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R&I India Flash Report

CHANGES TO THE EXTERNAL COMMERCIAL BORROWING REGIME – WHAT DOES THIS MEAN FOR MARKET ACCESS BY INTERNATIONAL INVESTORS AND LENDERS?

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Participation by international lenders and debt funds in the Indian market is tightly regulated by Reserve Bank of India's ("**RBI**") external commercial borrowing ("**ECB**") regime. These restrictions have limited secondary debt trading to defined channels and limited the end use of ECB loans. Although there has been some easing on 7 February 2019 (click here for our earlier flash report) and pursuant to the RBI's policy statement of 16 January 2019 (click here for our earlier flash report), a number of constraints remain. On 30 July 2019, the RBI announced further changes to facilitate limited direct secondary debt trading and to create certain avenues for the offshore refinancing of rupee debt.

Refinancing of rupee debt

The RBI has now permitted the refinancing of distressed rupee debt (classified as SMA-2 or NPA) by recognised international lenders, which now includes debt funds, certain distressed loan portfolios, involving borrowers in the infrastructure and manufacturing sector, provided the purpose of the original loan was to fund capital expenditure. This applies to companies undergoing pre-insolvency restructurings known as one-time-settlement ("**OTS**") transactions.

The RBI had separately provided for the refinancing of loans for companies undergoing the corporate insolvency resolution process in its 7 February 2019 circular where it permitted international lenders (other than foreign branches or overseas subsidiaries of Indian banks) to refinance the rupee debt of such companies subject to the receipt of RBI approval. The refinancing provisions for OTS transactions, in contrast, do not set out an explicit reference to RBI approval.

Solving the secondary debt trading issue?

Historically, restrictions in the ECB guidelines have meant that international debt funds and other non-Indian lenders could only acquire exposure to portfolios of non-performing loans in India by subscribing to security receipts backing pools of non-performing loans acquired by RBI regulated entities known as "asset reconstruction companies" ("**ARC**"). A number of international funds and lenders have criticised the cost and legal inefficiencies of this model. Also, ARCs are in the structural position of being both principal (they need to retain 15% of the security receipts) and agent (in respect of the security receipts issued to investors), a delicate balance. Finally, some ARCs are also reported to have capital constraints, which impacts their ability to acquire large volumes of secondary debt (as they need capital to fund their 15% holding requirement).

The RBI's recent circular of 30 July has permitted ECB lenders (other than foreign branches and overseas subsidiaries of Indian banks) to acquire certain distressed loan portfolios classified as SMA-2 or NPA, involving borrowers in the infrastructure and manufacturing sectors directly and without the use of an ARC interposed. Since ECB lenders now includes international debt funds, does this solve their secondary debt access issue? The answer is only partially, due to certain conditions and regulatory ambiguities:

- First, the ability to acquire these distressed loan portfolios without the use of ARCs is limited to only two sectors: infrastructure and manufacturing (because of the reference to "*such loans*" in the RBI circular). It would not seemingly apply to other sectors where there are also high levels of distress.

- Second, the "*resultant*" external commercial borrowing must comply with the ECB guidelines with regard to the cap on the all-in-cost of debt (450 basis point spread over the benchmark rate), end use and minimum maturity, amongst others. The use of the word "*resultant*" in this context is unclear, but if the meaning is that the original rupee loans so acquired must have also complied with the RBI's ECB requirements, then this will obviously limit the number of loans that would be capable of transfer in this manner.

- Third, because of the use of the term "*such loans*" in the RBI circular in this context, which appears after the provision on the refinancing of rupee debt (summarised above), it is unclear as to whether this ability to acquire secondary debt only applies as part of an OTS transaction or whether it can be acquired prior to any formal OTS transaction (i.e. to position an international debt fund ahead of any potential transaction of this nature). Logically, the former interpretation ought not to prevail as this would negate the value of this provision, but the drafting creates some ambiguity as to the regulatory intention.

Other changes

The RBI has also eased the end use and minimum maturity conditions that apply to ECBs. All ECB lenders can now provide ECB loans for the two previously restricted end uses of general corporate or working capital purposes. ECB loans for these purposes were only permitted to be advanced by "foreign equity holders" (significant direct or indirect shareholders or group companies). However, ECB loans for such purposes need to have a minimum average maturity of 10 years, which is likely to limit the pool of lenders likely or able to offer this product.

The RBI has also eased the minimum maturity period for ECBs used to refinance domestic rupee debt used for capital expenditure, provided the minimum average maturity of this ECB is 7 years. On lending by non-banking finance companies in this regard is also permitted on the same terms.

Takeaways

- *Secondary trading access issue not completely addressed*. Although it is encouraging that the RBI has opened a small window for direct secondary trading of distressed loans (and the fact that the RBI has allowed direct access is itself significant), the applicability conditions, in particular, the reference to the cost of debt of the transferred loan being capped, may limit the universe of loans capable of such transfer.

- *Potential strategies for international debt funds?* However, for loans that are capable of secondary transfer, if the coupon is capped, the primary route through which funds will look to generate sufficient returns on their capital will be to acquire the debt at a discount and then seek recovery through the OTS at a higher level.

- *Refinancing of rupee debt has its restrictions*. The easing of the end use restrictions on general corporate purposes and working capital is clearly intended to allow the access of much needed foreign capital to ease the credit crunch in the Indian market, but the long minimum maturity periods, which significantly outstrip the return horizons of many international debt funds may act as a deterrent. Such lenders may as a workaround lend on the basis that they can sell their loans, but that is an uncertain outcome as a market for such long term Indian corporate debt will then need to evolve.

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