may be made. To this extent, the new framework is a significant step in the right direction. However, by continuing its overtly prescriptive approach towards matters that are purely contractual, the framework falls short of going the whole way in providing an economically sound foundation for regulation of foreign lending to Indian firms.

At the outset, given the general sensitivity in the public discourse to foreign credit, it is imperative to reiterate the two advantages of the ability to raise credit from foreign markets -- firstly, it allows the Indian borrower to explore the options of cheaper borrowing costs that may not be available onshore. Secondly, it diversifies the risk of default by not restricting lending options to onshore lenders only. There are potential currency risks that a borrowing firm may face when borrowing in foreign currency. At a firm level, the management of such currency risk must be left to the private entity. However, at a macro-level, large unhedged currency exposures may lead to successive defaults by borrowing firms, which in turn, may have a cascading effect on domestic lenders. Apart from the systemic risk spill-overs that may emanate from unhedged borrowings denominated in foreign currency, the ability to raise foreign credit is a good thing for firms and the economy.

Difficulties with old regulatory framework

India's regulatory framework governing foreign currency borrowing by Indian firms has traditionally been complicated. The RBI imposed controls on each aspect of the transaction, namely, a cap on the aggregate amount that could be borrowed, eligible lenders, eligible borrowers, interest rate ceilings, uses to which the borrowed amount can be put, the kinds of collateral that a borrower may offer to a lender, and so on.

The complexity of the policy was exacerbated by sectoral dispensations. For example, while all borrowers could borrow upto $500, infrastructure sector entities could borrow upto $750 million and million, software sector firms could borrow upto $200 million. Similarly, while there was a general prohibition on utilising the loan proceeds for working capital purposes, the prohibition was relaxed for airline sector companies. Firms seeking relaxations from the rules could do so with the prior approval of the RBI. The framework ended up creating potential for rent-seeking and regulatory ad-hocism. Most importantly, the framework lacked a strong foundation for regulating foreign currency borrowing with an underlying economic

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rationale. Despite recommendations made by several expert committees constituted by the Ministry of Finance, no significant steps were taken to rationalise this framework.

Half-way mark on the road to simplicity

Finally, in 2015, a substantially revised framework for foreign currency borrowing was implemented. Under this framework, RBI adopted a more relaxed regulatory approach towards longer term borrowing. The framework allowed Indian firms to borrow offshore in domestic currency, through loans and Masala bonds. However, it continued to be instrument-specific resulting in different regulatory treatment for loans and bonds. Similarly, foreign portfolio investment in onshore rupee denominated bonds was not covered under this framework. Resultantly, different rules of the game applied to foreign investment in instruments that were fundamentally similar to each other.

Problems with the new foreign debt policy

The fresh set of changes introduced in January 2019 harmonised the foreign borrowing framework in three ways. The new policy laid down uniform criteria for borrowers, by allowing all entities eligible to receive Foreign Direct Investment (FDI) to borrow equally from the foreign debt market. It also expanded the list of eligible lenders to include all foreign entities that may wish to lend to Indian entities. Finally, it harmonised the treatment for foreign currency borrowing (notwithstanding the tenure of the borrowing) and merged the framework governing rupee denominated loans and bonds.

Despite the overall simplification of the regulatory approach, critical mistakes persist. First, the policy requires all external commercial borrowing to have a minimum maturity period of three years. A mandatory minimum maturity period shrinks the ability of small and medium sized firms to raise such debt. It is rational for foreign lenders to take short-term exposure to small and medium sized firms, and gradually increase the tenure of the borrowing once it begins trusting the borrower's credit-worthiness. Mandating a specified minimum period and capping interest rates on such borrowing, effectively enables only Indian firms known globally to access the offshore credit market.

Second, in a bid to harmonise the foreign currency denominated and rupee-denominated debt, the new framework caps the return on the latter. This is problematic. First, the currency risk in case of rupee-denominated borrowing being borne by the foreign lender, the case for a ceiling on rupee-denominated returns is weak. Second, the regulation restricts the return to a spread of 450 basis points over a "benchmark rate". While the benchmark rate for foreign currency borrowing is the six-month LIBOR rate, the benchmark rate for rupee-denominated borrowing is the yield on government securities of a corresponding maturity. A common ceiling on the spread over the benchmark rate does not automatically translate into uniform borrowing costs for foreign currency and local currency borrowing. This is because the trajectory of the two benchmarks are different.

For example, the benchmark 6 month USD libor rate is around 2.8 per cent. With a ceiling of 450 bps, it means that an Indian firm can borrow at the interest rate of not more than 7.3 per cent. This automatically restricts small and medium sized firms from raising such debt, even if their future earnings are in a position to service it. The prevailing bechmark rate for offshore local currency borrowing is around 6.5-7 per cent, this translates into an interest rate cap of 11.5 per cent. Additionally, the foreign lender will charge a premium for bearing the currency risk. Given that the earlier policy allowed the interest rate on rupee-dominated borrowing to be "commensurate with market conditions", hard-coding a ceiling in the new policy is regressive.

Finally, the new regulation continues to make sectoral dispensations for oil marketing companies, start-ups and the infrastructure sector. Thus, the approach towards centrally planning the allocation of foreign capital persists. Similarly, the ability to seek exemptions under an "approval route" still persists.

To summarise, while the new foreign commercial debt policy is a sincere endeavour at simplifying the regulations, the substantive restrictions continue to pervade the regulatory approach. An explanation on the economic rationale underlying these restrictions is long overdue.

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