Submission of Comments to the Department of Economic Affairs (Financial Market Division), Ministry of Finance, Government of India

on

"Sahoo Committee's Report on Foreign Currency Borrowings"

1. Background

The Ministry of Finance (MOF) constituted a Committee under the Chairmanship of Shri M.S. Sahoo, to comprehensively review the framework of access to domestic and overseas capital markets. Accordingly, in February 2015, the Committee submitted to the MOF, its report on Foreign Currency Borrowings. Further, the MOF, in order to take into consideration views of various stakeholders, invited comments/ suggestions from interested stakeholders on the report.

Consumer Unity & Trust Society (CUTS, www.cuts-international.org) is a vigilant institution working in the area of economic regulation, financial sector, consumer protection, competition, trade, and investment since last 30 years. CUTS' comments on the report are set out in the following sections:

2. Extant Framework of External Commercial Borrowings (ECBs)

ECB[1] can be accessed under the automatic route or the approval route. Under the automatic route, no approval is needed to access ECB. Under the approval route, specific approval from the Reserve Bank of India (RBI) is necessary. Borrowings, whether under the automatic or the approval route, are subject to numerous restrictions, including restrictions on who can borrow, who can lend, the terms of the borrowings, the uses to which the borrowed amount can be put ('end-use'), the cost of borrowing ('all-in-cost') and so on.[2]

Proposal:

The Committee recommends a complete liberalisation of ECB regulations, including permitting all firms to borrow in foreign currency without any upper ceiling, subject to specific hedging requirement. In addition, the Committee suggests completely doing away with the requirement of seeking prior approval of the RBI for such borrowings. It further recommends that the restrictions on lenders, end-uses, maturity of the loan, all-in-cost, etc. prescribed in the extant framework must be dismantled right away, as they do not serve any economic purpose in present day economic environment or address any market failure

[1] External Commercial Borrowings (ECB) and Trade Credits are governed by clause (d) of sub-section 3 of section 6 of the Foreign Exchange Management Act, 1999 read with Notification No. FEMA 3/2000-RB viz. Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000, dated May 3, 2000, as amended from time to time.
[2] Master Circular (No. 12/2014-15) on External Commercial Borrowings and Trade Credits dated July 1, 2014.

associated with ECB, viz., systemic risk arising from currency exposure and global risk tolerance. However, to mitigate volatility and uncertainty in ECB inflows, the Committee recommends continuation of aggregate "soft cap" determined internally by the authorities. The process of approval for high value transactions, if any, must be objective, time-bound and transparent.

Suggestions:

While easing of ECB regulations is a welcome move in the current capital-controlled environment, however, if all restrictions on the debt are completely removed right away, it could lead to abuse, especially when restrictions on equity caps continue.[3] Further, overseas lending without any restrictions at times can be irrationally exuberant. This could results in market failure, as there is a possibility of correlated failure of numerous borrowing firms if there is a large exchange rate movement.

Therefore, some restrictions on ECB borrowings should be in place for time-being, for an overall perspective of microeconomic stability and safeguarding Indian firms from very large exposures. Accordingly, it is advisable that dismantling of restrictions should be done in a calibrated manner rather than following a big-bang approach in dismantling all restrictions right away. In addition, 'one rule, fits all' does not work in practice and is quite difficult to implement across all sectors. Therefore, sector-specific restrictions/regulations should be there as some sectors (like oil sector, etc.) are more sensitive to the market fluctuations vis-a-vis others.

3. Mandatory Hedging

At present, companies hedge all or a part of their foreign borrowings voluntarily, based on the currency risks they face. As such, the firms that borrow in foreign currency may not hedge their risks from currency exposure fully or even undertake excessive borrowing/risks because of the two main reasons. First, the firms may not be able to hedge their currency exposure because the onshore derivatives market is shallow and illiquid, and the firms do not have excess to the overseas derivatives market. Second, the more companies hedge, the more it increases their costs.

