Analytical Speaking

Guide to ECB and FDI

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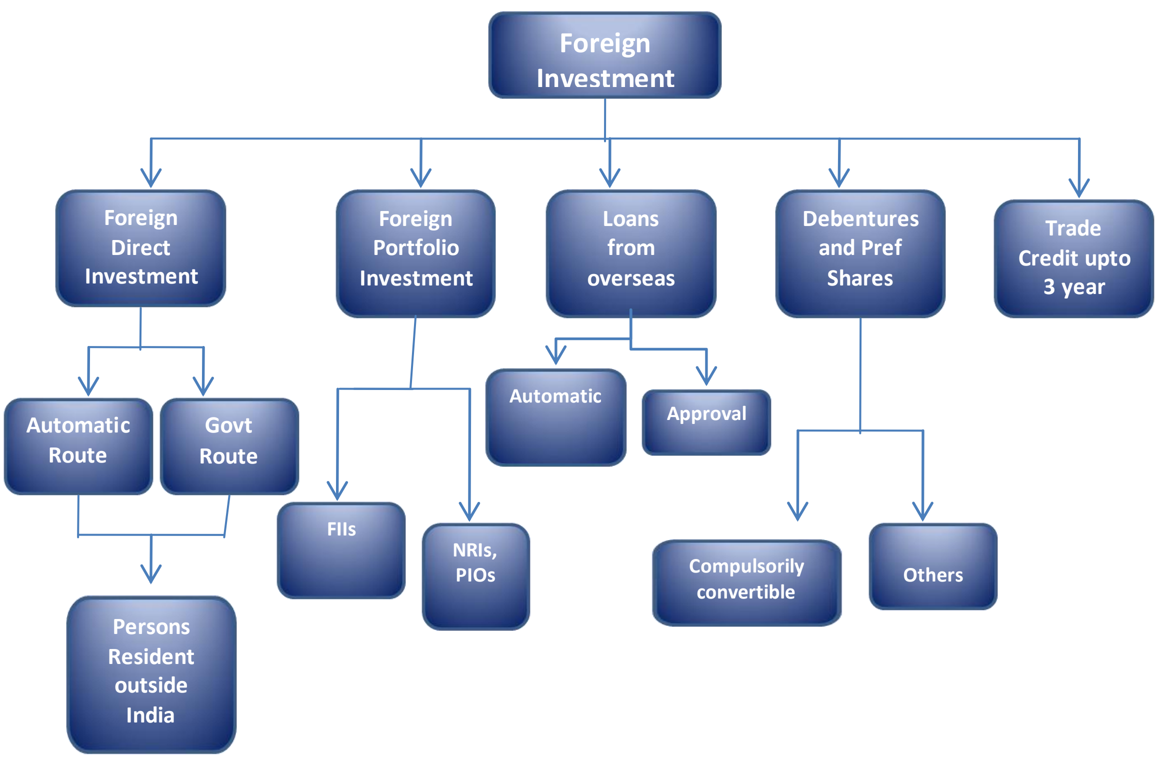
With increasing integration of India with the global economy, the relevance of capital inflows (that is, investments by way of equity or debt) into the country has increased tremendously. However, India continues with limited capital account convertibility – hence, capital account transactions are still not free from controls.

There are broadly two sets of regulations application on capital account inflows – Foreign Direct Investments (FDI), and External Commercial Borrowings and Trade Credits (ECBs). Very common misconceptions exist as to what transactions are covered under which Regulation, and whether the transaction in question is covered by either of these Regulations. This write up is intended to be a simplified guide to the FDI and ECB Regulations.

Is it a Capital Account Transaction?

The first significant question is – is the transaction at all covered by FDI and ECB Regulations? Current account transactions are not covered by these regulations – hence, the transaction must be a capital account transaction. Capital account transactions are defined by sec. 2 (e), read with sec. 6 (3) of FEMA. Borrowing, lending, investments in securities, giving of guarantees, etc are examples of capital account transactions. An import of goods is not a capital account transaction, even if the payment is due for such import (subject, of course, to trade credit regulations discussed below).



