"Liberalization of External Commercial Borrowings Policy"

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"A decade and half ago the prospect of India becoming a major player in the global economy seemed a distant dream, only a theoretical possibility. During the last 14 years there has been a sea change not only in the world's perception about India's future, but in our own perception about ourselves. The world has acknowledged the "arrival of India". We no longer discuss the future of India: we say the future is India" remarked the then Union Minister of Commerce and Industry, Mr. Kamal Nath.

The Indian regime has seen a sea change in last few years, with more relaxations to attract resources to India. 21st Century has witnessed remarkable liberalization in the Indian laws governing foreign funding and the Indian economy has seen a phenomenal growth over the last few years.

The boom in the Indian economy was fuelled by substantial Foreign Direct Investment (FDI). However, over the course of last year, the subprime crisis in the US has snowballed into an international economic crisis. As the impact of this crisis was gradually felt across the globe, it has also affected India and has lead to a virtual stoppage of equity funding for corporates.

In view of the cautious approach of the Investors towards equity funding, Indian enterprises have started taking recourse to debt funding route frequently.

The cost of funds in the Indian market has been relatively higher than International market and there has been a growing tendency for Indian corporate to raise funds from International markets. Such financing is arranged on prevalent rates of interest, which are fixed in terms of Basic rate of London Interbank Offered Rate (LIBOR) plus other charges and is commonly referred to as External Commercial Borrowing (ECB).

Indian Enterprises during the course of last few years have accessed significant amounts of foreign debt. In 2006-07, Indian companies had raised $25 billion through ECBs which had climbed to $31 billion in 2007-08. A quick look at recent statistics shows that the quantum of ECBs accessed through the Approval route (with prior RBI approval) have touched $2 billion in June this year, the highest in any month since the collapse of the Lehman Brothers in September, 2008[1].

Foreign Investment in India

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[1] *The Economic Times dated July 31, 2009.*

The legal framework for foreign investment in India falls under two categories: one governs the investment in capital i.e. equity and the other borrowings. Equity is governed by the Foreign Direct Investment (FDI) Policy whereas foreign investment in the form of borrowings is governed by the External Commercial Borrowings (ECB) Policy and Regulations.

In India, till late, companies were raising funds under the FDI route through issue of hybrid instruments such as optionally / partially convertible preference shares and debentures which are intrinsically debt-like instruments. However, in June 2007, the Reserve Bank of India (RBI) clarified that ***"only those instruments which are fully and mandatorily convertible into equity, within a specified time would be reckoned as part of equity under the FDI policy and will be eligible to be issued to person's resident outside India under the Foreign Direct Investment Scheme"*[2].** Thus it was clarified that investment in non-convertible / optionally / partially convertible preference shares and debentures or any other instrument with no specified period for conversion in equity shall come under the purview of ECB Guidelines.

External Commercial Borrowings

ECB covers under its umbrella commercial loans in the form of bank loans, buyers' credit, suppliers' credit, securitized instruments (e.g. floating rate notes and fixed rate bonds) availed of from non-resident lenders with minimum average maturity of 3 years. ECB can also be in form of credit from official export credit agencies and commercial borrowings from private sector window of Multilateral Financial Institutions such as IFC, ADB, AFIC, CDC etc.

ECBs are being permitted by the Government for providing an additional source of finance for the Indian corporates for expansion of existing capacity as well as for fresh investment. In short, ECB includes any kind of funding other than equity such as bonds, credit notes or anything of that nature satisfying the norms of the ECB Policy. ECB is generally for a ***specific period*** of time which can be as short as 3 years and carry a ***fixed return*** as the rate of interest is usually fixed. One of the advantages for the borrowers availing ECBs is that there is ***no dilution in ownership*** and considerably large funds can be raised because of its ***easy availability***.

