Overview of the Report of Working Group on Foreign Investments

29th July 2010

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Chairman of the Working Group

Executive Summary

Formation of Group

- Working group formed by Department of Economic Affairs (DEA)
- Objective of rationalizing the present arrangements relating to foreign portfolio investments by FIIs, NRIs and other foreign investments like FVCI and Private Equity entities, etc.

Mandate

- Review not only the policy but also operational and procedural issues creating bottlenecks in capital flows
- Major focus areas included:
  - Structure of regulation and rationalizing the instruments
  - Arrangements and programs through which India regulates capital flows

Process

- The Group looked at foreign exchange law with regard to listed and unlisted equity, corporate and government securities and derivatives as well as tax policy related to these matters
- The Group did not look at FDI policy except in places where FDI policy and portfolio investment were intertwined

Recommend-ations

- Recommendations are intended to reduce costs, complexity and legal uncertainty within the existing framework of capital account convertibility maintained by the Government

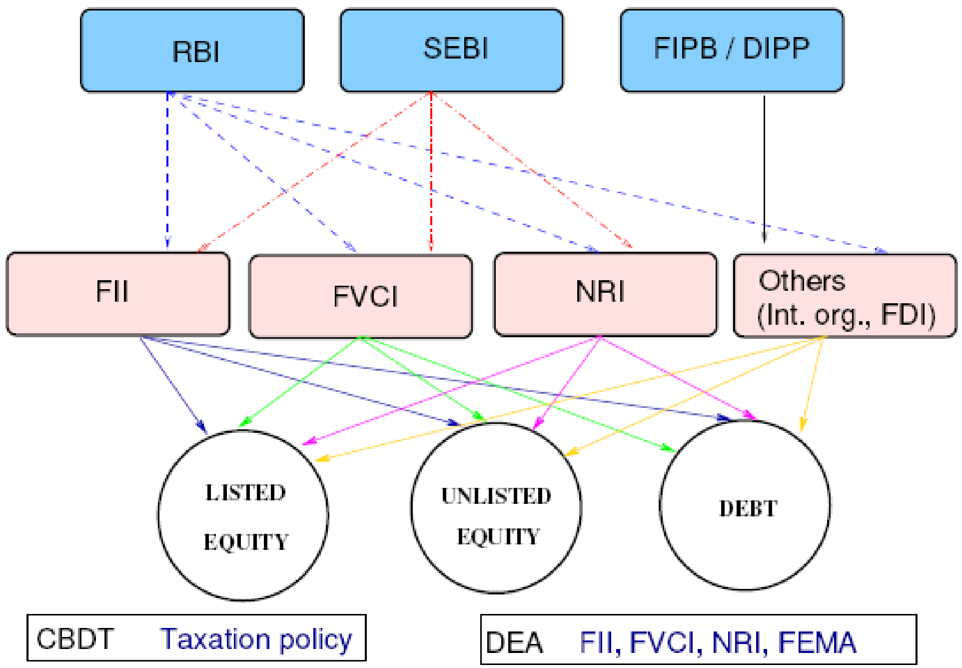
Approach of the Group

- Comprehensive look at regulations made in the last two decades
- Examined India's internationalization and trends of two way flows to/from India
- Identify countries which can form a comparable cohort for India
- Assessed possibility of *en masse* exit by foreign investors
- Recommendations regarding further strengthening the rule of law and legal process
- Not to comment on macro-economic policy or on monetary policy issues but make a distinction between policy on foreign flows and policy on macro prudential regulations
- Study of the recommendations made by past committees
  - Committee on Fuller Capital Account Convertibility (The Tarapore Committee)
  - Committee on Financial Sector Reforms (The Raghuram Rajan Committee)
  - High Powered Expert Committee on Making Mumbai an International Financial Centre (The Percy Mistry Committee)

Regulatory Framework

- Institutional bodies regulating capital flow into India – RBI, SEBI, FMC, IRDA, PFRDA
- The Finance Minister heads the Foreign Investment Promotion Board ("FIPB") which approves FDI, on a case by case basis
- The Ministry of Commerce and Ministry of Finance hosts the Department of Industrial Policy and Promotion ("DIPP") which is responsible for promulgating policy on FDI

