The policy puzzles of foreign currency borrowing by Indian firms

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Capital controls on foreign borrowing

Rationale for restrictions

- EM Crisis related to large foreign debt
- India Crisis 1991 related to short term foreign debt
- Asian Crisis related to unhedged foreign currency exposure leading to bank and corporate balance sheet mismatches.
India: The policy framework

Assumptions

- Large foreign debt can make the country vulnerable
- Large foreign debt can make exchange rate management difficult
- Long term debt is better than short term
- It is not desirable if poorly rated companies borrow abroad and default.
Outcomes

- Restrictions often change
- Some sectors given more access to external finance.
- Easing and tightening restrictions on debt flows (e.g., all-in-cost ceiling) used as a tool for managing capital flows.
- The allocation mechanisms for External Commercial Borrowing (ECB) has become more and more complex and increasingly discretionary.
- Further, recent times have seen a large build-up of unhedged foreign currency exposure.
The regulatory framework.
Broad facts about firm foreign borrowing.
Concerns about the ECB framework.
Policy directions.
Part I

Existing regulatory framework
Type of foreign borrowing

- **Foreign currency denominated borrowing:**
  1. Trade credit
  2. ECB

- **Rupee denominated borrowing:**
  1. Foreign investors buy bonds issued locally
  2. Rupee denominated ECB
ECB restrictions

1. Eligibility criteria to borrow
2. Recognised lenders list
3. Quantitative caps and minimum maturity
4. All-in-cost ceiling
5. End-use restrictions
6. Activities not permitted with foreign exchange
7. Restrictions on Guarantees
8. Rules about timing of remittance of ECB proceeds
9. Prepayment restrictions
10. Refinancing of an existing ECB
11. Legal procedure

Loans up to a certain ceiling (presently USD 750 Million) are on automatic route. Beyond that, they have to seek approval.
The regulator specifies the maximum ceiling on interest cost.

- 350 basis points over the six-month LIBOR for ECB with tenor of three to five years.
- 500 basis points over the six-month LIBOR for tenor of more than five years.
Borrowing is:

- Permitted for specified purposes, usually for investment in capital goods.
- Not allowed for on-lending or investment in capital market, real estate, working capital, general corporate purpose and repayment of existing rupee loans.
ECB is prohibited for refinancing rupee loans except:

1. Infrastructure companies are permitted to utilise 25% of the fresh ECB towards refinancing of the rupee loans.
2. Power companies can utilise up to 40% of the fresh ECB towards refinancing of the rupee loans availed.

Refinancing is prohibited for these exceptions if it is from Indian banks abroad.

ECB for working capital has been allowed for the aviation sector, but prohibited for all others.
Part II

Broad empirical facts about foreign borrowing
Data description

- Firm level data on FCB from the CMIE database.
- Non-financial firms.
- FCB measures debt taken by a company denominated in a currency other than the Indian rupee.
- FCB is the sum of ECB and trade credits.
- Years: 2004 to 2015
Aggregate firm level FCB versus total FCB

USD Billion

- Total outstanding FCB
- Outstanding FCB for prowess companies


0 20 40 60 80 100 120

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### Descriptive statistics
For 2011-12

<table>
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<tr>
<th>Variable</th>
<th>Category</th>
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<td>Interest cover</td>
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<td>Non-FCB firms</td>
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Part III

Areas of concern
RBI warns companies, banks on unhedged forex loans

PTI  Apr 7, 2015, 10.10PM IST

Tags: Rupee | reserve bank of india | RBI | Raghuram Rajan |

MUMBAI: Reserve Bank Governor Raghuram Rajan today warned companies against keeping their foreign currency exposures unhedged, saying they might face "big risk" in case of change in the monetary policy globally.

"They (companies) have to recognise that they are taking a big risk (by not hedging their forex exposures), especially if monetary policy changes around the world," Rajan said at a post-policy media briefing.
RBI DG: Rising unhedged foreign currency exposure

Corporates should manage their forex risk: Reserve Bank

Khan added that it may turn out to be a significant cost for corporates due to unexpected exchange rate movements

Hedged borrowing fell from 35 percent in 2013-14 to 15 percent in July-August 2014.
The proportion of hedged external commercial borrowings (ECBs) and foreign currency convertible bonds (FCCBs) declined from 35% in 2013-14 to 15% in July-August 2014, according to the central bank’s estimates.

The latest to warn Indian companies was RBI’s executive director G. Mahalingam, who as a keynote speaker in a treasury summit on Wednesday said a fall in hedging is being seen in all emerging markets as they are enjoying stable exchange rates on steady capital flows from yield-chasing investors. RBI released his speech copy on its site on Friday.
Areas of concern - 1: Unhedged currency exposure

Market failure due to FCB arises out of a combination of the following three elements:

1. **A managed exchange rate**: Higher potential for large and sudden depreciation.
2. **A class of firms with large unhedged foreign borrowing and low shock absorbing ability**: Firms with substantial FCB and small amounts of equity capital to absorb shock are vulnerable.
3. **This class of firms is large when compared with GDP**: Otherwise FCB is just an ordinary business risk that some firms bear.
Why do firms carry unhedged currency exposure?