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What is FDI?

The word FDI covers investments in equity shares, compulsorily convertible debentures, compulsorily convertible preference shares. This is where money directly comes into a company. Of course, money may be getting into a company through indirect route – for example, shares bought on a stock exchange – that is not a case of foreign direct investment, and hence, not covered in this article.

So, it is important to note that only where debentures are mandatorily convertible into equity that it is taken as FDI. Optionally convertible debentures, non convertible debentures, debentures with call or put options, etc. will all fall under ECBs – discussed separately. Same is true in case of preference shares – preference shares are mandatorily redeemable as per Companies Act. However, for a preference share to count as FDI, it has to be compulsorily convertible into equity.

In case of FDI, there is no question of repatriation principal. In case of equity and dividends, there will only be distribution of dividends, and in case of debentures, payment of interest until conversion.

While the FDI norms talk about mandatory conversion of preference shares and debentures, they do not lay down the maximum term by which such conversion must happen. RBI/2006-2007/435 A.P. (DIR Series) Circular No.74, dated 8th June 2007 provides that the debentures must be compulsorily convertible within a "specified time", without specifying what that time is. The understandable meaning of this requirement is that the debentures must not be convertible at an unspecific time.

Who can receive FDI?

Most corporates may receive inflows on account of FDI. There are minimum capitalization norms in case of NBFCs. Note that investment companies are not allowed to receive FDI. There are also certain negative-listed sectors, and there are conditions subject to which FDI is permitted in the real estate sector. These details are being skipped in this article for the sake of brevity.

What is ECB?

There are several forms of debt instruments through which Indian companies may source debt funding. These are commonly termed as external commercial borrowings (ECBs), foreign currency convertible bonds (FCCBs), foreign currency exchangeable bonds (FCEBs), preference shares and debentures which do not fall under FDI guidelines (see discussion above), and trade credits (TCs). We discuss each of these below.

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External commercial borrowings:

ECBs fall under two routes: automatic route and approval route:

Automatic route:

ECB route is allowed only to “eligible borrowers”, from “recognized lenders”. The term “eligible borrowers” includes most corporates, but excludes banks, financial institutions and NBFCs. Infrastructure finance companies are permitted to raise ECBs. SEZ units are also allowed to raise ECBs. Recognised lenders means (i) international banks, (ii) international capital markets, (iii) multilateral financial institutions (such as IFC, ADB, CDC, etc.) / regional financial institutions and Government owned development financial institutions, (iv) export credit agencies, (v) suppliers of equipments, (vi) foreign collaborators and (vii) foreign equity holders. In order for a foreign equity holder to be a lender, there are minimum equity holding requirements too. The essence of the so-called “recognized lender” criteria is that not one can lend money under the terms of ECB. For example, individuals, finance companies, NGOs, etc cannot be lenders under ECBs. There is a separate dispensation in case of ECBs by NGOs engaged in microfinance – this is not being discussed in this article.

The amount of ECBs that may be raised, and the minimum average maturity conditions, are as follows:

Maturity	**Hotels, Hospitals, and software sector corporates**	**Other corporates**
Maturity of less than 3 years	Not counted as ECB – may be under trade credit	Not counted as ECB – may be under trade credit
Average minimum maturity of upto 3 years	Upto USD 20 million	Upto USD 20 million
Average minimum maturity of 5 years	Upto USD 100 million	Upto USD 500 million

The ceilings on all-in cost at this time are 300 bps + 6M Libor in case of average maturity of 3-5 years, and 500 bps + 6M Libor in case of average maturity of more than 5 years.