Current Regulatory Structure



Existing policy frameworks for capital flows create a complex, overlapping web of law marked by administrative bottlenecks, contradictory and sometimes duplicate processes

India's Internationalization

- Brazil, South Korea, South Africa and Turkey (BSST) identified as a comparable cohort
  - Have large internal markets
  - Democratic governance
  - Offer the closest comparison for the policy problems faced by India
- India's foreign investment framework affected by perception that it poses threat to economy
- India is already more integrated into the world economy than in years before
  - Gross investment position on current account rose by 23% in the 1990s, and an additional 40% from 2000 to 2008
  - Gross flows on the capital account, rose by 12% from 1990 to 1998 and by 43% from 2000 to 2008
  - Foreign engagement of listed Companies (in terms of imports, exports, foreign equity, foreign borrowing and overseas assets) grown roughly tenfold both by size and by number
  - India's integration with the global economy comparable to the BSST cohort in the latter half of the period of liberalization from 2000 to 2008

India’s Internationalization

- India's foreign investment framework influenced by perceptions that foreign investment flows are volatile in nature
  - Greatest exit by foreign investors was after the Lehman crisis of September 2008;
  - and not on domestic events like 26/11 Mumbai attacks, attack on Parliament in 2001, Gujarat riots of 2002, etc
  - While the likelihood of large scale exit by foreign investors is a possibility, it is unlikely

FII activity during the Lehman crisis

(Rs. crore)

Month	Gross buy	Gross sell	Net buy
Jul 2008	70,592	68,010	2,582
Aug 2008	48,914	49,792	(877)
Sep 2008	75,214	80,061	(4,846)
Oct 2008	52,014	68,310	(16,296)
Nov 2008	37,746	36,383	1,363
Dec 2008	38,925	36,979	1,945

FII activity at times of domestic stress

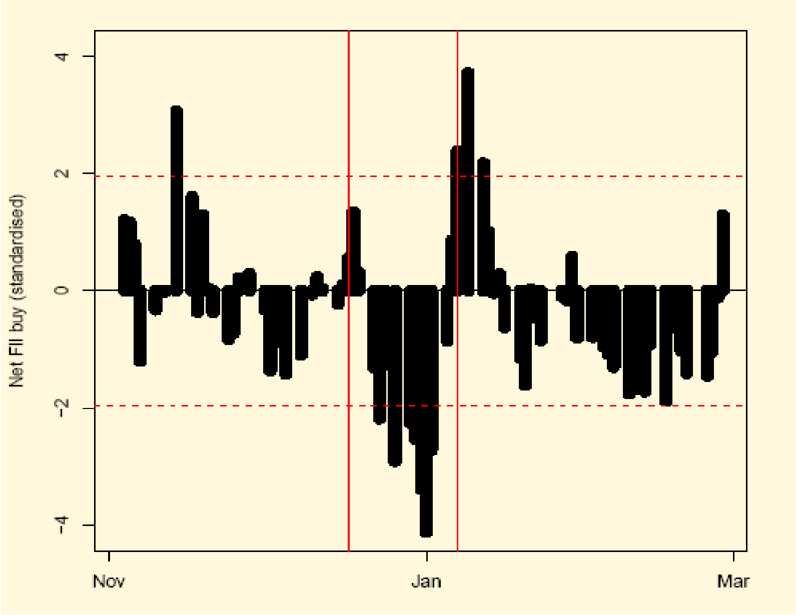
		Net FII Flows (Rs. Crore)			Percent to mkt. capn.		
Event	Event Date	T-1	T	T+1	T-1	T	T+1
Parliament attack	12-12-2001	-91.0	78.8	-90.4	-0.015	0.012	-0.015
Gujarat riots	27-02-2002	141.8	178.8	-2.9	0.020	0.025	0.000
UPA government	13-05-2004	-295.1	-604.4	-504.4	-0.029	-0.060	-0.050
Mumbai attacks	26-11-2008	-436.0	holiday	419.4	-0.015	NA	0.015

