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Modifications of the External Commercial Borrowings Policy: Implications for Overseas Investments

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Overseas borrowing rules for firms are governed by policy directives from the Government of India. The External Commercial Borrowings (ECB) policy is regularly reviewed by the Government of India in consultation with the Reserve Bank of India (RBI) to keep it aligned with evolving macroeconomic situation and changing market conditions. On 29 May 2008[1], there has been a partial modification of the ECB policy.

- The all-in-cost ceilings in respect of ECBs have been modified as follows:

AVERAGE MATURITY PERIOD	ALL IN COSTS OVER 6 MONTHS LIBOR	
	Existing	**Proposed**
3 years and up to 5 years	150 bps	200 bps
More than 5 years	250 bps	350 bps

- Borrowers in the infrastructure sector will now be permitted to avail ECB up to USD100 million for permissible end uses under the approval route.
- In the case of other borrowers, the existing limit of USD20 million has been enhanced to USD50 million under the approval route.

In August 2007, the ECB norms were tightened, to control money supply, aimed at controlling inflation and allaying fears of overheating. The move checked the rise of the rupee, considered responsible for eroding competitiveness of Indian exports and widening current account deficit. The reduced credit availability reduced capital flows into the economy. The present notification attempts to relax this.

As a further measure, the Government announced that Foreign Institutional Investors (FIIs) would also be allowed to invest up to five billion dollars in government securities and up to

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[1] Press Release BSC/SS/GN-132/08 dated 29 May 2008 (website of the Press Information Bureau, GOI).

three billion dollars in corporate bonds. At present, they are allowed to invest up to 3.2 billion dollars in government securities and 1.5 billion dollars in corporate bonds.

Simultaneously, the Securities and Exchange Board of India (SEBI) has relaxed investment norms for investors from abroad allowing Non-Resident Indians (NRIs) and overseas Sovereign Wealth Funds (SWFs) to register as FIIs. In addition, international or multilateral organisations, foreign governmental agencies and overseas central banks can also register as FIIs now. Asset management firms founded by overseas Indians can also register as FIIs, which will enable them to buy and sell shares directly through a broker. Last year, the regulator had curbed the use of participatory notes, or P-notes, used by unregistered foreigners to take exposure in Indian stocks.

The new net worth required for registration would be $2 billion for foreign corporate, and $50 million for foreign individual to operate in the Indian market. They can operate as sub-accounts, where FIIs registered in India manage the investments. Till now sub-accounts, on whose behalf investments made in India by FIIs, had to be primarily broad-based - this meant that sub-accounts had to have at least 20 investors, and no one could hold over 10% stake. Now a sub-account investor can have as much as 49% stake, which would make it possible for just three investors to form as a sub-account - two with 49% stake each and one with 2%.

NRIs, however, would continue to be prohibited from participating in the capital markets as sub-accounts of FIIs, and also from investing their proprietary funds in the market. Earlier, NRIs were not permitted to register as FIIs or invest through the sub-account route. SEBI also clarified that unregulated university funds, endowments and charitable trusts can seek registration as FIIs.

SEBI has also allowed FIIs to invest in collective investment schemes. "The type of securities in which FIIs are permitted to invest has been widened to include schemes floated by a collective investment scheme (CIS)," SEBI said. CIS, as per current rules, are those schemes in which payments made by the investors are pooled and utilised with a view to receive profits. Under CIS, the profit received is managed on behalf of the investors who do not have any day-to-day control over the management and operation of such schemes.

At present, FIIs are allowed to invest in stocks through the primary and secondary markets, mutual funds, government securities, derivatives and commercial paper.

Referring to offshore derivatives, SEBI said FIIs would not be able to invest in offshore derivatives like P-notes; equity linked notes, etc., unless such derivatives are issued in compliance with know-your-client (KYC) norms.

