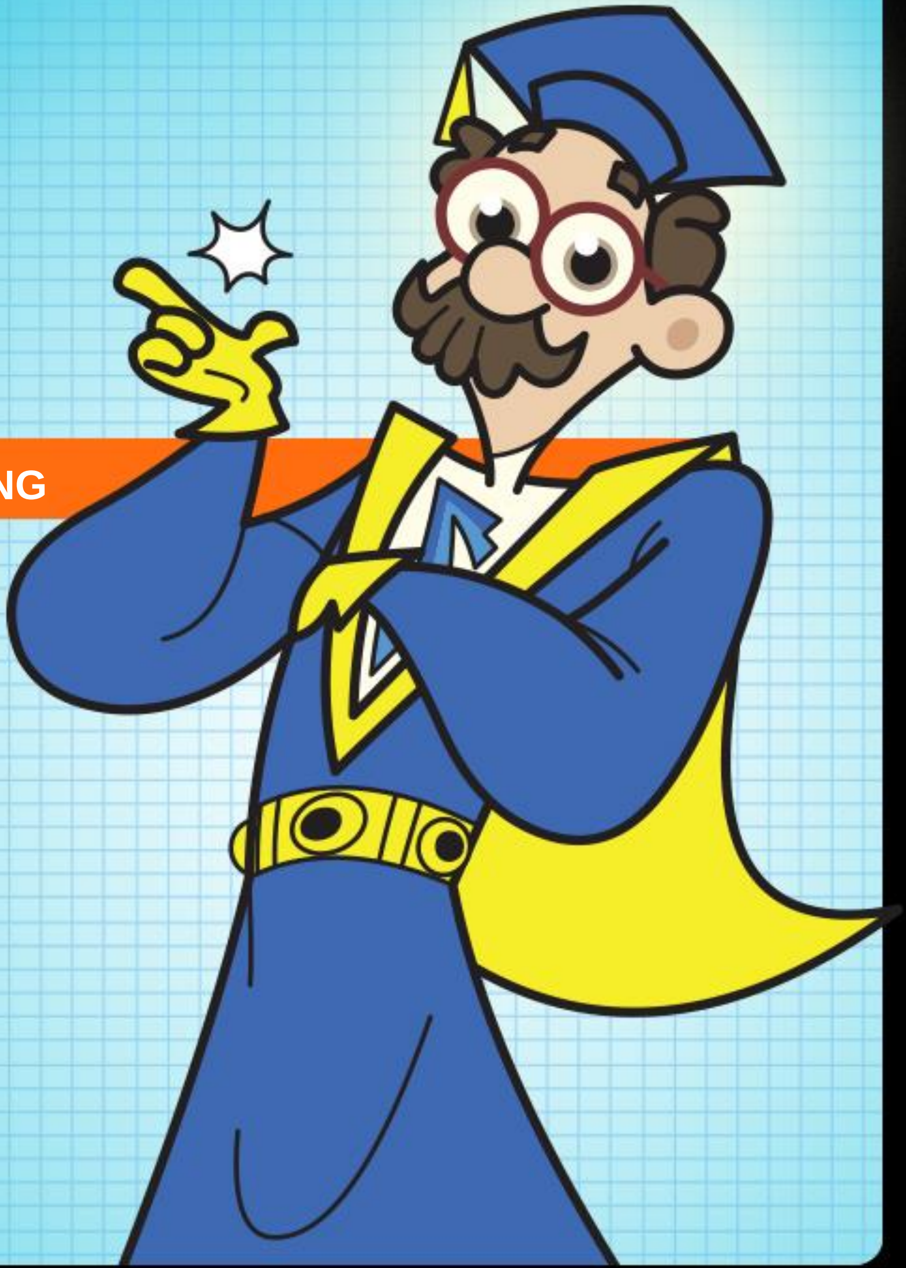
EXTERNAL COMMERCIAL BORROWING



Understanding

External Commercial Borrowing

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EXTERNAL COMMERCIAL BORROWING

Let's assume you suddenly have a guest at home and you are running short of milk to prepare tea.

In such a scenario you will have no option but to borrow some from your neighbors, which you can replace later.

EXTERNAL COMMERCIAL BORROWING

Likewise, external means non-Indian / foreign source, commercial would mean engaged in commerce and borrowing means acquire temporarily with a promise to return along with interest.

The concept of this strange sounding term is just as simple.

EXTERNAL COMMERCIAL BORROWING

ECB has become a major source for raising money by large Indian companies in recent years. In comparison with India, interest rates are a lot lower abroad. Therefore, this is the single biggest incentive for companies raising money from overseas.