Source: CMIE Business Beacon

India’s Internationalization

- In terms of the role of corporate governance, India's institutions also appear resilient and able to help attract foreign investment
  - Foreign Investors did not generalize when accounting fraud was disclosed by Satyam
  - No large-scale exit by foreign investors from India
- Overall, foreign participation in the economy is deep rooted
- Stakeholders have embraced and internalized foreign participation in the economy

Buy/Sell by all FIIs in shares of firms other than Satyam



Source: CMIE Business Beacon

Legal Process

Observations

- Foreign exchange regulation seen as an instrument of monetary policy
- These rules are a significant part of financial sector regulation
  - They affect the ability and extent of individual actors to participate in markets
- Best practices and basic principles of due process and rule of law should apply to these matters
  - Similar to those which apply to other areas of regulation, including financial sector regulation
- Rule of law should include formalized procedures for
  - Transparency and legal certainty
  - Participation as well as accountability
  - Fairness and equality before the law

Legal Process - Some Issues in Current Arrangements

- For registration of FIIs, there is no fixed timeline within which the application must be granted or rejected by SEBI
  - Regulator could sit on applications for an indefinite period of time and since no order has been passed, provisions for appeal cannot be invoked
  - Reviewing authority is the same as the original authority
- For FVCIs, there is no explicit requirement for SEBI to give any reasons for rejection of foreign venture capital applications
  - No procedure for application for reconsideration available, which is available to FIIs
- In the case of subaccounts, SEBI is not required by regulation to provide a procedure for reconsideration of applications of subaccounts
- Looking at the handling of permissions under FEMA by the RBI, no formal system of appealing permissions currently exists
  - There is no time limit within which a permission may be granted or denied
  - No related obligation to provide reasons for the denial of a permission

Legal Process

Recommendations

- Respect and protect basic principles of legal due process when agencies apply foreign investment or foreign exchange law to individual market participants
- **Create a financial sector appellate tribunal, or extend the authority of the Securities Appellate Tribunal**
  - To hear appeals on exchange control regulations affecting individual market participants
- Institute processes of required public consultation before issuing any directives of law and policy
- Involve law departments more integrally in the formation of policy
- Create more user-friendly access to the law through public information systems
  - Provision of real-time access to comprehensive statements of law as well as decisions and reasoned orders of appellate tribunals with regard to securities matters