The Reserve Bank of India (RBI), vide its Notification No. FEMA 3/2000-RB dated 03.05.2000 has issued the ***Foreign Exchange Management (Borrowing or lending in Foreign Exchange) Regulations, 2000*** which govern the External Commercial Borrowings and Trade credits. ECBs are governed by clause (d) of sub-section 3 of section 6 of the Foreign Exchange Management Act, 1999 (FEMA) read with regulation notified vide Notification No. FEMA 3/2000-RB dated 03.05.2000, as amended from time to time and the Master Circular on ECB issued from time to time. *The current Master Circular on ECB was issued on July 1, 2009.*

ECB can be accessed under two routes, which are (i) **Automatic Route** i.e. do not require RBI / Government of India's approval and (ii) **Approval Route** i.e. requires prior approval of RBI.

[2] *A.P. (DIR Series) Circular No.74 dated June 8, 2007* ***[RBI/2006-2007/435]***.

End-Use

ECB is permitted only for permissible uses and can be raised only for:

- Investment [such as import of capital goods (as classified by DGFT in the Foreign Trade Policy), new projects, modernization/expansion of existing production units] in the real sector – industrial sector including small and medium enterprises (SME), infrastructure sector and specific service sectors, namely hotel, hospital and software in India.
- Overseas Direct Investment in Joint Ventures (JV)/Wholly Owned Subsidiaries (WOS) subject to the existing guidelines on Indian Direct Investment in JV/WOS abroad.
- First stage acquisition of shares in the disinvestment process and also in the mandatory second stage offer to the public under the Government's disinvestment programme of PSU shares.
- Payment for obtaining license/permit for 3G spectrum[3].
- Lending to self-help groups or micro credit or for micro finance activities by Non-Government Organizations (NGOs).
- Buyback of Foreign Currency Convertible Bonds (FCCBs) subject to compliance with certain terms and conditions.

What is prohibited?

Some end-use restrictions have been put on ECB such as:

- Utilisation of ECB proceeds is not permitted for on-lending or investment in capital market or acquiring a company (or a part thereof) in India by a corporate.
- ECB proceeds are not permitted for investment in real estate sector.
- Utilisation of ECB proceeds is also not permitted for working capital, general corporate purpose and repayment of existing Rupee loans.

Liberalization of ECB Policy

The ECB policy has undergone certain modifications / liberalization in the past few years and is regularly reviewed by the Government in consultation with the RBI keeping in tune with the evolving macro economic conditions, sectoral requirements, global developments. The Government has modified its policy on ECBs to suit the funding requirements of corporates, developers of integrated townships, Special Economic Zones (SEZ) and Non-Banking Financial Companies (NBFCs) engaged in infrastructure development.

Who can avail ECBs?

Eligible borrowers under **Automatic route**:

[3] *Inserted vide – A.P. (DIR Series) Circular No. 26 dated October 22, 2008* ***[RBI/2008-09/245]****.*

- Corporates including those in hotel, hospital, software sectors are eligible to raise ECB except financial intermediaries. *Individuals, Trusts and Non-Profit making organisations are not eligible to raise ECB.*
- SEZ Units are allowed to raise ECB for their own requirement.
- NGOs engaged in micro finance activities are eligible to avail ECB subject to certain conditions.

Eligible borrowers under **Approval route**:

- Financial Institutions dealing exclusively with infrastructure or export finance.
- Banks and financial institutions which had participated in the textile or steel sector restructuring package as approved by the government.
- NBFCs availing ECB, with minimum average maturity of 5 years from multilateral financial institutions, reputable regional financial institutions, official export credit agencies and international banks to finance import of infrastructure equipment for leasing to infrastructure projects.
- FCCBs by housing finance companies satisfying the minimum criteria.
- Special Purpose Vehicles, or any other entity notified by the reserve Bank, set up to finance infrastructure companies/projects exclusively, will be treated as financial Institutions and ECB by such entities will be considered under the Approval route.
- Multi-State Co-operative Societies engaged in manufacturing activities satisfying certain conditions.