What's New

- More overseas entities can invest as sub-accounts of FII.
- Sub-account investor can have as much as 49% stake; so just these investors can form a sub-account.
- Foreign portfolio managers can take exposure to collective investment schemes like art funds.
- FIIs can issue P-notes to entities like some hedge funds.
- NRIs can set up their own advisory companies and get funds registered as FII with SEBI.

New Considered FIIs

- Sovereign Wealth Funds (SWFs).
- NRI-owned/ set up asset management company, investment manager / advisor / institutional portfolio manager.
- Unregulated university funds.
- Endowments and charitable trusts.
- International or multilateral organisations.
- Foreign government agencies.
- Overseas central banks.

These relaxations come in the wake of a rupee that is weakening against the dollar. The rupee has lost nearly 8% since January 2008, and is currently trading at around 42.4 to the dollar. FII flow has been negative since March 2008.

Background

The position in May 2008 is very different from that prevailing one year ago. At that time, the financial markets in India were buoyant, and returns in the equity markets in India were among the best in the world in 2007. This encouraged significant FII flows into the market[2], and there was considerable investment taking place through venture capital and private equity deals. The rupee, which was around 42 to the dollar around March 2007, had strengthened by 12% to nearly 39 to the dollar by October 2007. Inflationary pressures were starting to appear, but the Government as well as the RBI were confident that these could be contained.[3]

At that time, there were two concerns. The first related to capital inflows and the ability of the economy to absorb these. It was evident that the pace of investment in infrastructure was not yet adequate to absorb these inflows. During 2007, the RBI had to resort to repeated interventions in the forex markets to purchase dollars and to sterilise the liquidity through issue of Market Stabilisation Scheme (MSS) bonds[4]. The total issue of bonds in 2007-2008 exceeded Rs 130,000 crore (approximately $35 billion). Between August and December 2007, the stock of MSS bonds increased by over $10 billion.[5]

Apart from financial market investments, two other factors contributed to these inflows. The first was the growth of remittances by overseas Indians (termed 'invisibles' by the RBI), that grew to over $22 billion in 2006-07, and to $28 billion the next. Second, there was an increase in ECBs by private sector that added to the available liquidity. Though the RBI had indicated a cap of $23 billion for these borrowings, since a significant proportion happened under the 'automatic' route, the figure was exceeded substantially. Between August and December 2007, there was considerable comment in the media and among analysts that these flows need to be monitored, and that substantial quantity of funds were being used in the financial markets for speculation. There was also concern that the 'P-notes'[6] added an element of non-transparency to the markets and the identity of investors.

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[2] Institutional investment peaked to over Rs. 20,000 crore in Dec 2007; RBI.

[3] Macroeconomic and Monetary Policy Developments 2008; RBI; 29 April, 2008.

[4] These bonds are off budget instruments, with the interest commitment being borne by the Government as a budgetary commitment.

[5] RBI indicators, 29 April 2008.

[6] Subscriptions by overseas investors to instruments for investments in Indian markets through an approved mutual fund or FII.

The stronger rupee led to some decline in the growth of exports to 22.6% between April 2007 and February 2008, and the negative merchandise trade balance increased from around $50 billion in 2006-07 to $ 72.5 billion in the same period in 2007-08.

At this time, the Government took several steps to reverse these trends. There was an announcement that investments through P-notes would not be permitted, and that existing investors should unwind their positions within six weeks. At the same time, these investors could register themselves as FIIs, and the procedure for these compliances were eased. A restriction on ECBs was imposed, most importantly, restricting access to the real estate and financial sector investments. ECB borrowings were to be parked outside the country until actually required for the purpose intended. The 'prior approval' route was tightened, with longer queues for approval. The RBI also stepped in progressively with a tighter monetary policy, hiking CRR and repo rates progressively, in an attempt to drain some liquidity from the economy.