Proposal:

The Committee recommends making hedging mandatory for a part of a company's ECB loans. The recommendation came under the backdrop of the massive exposure companies have to a global markets crash, or a currency meltdown, as was seen in 2013-14, when the rupee plunged to a lifetime low of 68.85/$ (August 28, 2013). During the financial year 2013-14, Indian companies borrowed to the tune of

[3] *'Sahoo panel favours easing ECB norms'*, available at http://www.livemint.com/Home-Page/tZcvGc6tvINpp2lTWd6GAO/Sahoo-panel-favours-easing-ECB-norms.html, last visited on May 9, 2015.

$33.23 billion from abroad[4], which resulted in the huge exposure of around 50,000 crore due to large foreign exchange movement.[5]

Suggestions:

Experts says that while mandatory hedging might help reduce a shock from a global financial turmoil, it also increases the cost of borrowings as well. In some cases, the total cost may even be higher than the cost of borrowings from domestic debt markets.[6] Therefore, cost-benefit analysis of borrowing in foreign currency needs to be undertaken before making any choice of alternative.

Further, as mentioned above, some sectors are more sensitive to the market fluctuations vis-a-vis others. Therefore, the approach of mandatory hedging would not work across all sectors of the economy uniformly. The hedging in case of sectors which are less vulnerable to exchange rate fluctuations would limit the potential incremental benefits of borrowing from overseas rather than borrowing from domestic markets.

Accordingly, the customised hedging strategy should be devised for different sectors of the economy, when comes to borrowing from foreign debt market.

In addition, it must be understood that the onshore derivatives market is shallow and illiquid, and the firms do not have excess to the overseas derivatives market (as highlighted above). Therefore, there is an explicit need to strengthen the onshore derivatives market before making hedging mandatory for ECB borrowings from overseas.

4. Need for impact assessment of regulatory requirements

As per the Resolution of Financial Stability and Development Council (comprising financial sector regulators) dated October 24, 2013, it was decided that all regulations after October 31, 2013 and all other subordinate legislations (including circulars, notices, guidelines, letters, etc.) issued after December 31, 2013 must comply with the following requirements[7]:

- No subordinate legislation may be published without a Board resolution determining the need for such subordinate legislation.
- All draft subordinate legislations should be published with statement of objectives, the problem it seeks to solve, and <u>a cost-benefit analysis</u> (using best practices).

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[4] *'Part-hedging must for ECBs: Sahoo Panel'*, available at http://www.business-standard.com/article/economy-policy/part-hedging-must-for-ecbs-sahoo-panel-115032500031_1.html, last visited on May 9, 2015

[5] At the closing rupee-exchange rate of 53.81/$ on May 2, 2013, this amount is equivalent to Rs. 1.78 lakh crore, while at an exchange rate of 68.85, it is equivalent to Rs. 2.29 lakh crore.

[6] Supra Note 4

[7] Department of Economic Affairs, Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code, December 26, 2013

- Comments should be invited from the public and all comments should be published on the web site of the regulator.

While the Government has invited comments from public on the proposed change in framework and also rationalises the framework relating to ECB, consequently complying with condition 1 and 3; condition 2 seem not to have been complied with. Specifically, no statement objective, or cost-benefit analysis of regulations seems to have been undertaken.

Therefore, cost-benefit analysis of proposed changes in the ECB framework needs to be undertaken. Further, there is a need to review the (intended and unintended) impact/ consequences of the proposed amendment.

CUTS has been implementing projects on undertaking regulatory impact assessment (through cost-benefit analysis) of select legislations in energy (http://www.cuts-ccier.org/ADB-RIA/) and financial (http://www.cuts-ccier.org/BHC-RIA/) sectors. We have also conducted training-cum-advocacy programmes for regulators, wherein representatives of SEBI have participated (http://www.cuts-ccier.org/BHC-RIA/event-Training_Programme_on-Regulatory_Impact_Assessment_(RIA).html). We would be happy to work with the Government to undertake cost benefit analysis of the proposed and other regulations.

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