There are also end-use restrictions in case of ECBs. ECBs are allowed only for investment in real sector, that is, not in financial sector. The so-called real sector includes industry, infrastructure, and specified services, that is, hotels, hospitals, and software. Infrastructure is defined to include (i) power, (ii) telecommunication, (iii) railways, (iv) roads including bridges, (v) sea port and airport, (vi) industrial parks, (vii) urban infrastructure (water supply, sanitation and sewage projects), (viii) mining, exploration and refining and (ix) cold storage or cold room facility, including for farm level pre-cooling, for preservation or storage of agricultural and allied produce, marine products and meat. The investment requirements are generally for import of capital goods, modernization, expansion, etc. Therefore, for something purely working capital requirements, or so-called general corporate requirements, of existing units, ECB route is not available. ECBs are specifically not permitted for investment in real estate, capital market, money market, etc.

Under the automatic route, there is no need for RBI approval. However, there is a formality for obtaining a loan registration number (LRN), before the draw down under the loan.

Approval route:

It is not that the approval route is open for any loan not covered by the automatic route. The automatic route is also limited to certain types of ECBs – for example, borrowings with minimum average maturity of 5 years in case of NBFCs, borrowings in excess of 50% of net owned funds in case of infrastructure finance companies, FCCBs in case of housing finance companies, etc.

The terms as to recognized lenders remain the same as in case of automatic route. This means that unrecognized lenders cannot give loans to Indian Corporates either under the automatic route, or under the approval route. The all-in cost ceilings, end-use restrictions, etc are similar to those under automatic route.

Foreign Currency Exchangeable Bonds (FCEBs)

FCEBs are substantively similar to a convertible bond, with the difference that in case of FCEBs, the bonds are issued by one company (issuer company), and the bonds are exchanged against equity shares of another company (offered company). The expression "offered company" should not be misunderstood as if the shares will be offered by this company, as the equity shares are not being offered by the so-called offered company. They are already there with the issuer company. So, the scheme of FCEBs is that the issuer company is a promoter of the offered company, already holding shares in the offered company. The issuer company raises money by way of bonds, and the bonds will be redeemed by exchanging the shares of the offered company, instead of repaying cash. The language of the ECB norms suggests that there is no scope for payment of FCEBs in cash.

The eligibility norms require the issuer company to be a part of the promoter group of the offered company, and the offered company to be eligible for receiving FDI. The norms for FCEBs are almost similar to those in case of FDI. Hence, the subscriber to FCEB can be any person eligible to invest in FDI.

Since FCEBs may have regular servicing requirements, the all-in cost restrictions in case of ECBs apply to the interest payable on FCEBs as well.

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As regards the rate at which the exchange of shares of the offered company will take place, there are norms for fixation of the exchange price, fixed at the time of the issue.

FCEBs are permitted only under the approval route – so, they require the prior approval of the RBI.

Trade Credit

Trade Credit includes credit for imports for tenure of less than 3 years, extended either by the overseas supplier, or an overseas lender. Note that the question of it being a Trade Credit will not arise unless there is an import of the asset, and the credit is for payment of the price of imported goods. In other words, a trade credit cannot result into net payment of cash to the importer. Also note that where the maturity is more than 3 years, the transaction counts as ECB, and is covered by the ECB norms discussed above.

There are two types of trade credit – **buyer's credit** and **supplier's credit**. Supplier's credit is the credit extended by the overseas exporter – that is, late payment facility or deferred payment facility. Buyer's credit is loan or credit arranged by the buyer from *an overseas bank or other lender*. So, what if the buyer arranges a credit from an Indian lender? A credit or loan facility arranged from an Indian lender will not be covered by FEMA at all, unless it is denominated in foreign currency.

TC rules permit an importer to use a credit of upto 1 year, and in case of capital goods, upto 3 years, for an amount upto USD 20 million per import. "Per import" may be taken to mean an import made under a single invoice, at one point of time. The all-in costs for either buyer's credit or supplier's credit should not be more than 200 bps above 6M Libor.