



Comments on
“Corporate Choice for
Overseas Borrowings: The
Indian Evidence,”
by Bhupal Singh

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Key Findings

- Large number of firms engage in ECBs - size of the borrowings is small.
- Borrowings are primarily for import of capital goods, setting up of new projects, modernization or expansion of existing units.
- High correlation between ECBs and the flow of capital goods imports
- The volume of ECBs is influenced/driven by
 - Interest rate differentials
 - Credit constraints



Multiple regimes?

- Quarterly data for the period 1993:Q1 to 2007:Q4 is used for the analysis
 - Flows really only got going around 2003:2004
 - Are the results reflecting the economic environment of the '90s or of the '00s? Perhaps finding of interest rate arbitrage etc. applies to the earlier period of the data, which is what is driving the results? If so, applicability to the current environment may be inappropriate.



Corporate Choices being driven by regulations?

- There are a lot of governmental restrictions on ECBs
 - Smaller-size loans may be for smaller maturities; larger-size loans must be for longer maturities.
- Could this explain the finding that “Large number of firms engage in ECBs - size of the borrowings is small?”
- Hypothesis: Foreign lenders worry about moral hazard and information asymmetry and hence prefer to give shorter-maturity loans.
 - Governmental regulations tie loan size to loan maturity and hence we find that loan sizes are small, even though the driver is really the loan maturity.



Additional Evidence for Hypothesis

- Table 9 documents the growing proportion of larger (and hence longer-maturity) loans in more recent years.
- Bhupal attributes this to “the market access by a number of Indian companies for financing overseas acquisitions and sizeable transactions relating to leasing and hire purchase of aircrafts by the domestic airline companies for capacity expansion.” That is, the more recent borrowings are for (larger and) longer-duration investments.
- But perhaps firms may be going in for larger projects because lenders are more willing to entertain the moral hazard involved as they become more familiar with borrowers.

More regulation-driven corporate choice?

- Automatic approval from regulators for investment in the real sector particularly for infrastructure development.
- Approval needed for other loans.
 - Could this explain the finding that “Borrowings are primarily for import of capital goods, setting up of new projects, modernization or expansion of existing units?”

Another example of regulation-driven corporate choice?

- There are price ceilings in the form of maximum spreads on rates paid over six-month LIBOR.
 - Could this explain the popularity of FCCBs (Foreign Currency Convertible Bonds), i.e. they are an attempt to use equity-sweeteners to effectively raise the “interest rate” on the bonds?
 - This also suggests that the time series of interest rates paid on ECBs may be mis-interpreted if taken to be simply the rate of interest on Indian corporate borrowings. At times, when the actual interest rate rises (for whatever reason), that borrowing might move to the FCCB market, thus reducing the observed interest rate in the (non-FCCB) ECB market.

Are we seeing interest-rate arbitrage, or...?

- There does seem to be a correlation between the interest-rate differential and the volume of ECBs.
 - Could this be a spurious correlation?
 - Perhaps the spread reflects a risk premium that is correlated with ECBs?
 - Suppose greater interest-rate differentials reflect higher levels of economic activity in India relative to LIBOR economies and the riskiness of the marginal firm is higher at these higher levels of economic activity.



Are we seeing interest-rate arbitrage, or...?

- This would generate a correlation between the interest rate differential and ECBs, but the interest rate differential would only be proxying for the higher risk.
- This seems to be the story in the ECM as well:
 - “the response of the interest rate (rd_t) to higher external borrowings suggests that the interest rate differentials persist despite higher inflows through external borrowings?”
- If it is arbitrage, are there no other ways to exploit it?
- What about foreign exchange traders? What about traders in interest rate derivatives?



Suggestions for future work

- Look at the cross-sectional evidence:
 - Is the posited behavior of corporate borrowers in terms of loan size, loan maturity, arbitrage activity etc. consistent with variations across firms?
- Look at the proportion of capital raised in the form of ECBs, rather than the size of the ECBs. Higher levels of ECBs might be accompanied by higher levels of equity or higher levels of domestic borrowing. This would cast doubt on the interest-rate arbitrage hypothesis.
- A model that looks at the choice of different kinds of debt - straight debt denominated in rupees, straight debt denominated in dollars, FCCBs etc. would have more power to discriminate between different hypotheses.