Sectoral criteria

Entities in the ***services sector*** such as hotels, hospitals and software sector are allowed to avail of ECB up to USD 100 million per financial year for import of capital goods, under the Approval route[4]. Corporates in such sectors have also been permitted to avail of ECB up to USD 100 million per financial year, under the Automatic route for foreign currency and / or Rupee capital expenditure for permissible end-use[5]. However, the proceeds of the ECBs should not be used for acquisition of land.

As per the extant Policy, utilization of ECB proceeds in the ***real estate*** sector is not permitted. ECB proceeds may however, be utilized for the development of *'integrated townships'* (which includes housing, commercial premises, hotels, resorts, city and regional level urban infrastructure facilities such as roads and bridges, mass rapid transit systems and manufacture of building materials)[6].

It may be noted that in May, 2007, RBI had withdrawn the exemption accorded to the ***'development of integrated township'*** as a permissible end-use of ECB[7]. This was removed as one of the end-uses of ECB in view of the concerns over lending to real estate and to prevent speculative activities. However, as a sector specific measure, the use of ECB proceeds for the development of integrated township has been reintroduced

[4] *A.P. (DIR Series) Circular No. 46 dated June 2, 2008 **[RBI/2007-08/346]**.*
[5] *A.P. (DIR Series) Circular No. 46 dated January 2, 2009 **[RBI/2008-09/343]**.*
[6] *As defined in **Press Note 3 (2002 Series)** dated January 04, 2002, issued by DIPP, Ministry of Commerce and Industry, GOI.*
[7] *A.P. (DIR Series) Circular No. 60 dated May 21, 2007 **[RBI/2006-07/409]**.*

and permitted in January 2009, under the Approval route, until June 2009[8] subject to the condition that the minimum area to be developed should be 100 acres for which norms and standards are to be followed as per local bye-laws/rules. In the absence of such bye-laws/rules, a minimum of two thousand dwelling units, for about ten thousand population needs to be developed.

However, in June 2009, the prevailing conditions were allowed to continue, permitting development of integrated township as a permissible end-use, under the Approval route, until December 31, 2009[9].

Likewise, ***NBFCs*** are permitted to avail of ECB for a minimum average maturity period of five years to finance import of infrastructure equipments for leasing to infrastructure projects in India.

This requirement was subsequently modified to provide that NBFCs which are exclusively involved in financing of the infrastructure sector, are permitted to avail of ECBs from multilateral / regional financial institutions and Government owned development financial institutions for on-lending to the borrowers in the infrastructure sector under the Approval route, subject, inter alia, to the condition that the direct lending portfolio of the eligible lenders vis-a-vis their total ECB lending to NBFCs, at any point of time should not be less than 3:1[10].

In June 2009, on a review of the ECB Policy, it was decided to dispense with this condition with effect from July 1, 2009[11]. However, the proposals will continue to be examined by the RBI, under the Approval route.

ECB is also permissible for the ***infrastructure sector*** which includes power, telecommunication, railways, road including bridges, sea port and airport, industrial parks, urban infrastructure (water supply, sanitation and sewage projects), mining, refining and exploration. At present, borrowers in the infrastructure sector are allowed to avail of ECB upto USD 500 million per financial year for Rupee expenditure for permissible end-uses under the Approval route[12].

Recently, the requirement of minimum average maturity period of seven years for ECB more than USD 100 million for Rupee capital expenditure by the borrowers in the infrastructure sector has also been relaxed[13].

Further, units in ***Special Economic Zones*** are also permitted to access ECBs for their own requirement. Lately, SEZ developers are allowed to avail of ECB under the Approval route for providing infrastructure facilities, as defined in the ECB Policy, within the SEZ. However, ECB *is not permissible for the development of integrated township and commercial real estate* ***within the SEZ***[14].

