FIMPACT

IFMR Investments Newsletter

IMPACT THROUGH INVESTMENTS

The current regulatory framework for foreign investments in India offers different routes for impact investing in India's microfinance sector. In the next few newsletters, we will give an overview of these different structures and round it up with a summary newsletter highlighting the pros and cons of the alternative routes. In today's newsletter, we analyze the External Commercial Borrowings (ECBs) route.

India's central bank, the Reserve Bank of India (RBI), defines ECBs as commercial loans in the form of bank loans, securitized instruments, etc. from non-resident lenders with a minimum average maturity of 3 years. ECB can be accessed either under the 'Automatic' route or 'Approval' route.

Eligibility for Microfinance Institutions for availing ECBs

Microfinance Institutions (MFIs) are eligible for ECBs under the 'Automatic' route. Such MFIs should be registered as Societies, Trusts, Co-operatives or Non-Banking Financial Companies- Microfinance Institutions (NBFC-MFIs). However, MFIs registered as Section 25 companies (NGOs), Societies, Trusts and Co-operatives should have a satisfactory borrowing relationship for at least 3 years with a commercial bank in India which is authorized to deal in foreign exchange. Such MFIs would require a 'fit and proper' certificate relating to status of their Board/Committee of management from the designated bank.

Recognized Lenders

The following table lists out the recognized lenders from which MFIs in India can source ECBs.

Recognized lenders for different categories of MFIs in India

MFIs registered as Societies, Trusts and Co-operatives	•International banks •Multilateral financial institutions •Export Credit Agencies •Overseas organizations •Individuals
NBFC - MFI	•Multilateral institutions •Regional financial institutions •International Banks •Foreign equity holders •Overseas organizations
Section 25 Companies	•International Banks •Multilateral financial institutions •Export credit agencies •Foreign equity holders •Overseas organizations •Individuals

Source: RBI

Requirements for foreign equity holder to be recognized as a lender

A foreign equity holder in a MFI will be eligible as a recognized lender under the automatic route if the following conditions are met,

1) For ECB up to USD 5 million - minimum paid-up equity of 25 per cent held directly by the lender,

2) For ECB more than USD 5 million - minimum paid-up equity of 25 per cent held directly by the lender and ECB liability-equity ratio not exceeding 4:1

Amount, Maturity, Pricing and Hedging Requirements

MFIs can raise ECB up to USD 10 million or its equivalent during any financial year. The all-in-cost ceilings for ECB are as follows:

Pricing cap for ECBs

Average Maturity Period	All-in-cost* ceilings over 6 month LIBOR
3 years and up to 5 years	350 basis points
More than 5 years	500 basis points

Source: RBI

* All-in-cost includes rate of interest, other fees and expenses in foreign currency except commitment fee, pre-payment fee, and fees payable in Indian Rupees. The payment of withholding tax in Indian Rupees is excluded for calculating the all-in-cost.

The designated bank in India has to ensure that at the time of drawdown of the external borrowings, the forex exposure of the borrower is fully hedged.

Restrictions on Security

The creation of charge over immovable assets and financial securities in favour of the overseas lender is subject to guidelines as specified in India's Foreign Exchange Management Act (FEMA) Regulations. The designated bank in India can issue a 'no objection' certificate under FEMA for creating a charge after satisfying itself of the following conditions,

1) The period of such charge on immovable assets has to be co-terminus with the maturity of the underlying ECB.

2) Such 'no objection' should not be construed as a permission to acquire immovable asset (property) in India, by the overseas lender / security trustee.

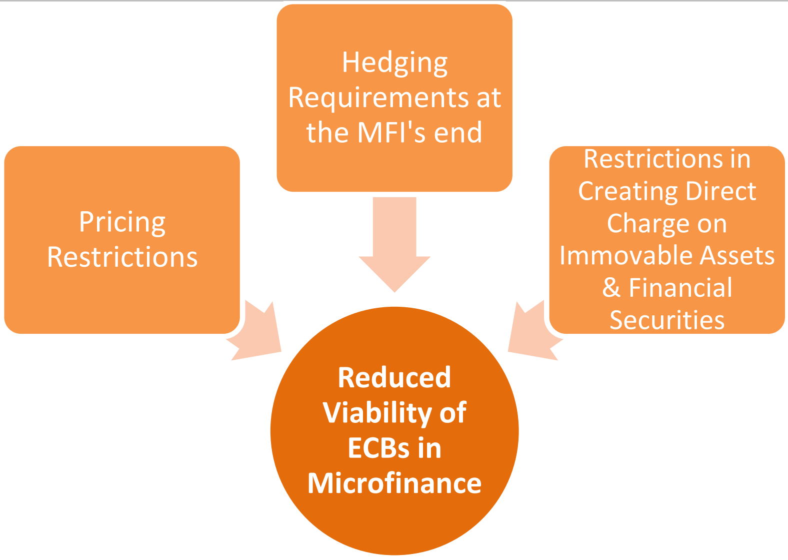
3) In the event of enforcement / invocation of the charge, the immovable asset (property) will have to be sold only to a person resident in India and the sale proceeds shall be repatriated to liquidate the outstanding ECB.

Thus, under current regulations, the overseas lender cannot directly create any charge on the MFI's immovable assets and financial securities for the issuance of the ECB.

Conclusion

As highlighted in the guidelines above, ECBs are regulated by RBI as part of its overall supervisory functions. Some of the requirements for ECBs are challenging to meet.

Factors contributing to reduced viability of ECBs as an effective medium for lending to MFIs in India



1) The guidelines differ for different categories of MFIs and different recognized overseas lenders which have to be adhered to before operationalizing the ECB. For equity holders who want to lend to investees via ECB, the guidelines for amount and ECB liability-equity ratio has to be adhered to.

Also, the ECB guidelines specify that NBFC-MFIs are eligible for overseas borrowing. However, only a handful of NBFCs operating as MFIs have been granted the NBFC-MFI license, thereby precluding a large number of NBFCs engaged in microfinance from availing the ECB facility.

2) The pricing cap applicable renders ECB as an unviable proposition for many recognized lenders when compared to alternate routes of lending to MFIs in India.

3) The inability to issue ECB denominated in INR except under certain cases (ECB from foreign equity holders can be denominated in INR and NGOs engaged in microfinance can avail of INR denominated ECBs) and the simultaneous requirement for MFIs to fully hedge their currency exposure renders ECBs as a very costly source of funding. Since most ECBs are required to be denominated in foreign currency, the MFI will have to hedge the currency risk at their end which will severely bloat the total funding cost of the ECB given the high cash collateral requirements which the hedging counterparty will demand.

Since international recognized lenders are expected to be in a better position to hedge their currency exposure, it would be ideal to structure ECBs in INR denomination and relax/widen the pricing caps to allow the recognized lender to recoup the forward premia on their INR exposure.

4) It is unclear if the hedging cost incurred by the MFI can be included under 'financing cost' for calculating the margin cap under RBI's NBFC-MFI guidelines.

5) Any security which is created for the ECB will have to meet existing FEMA guidelines which restrict creation of direct security on Indian immovable assets and financial securities by overseas lenders.

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As highlighted above, the current framework of overseas borrowings for MFIs in India has many challenges. This has resulted in not even a single ECB transaction being facilitated for MFIs in India since the revised ECB guidelines were issued. In our next newsletter, we will explore an alternative route of lending to Indian MFIs through registration as a foreign institutional investor.