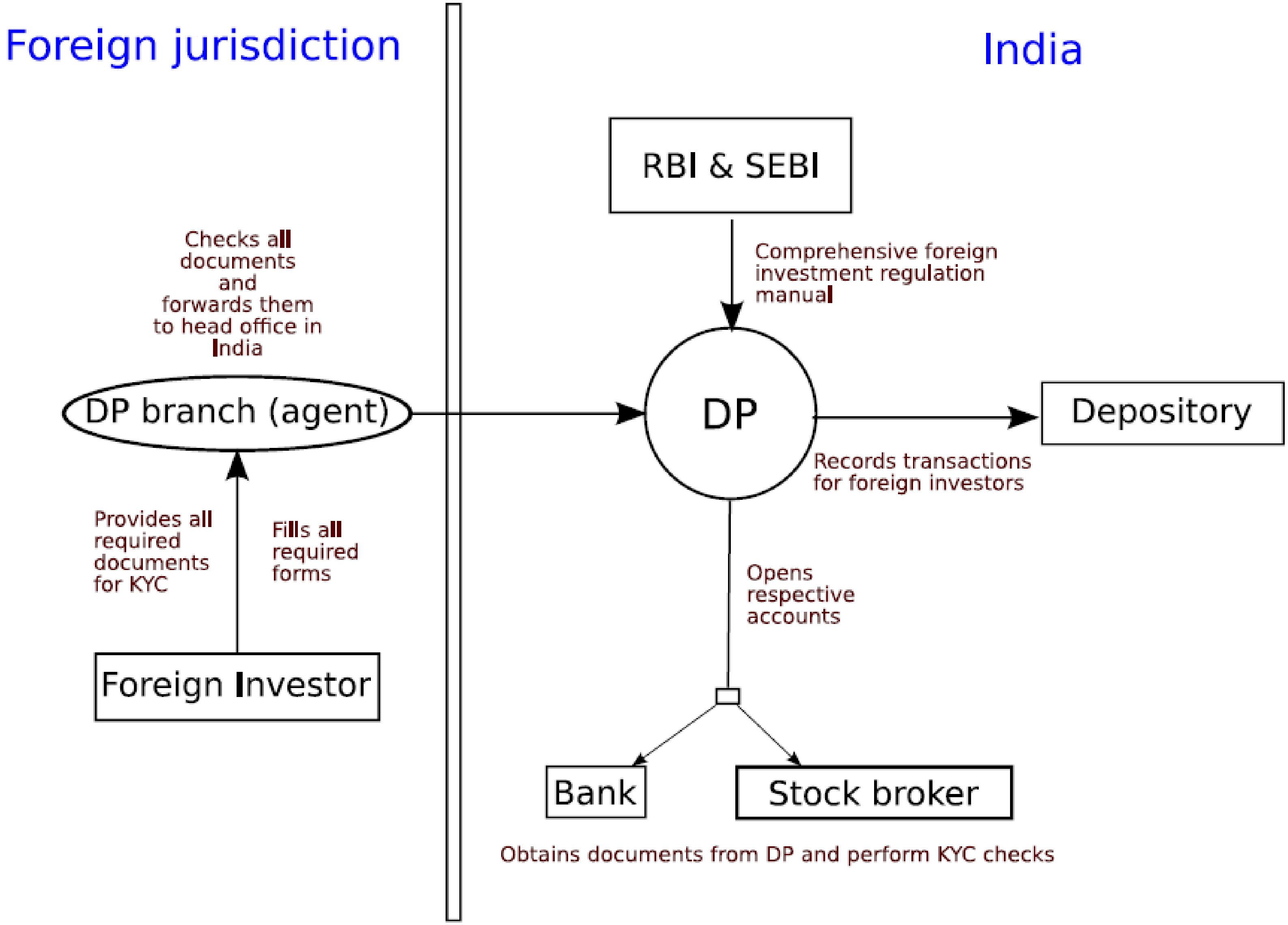
Qualified Financial Investor

Observations

- FII framework relevant in the early 1990s – a reflection of India's gradual opening to world economy
- Today, foreign investors face an ad hoc system of overlapping, contradictory or non-existent rules for different categories of players
  - Problems of regulatory arbitrage and lack of transparency – creates onerous transaction costs
  - This increases the cost of capital for Indian Companies accessing foreign equity capital
- Multiple government working groups have commented on ad hoc structure of India's capital flows management
- Concerns relating to money laundering, terrorist financing and KYC
  - Present regulatory frameworks are not complete and sufficient to track investments and address concerns

Qualified Financial Investor

Proposed QFI Framework



Qualified Financial Investor

Recommendations

- **Create Qualified Foreign Investors (``QFI") as a single class of investors for all portfolio investments**
  - Depository Participants (``DPs"), with global presence through branch network or agency relationships would be responsible for enforcing OECD–standard KYC requirements
  - Such DPs would have higher capital requirements and would need to pass a detailed fitness test administered by SEBI
  - FIIs, FVCIs and NRIs would be abolished as an investor class
- Investment limits
  - Investment in listed/unlisted securities upto 10% of shares would be considered portfolio investment
  - Investment above 10% would be considered FDI requiring compliance with existing FDI regulations
  - OECD countries and BSST peer countries have similar distinction

Qualified Financial Investor

Recommendations

YC Requirements

- Promulgate broader KYC requirements that meet OECD standards of best practices
- These requirements would combine adherence to Prevention of Money Laundering Act rules and information required for market monitoring by all regulators into one master file

losely review sectors where limits set by FDI and portfolio investment policy overlap

ll regulated investment under FDI policy or other sectoral regulation such as regulation of mutual funds or pensions and takeover regulations under the Companies Act, would continue as before

n areas where there are no separate ceilings by Acts of Parliament, QFI investment