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[8] *A.P. (DIR Series) Circular No. 46 dated January 2, 2009* ***[RBI/2008-09/343].***
[9] *A.P. (DIR Series) Circular No.71 dated June 30, 2009* ***[RBI/2008-09/517].***
[10] *A.P. (DIR Series) Circular No. 46 dated January 2, 2009* ***[RBI/2008-09/343].***
[11] *A.P. (DIR Series) Circular No.71 dated June 30, 2009* ***[RBI/2008-09/517].***
[12] *A.P. (DIR Series) Circular No. 16 dated September 22, 2008* ***[RBI/2008-09/190].***
[13] *A.P. (DIR Series) Circular No. 26 dated October 22, 2008* ***[RBI/2008-09/245].***
[14] *A.P. (DIR Series) Circular No.71 dated June 30, 2009* ***[RBI/2008-09/517].***

Recently, it was clarified that corporates, which have violated the extant ECB Policy and are under investigation by the RBI and / or by Directorate of Enforcement, will not be allowed to access the Automatic route for ECB. Any request by such corporates for ECB will be examined under the Approval route[15].

All-in-cost ceilings

The **all-in-cost ceilings**[16], in respect of both the Automatic as well as Approval routes are as under:

Average Maturity Period	All-in-cost ceilings over 6 months LIBOR[17] (w.e.f. October 22, 2008)
Three years and upto five years	300 bps
More than five years	500 bps

However, under the Approval route, the above requirement of all-in-cost ceilings on ECB has been relaxed, until June 30, 2009[18]and the same has now been extended until December 31, 2009[19].

However, ECB beyond the permissible all-in-cost ceilings mentioned above can be availed under the Approval route.

Amount and Maturity

- Corporates can raise a maximum amount of ECB of USD 500 million or its equivalent during a financial year under the Automatic route and an additional amount of USD 250 million with average maturity of more than 10 years under the Approval route, over and above the existing limit of USD 500 million under the Automatic route, during a financial year;
- Corporates in the services sector (which includes hotels, hospitals and software sector) are allowed to avail of ECB upto USD 100 million in a financial year;
- ECB upto USD 20 million or its equivalent can be raised, under the Automatic route, with minimum average maturity of three years in a financial year;
- ECB above USD 20 million and upto USD 500 million or its equivalent can be raised, under the Automatic route, with minimum average maturity of five years;
- NGOs engaged in micro finance activities can raise ECB upto USD 5 million during a financial year; and
- ECB upto USD 20 million can have call / put option provided the minimum average maturity of three years is complied with before exercising call / put option.

[15] *A.P. (DIR Series) Circular No.71 dated June 30, 2009* ***[RBI/2008-09/517]****.*
[16] *Includes rate of interest, other fees and expenses in foreign currency except commitment fee, pre-payment fee and fees payable in Indian Rupees for ECBs.*
[17] *For the respective currency of borrowing or applicable benchmark.*
[18] *A.P. (DIR Series) Circular No. 46 dated January 2, 2009* ***[RBI/2008-09/343]****.*
[19] *A.P. (DIR Series) Circular No. 64 dated April 28, 2009* ***[RBI/2008-09/460]****.*

However, this facility of call / put option is not permissible for such ECB upto a period of 10 years.

Conclusion

There is no doubt that ECBs occupy a very important position as a source of funds for Corporate. However, ECBs have suffered in view of the adverse economic conditions coupled with the Government regulations acting as a stumbling block.

The cost of funds has risen globally as more and more financial institutions are grappling with losses and write-offs and consequently there has been a growing tendency for Indian corporate to raise funds from International markets. However, ECB inflows have slowed down during the last one year, attributable partially to the liquidity crunch and crisis in US and Europe as well as to the relatively lesser appetite for funds among domestic companies.

The Reserve Bank of India has time and again, as an anti-inflationary measure, amended the ECB Policy, making it more restrictive. The RBI has tried to address the problems faced in the realm of ECBs by announcing a number of steps to liberalize and soften the policy and regulations, which would widen the options available to the Indian corporate to finance their requirements through foreign currency borrowings. While RBI officials have tried to stimulate the ECB market to provide the required foreign exchange liquidity at affordable rates, lenders globally have been either increasing rates of interest or demanding prepayment of existing loans.

The challenge for India lies in the regulator i.e. the RBI, ensuring that the ECB Policy remains proactive and reflects the economic reality.

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