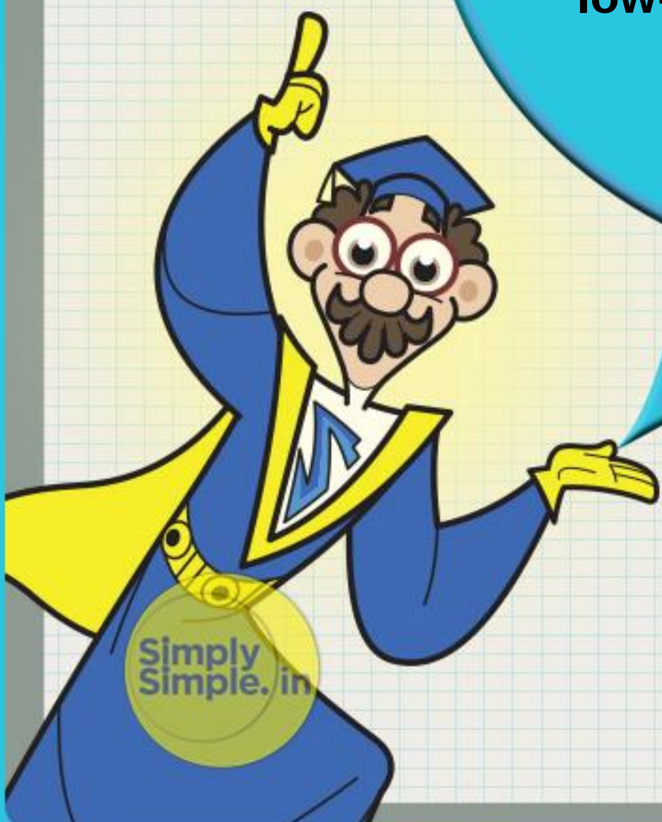
EXTERNAL COMMERCIAL BORROWING

For example, even if a company borrows in the international market at 4% for one year; the cost of borrowing for a similar tenor may be close to 10% in the domestic market.

Companies in India are allowed to borrow from overseas, under certain conditions, through different instruments, with a minimum average maturity of 3 years.

EXTERNAL COMMERCIAL BORROWING

The main objective is to provide companies with an option of low-cost capital.



EXTERNAL COMMERCIAL BORROWING

However, it is not that ECB is always beneficial to a company and the country and does not carry any risk. There is a definite risk involved and those reading newspapers these days should be able to guess easily.

EXTERNAL COMMERCIAL BORROWING

The depreciation of the rupee is the biggest hurdle to this kind of borrowing.

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EXTERNAL COMMERCIAL BORROWING

Let’s assume, I have borrowed $100 at 4% and converted it into rupees at Rs. 50 per dollar.

Now effectively I have borrowed Rs. 5,000 at 4%. Under normal circumstances, I will have to pay $104 after a year.

EXTERNAL COMMERCIAL BORROWING

So, if the currency were to remain stable, I would have added the interest amount (4% of Rs. 5,000 which is Rs. 200) to the principal to make it Rs. 5,200 and buy US dollars at the rate of Rs. 50 per dollar. This would fetch me Rs. 5,200/Rs. 50 = $104.

So far this makes complete business sense. Isn’t it?

EXTERNAL COMMERCIAL BORROWING

But what if the rupee depreciates to Rs. 60?

As far as the overseas party is concerned the liability of the Indian company is clearly $104.

At $1 = Rs. 60, Rs. 5,200 would only fetch me Rs. 5,200/ Rs. 60 = $86.67. There is thus a shortfall of $17.33 ($104 - $86.67).

EXTERNAL COMMERCIAL BORROWING

Now, the cost of buying additional $17.33 at Rs. 60 per dollar turns out to ($17.33 x Rs.60) = Rs. 1,040. Thus, the interest which was planned as Rs. 200 turns out to be (Rs. 200 + Rs. 1,040) Rs. 1,240.

EXTERNAL COMMERCIAL BORROWING

Now if you were to calculate the rate of interest the business enterprise in India lands up paying turns out to be

(Rs. 1,240 / Rs.5,000) x 100% which works out as 24.80% which is much more than the 10% interest rates prevailing in the local market.

EXTERNAL COMMERCIAL BORROWING

Thus, in this case the borrower would surely feel short changed.

The opposite will be the scenario incase rupee appreciates against the dollar.

EXTERNAL COMMERCIAL BORROWING

Hope you have understood the concept of External Commercial Borrowing.

Thinking of Investment

Contact

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