Moral hazard and incomplete markets

- **Patnaik and Shah (JIMF, 2009):** Indian firms carry significant unhedged currency exposure.
- Firms think the government will manage the exchange rate, and fail to hedge currency exposure.
- Hedging is hampered by inadequacies in the currency derivatives market.
- Long dated borrowing calls for long-dated derivatives contracts.
- These are often not traded on the market or may have to be constructed either through rolling over or through a dynamic trading strategy.
- Transaction cost may be prohibitive in an illiquid market.
ECB policy framework has a large number of levers.

- Tightening and easing of capital controls on foreign borrowing.
- Restrictions were eased after significant exchange rate depreciation.
- Large number of policy changes provide an unstable policy environment.
Areas of concern - 3: Complex policy framework

- **Industrial policy:** When the law favours certain industries over others. For example, firms in the civil aviation sector allowed to borrow for working capital requirements. Firms in the infrastructure sector are allowed to borrow for refinancing of rupee loans, other firms are not.

- **Economic knowledge required:** Detailed regulations need to be backed by economic reasoning that demonstrates the intervention addresses a specific market failure. For example, the regulation permits firms to borrow when their all-in cost is below LIBOR + 350 basis points, but blocks firms when their all-in cost is above LIBOR + 350 basis points.

- **Ease of doing business:** Current complex policy framework induces delays, uncertainty and costs of compliance, and legal fees.
Areas of concern - 4: Rule of law

- Current framework for policy making requires rules that are:
  1. Comprehensible and well known to all.
  2. Applied equally to identically placed persons.
  3. Predictable to practitioners.
  4. Free from arbitrary discretion.
  5. With reasoned orders for all actions.
  6. Orders subject to appeal.
Part IV

Policy directions
As the ECB framework has evolved, it has become more complex. There is increasing potential for abuse.

The Committee recommended compulsory hedging requirements for borrowers as an alternative to the present framework of all in cost ceiling, end-use restrictions, sectoral policies, maturity restrictions, etc.

It proposed including natural hedges.
Implication of hedging requirements

Hedging would:

- Reduce large scale unhedged exposure
- Raise cost of borrowing and keep total borrowing under control
- Simplify the framework for ECB
- Reduce the need for arbitrary restrictions like 350, 500 basis point over LIBOR end use or sectoral restrictions.
- Encourage firms with a natural hedge to borrow more than others.
Recent policy changes: 1

2. Increased access to rupee denominated borrowing:
   - Foreign investors cap in rupee denominated corporate bonds has been raised to USD 51 billion.
   - Policy reforms to develop corporate bond market will help increase liquidity and foreign participation.
Recent policy changes: 2

1. Issuance of rupee denominated bonds through ECB route: RBI proposed to allow Indian corporates eligible to raise external commercial borrowing (ECB) to issue rupee bonds in overseas centers with an appropriate regulatory framework.

2. Through bank provisioning:
   - To discourage banks from providing credit facilities to companies that refrain from adequate hedging against currency risks, the Reserve Bank of India (RBI) has prescribed additional provisioning for lenders.
   - It has also prescribed a manner in which losses incurred on unhedged foreign currency exposure should be calculated.
Recent policy changes: 3

Adoption of FSLRC Handbook

- All draft subordinate legislation governing foreign borrowing would be published with a statement of objectives, the problem it seeks to solve, and a cost-benefit analysis.

- This would be accompanied by a statement about the market failure that the regulator seeks to address through the proposed regulations.

- Any proposed change in regulations would be preceded by inviting comments from the public, which would be published on the regulator’s website.

- The Board would approve the final regulations after considering comments from the public, and modifications of the regulation consequent to the comments.

- All the approved regulations would be published on the website within 24 hours of their coming into force.

- The regulator and government would be required to develop a detailed legal process governing approvals. (all applications under the approval route would be accepted/rejected within a specified time, with reasons provided in case of rejection).
Part V

Many challenges exist
Measuring and hedging exposure

- Prescribing hedging ratio for each firm is a challenge.
- It is intrusive, instead of being a business decision of the firm.
- Exposure of the firm should be computed taking into account natural hedges such as exports and import parity pricing.
- Firms which do not have natural hedges would be required to buy currency derivatives but liquidity in the currency derivatives markets is limited.
- What should be the hedge ratio? Who is to decide and how? What signal will this give?
- Monitoring the hedging ratio is another challenge.
Addressing moral hazard and incomplete markets

- A hedging requirement imposed by the regulator, even if well implemented, can only be a medium term solution.
- The long term solution lies in greater rupee flexibility and liquid markets for hedging risks.
- Greater exchange rate flexibility should reduce moral hazard and firms would then hedge out of their own self-interest. It would be a business decision.
- Building the Bond-Currency-Derivatives Nexus would help create sophisticated markets onshore, through which access to hedging would improve.
Thank you.