In retrospect, it is possible to argue that these steps were somewhat belated, and did not yield the results intended. There were several reasons for this. First, the policy makers did not fully appreciate the impact of the financial downturn in the United States (U. S.). The Indian policy makers were confident that a domestic demand driven economy like India could weather the deflationary winds that were sweeping through the U.S. The assessment was that though FIIs were strapped for liquidity overseas, they may cash out of India as there were enough funds waiting with domestic savings in their hands to step in and shore up the markets. This is true, but the extent of the meltdown in the financial institutions has been considerably more than anticipated, and the Indian markets have seen an exodus of capital since February 2008, leaving the markets very volatile.

Second, the impact of the global food crisis was not factored in to calculations. The steep rise in prices of rice and edible oils, and most importantly, the concerns over global food production estimates, were factored in rather late. The Government did an excellent job of managing the crisis by ensuring that the winter wheat was purchased by the Food Corporation of India as a buffer (a record of over 21 million tonnes), and that the ban on rice exports would temporarily hold the prices of rice until the next harvest came in, and finally, adopted some administrative measures to prevent hoarding and black-marketeering. These measures have mitigated food prices inflation to some extent.

Third and most important has been the steep increases in prices of crude oil (35% since January 2008). Consumer pries are subsidised, with the subsidies being borne by the balance sheets of the Government-owned oil companies, and the issue of guaranteed bonds by the Government.[7]

The outflow of FII capital, the drain of liquidity through additional working capital borrowings by the oil and fertiliser companies, and for the procurement of food grains, the announcement of waiver of farm loans to the extent of US$18 billion, are likely to cause interest rates to harden and credit availability for industry to tighten. The scramble for dollars by the oil companies for crude and product purchases, coupled with the withdrawal of P-notes' investments, has put pressure on the rupee that has declined by over 8% against the

[7] Public Sector Companies are permitted to issue bonds in the market that are guaranteed for repayment by the Government, and hence, though an off-budget mechanism, part of the additional contingent liability of the Government.

dollar in the last twelve weeks. The current account deficit is likely to increase to 2.5% of the gross domestic product this year, a manageable, though a worrying figure.

The hardening of interest rates is likely to affect the borrowings of the Government, especially state governments and oil companies, and also make borrowings for industry and manufacturing more expensive. There are media comments that oil companies have put on hold capital investment programmes, which would have a downstream effect on machinery manufacturers.

At the same time, inflationary pressures continue. On the one hand, they are fuelled by commodity prices including steel and cement, and primary minerals. On the other hand, the high prices of crude would impact on prices of fertilisers, petrochemicals, industrial chemicals and plastics, thus impacting the input costs in several manufacturing sectors. High inflationary pressures prevent the easy option of reducing interest rates being exercised, and the country is likely to witness a slowdown of growth coupled with unacceptable inflation, a situation several countries are facing now.

The relaxations in the ECB and SEBI guidelines have to be viewed against the context of these developments. There is an attempt here to make credit available for genuine investors. It is interesting that the relaxations focus on those investors that have rupee investments to make, a clear indication that the Government is focusing on improving capital investments in these sectors, most importantly, infrastructure. The attempt to woo hedge funds and NRI money is an attempt to shore up the equity markets through these inflows.

The worry is that these steps may not be effective and adequate. The relaxations are for borrowings that require prior approval of the RBI, and this has proved to be a long and tortuous process, with the RBI reluctant to open the gates. There are large numbers of applications pending before the RBI even now, and there is little indication that the process would speed up.

Second, secondary market activity is likely to be much more selective, focused on those sectors that would benefit from the current market situation. These could include oil exploration, petrochemical, steel and cement, but one could easily argue that financial sector stocks, including banking sector stocks, would be under pressure.

Investments in infrastructure are a function of the costs and returns of the investment, and these depend crucially upon the extent to which oil price increases are passed on to the consumer. If the pass through is significant, it would impact consumer costs and spending and saving patterns; if too little, it would have a serious impact on the Government’s fiscal deficits and on interest rates as public sector firms scramble for working capital.

In short, this appears to be a wait-and-watch time for the Indian economy, as the managers and the policy-makers scramble for alternatives to keep the story of growth going, while at the same time putting out the flames of inflation.

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