Outflows into Equity

Observations

- Under the Liberalized Remittance Scheme (``LRS''), residents in India are allowed to remit up to USD 200,000 annually abroad
- Currently, entities that offer overseas investment products to residents do not have a regulatory framework to offer and market such investment avenues to investors resident in India

Recommendations

- **For consumer protection reasons, all entities structuring and offering offshore securities market-related products to residents Indians should register with SEBI**
  - Full disclosure to SEBI of all details of the product, promotional materials, including product literature, advertisements and brochures which SEBI can also forward to other regulators

Debt Regulation

Observations

- Group focused on 2 broad issues:
  - Exchange rate risk with foreign currency denominated debt
  - Lack of institutional development of the corporate debt market
- Exchange rate risks with foreign currency denominated borrowings as well as quantitative restrictions work against financial stability
  - Limit financing options that would further promote the country's development
- Developing the rules, systems and regulatory structure for a deep and liquid bond market, though not directly a foreign exchange matter, would:
  - Attract foreign investment
  - Promote a deep engagement of foreign investors with India
  - Help to shield the economy from currency mismatches

Debt Regulation

Recommendations

- Remove the caps on rupee-denominated corporate debt completely to address currency mismatches
  - If at all caps have to be put, they could be expressed in percentage instead of absolute terms
- Finish implementing recommendations from government committee reports over the past five years that have either partially or not been implemented
- Extend the QFI model to debt investments as well
- Extend consumer protection guidelines for investment in foreign securities under the LRS to investments in debt securities

Foreign Exchange & Derivatives

Observations

- Derivatives trading has minimal balance of payments implications
  - Net capital moving in or out of the country tends to zero if the number of foreign market participants is large
  - Policy decisions about derivatives trading should be seen as a separate matter from regulation of foreign investment
- Regulation of forwards and futures
  - Review allowing for participation in one route while banning the same in another
  - This redirects flows, invites regulatory arbitrage and may not have the intended effect
- Position limits should be crafted with market integrity in mind and be neutral to nationality
  - Intended to limit the ability of a market participant to engage in market manipulation
- Use of offshore derivative instruments
  - Group acknowledges that greater onshore participation facilitates financial stability

Foreign Exchange & Derivatives

Recommendations

- Capital flows management regulations should focus on spot instruments; not derivatives
- Harmonize the regulation of futures, forwards and options
  - Policy preference to encourage greater trade in exchange-traded, as opposed to over-the-counter derivatives
- Allow investment by Indian residents in derivatives trade abroad up to the USD 200,000 limit under the LRS without further regulation
  - Specially ban on taking margin payments should be restated to hold that, when taking margin payments, total liability should not exceed the LRS limit
- Streamline registration processes by implementing the QFI model
  - This would also reduce the incentives to participate in onshore markets such as those for participatory notes

Tax Recommendations

Recommendations

- Study administrative issues and revenue implications of shifting from a source-based to a residence-based system of taxation
  - Attention to other countries experiences with such transitions required
- Study IT systems and information sharing mechanisms with other countries
  - To properly implement taxation of global income of residents in a residence-based taxation system for capital gains
  - A study of such mechanisms in BSST and OECD countries, in particular, is required
- Study revenue and compliance advantages of source based taxation of capital gains
  - Whether tax and compliance burden would reduce if countries followed a source based taxation regime for capital gains
  - Draft Direct Taxes Code, if enacted in its current form, would remove this barrier to the development of financial services in the country
- Issue of classification as "Independent Agent" against Permanent Establishment

THANK YOU

Annexure - Selection of Comparable Cohort (1/2)

- The working group examined the quality of governance in the G-20 countries based on following indicators
  - Voice and accountability
  - Political stability
  - Government effectiveness
  - Regulatory quality
  - Rule of law
  - Control of corruption
  - Economic freedom
  - Political freedom

Governance Indicators		Brazil	China	Russia	South Africa	South Korea	Turkey	India
Regulatory Quality	1998	0.3	-0.26	-0.51	0.24	0.33	0.49	-0.39
	2008	0.19	-0.22	-0.56	0.63	0.73	0.22	-0.21
Voice and Accountability	1998	0.19	-1.38	-0.58	0.85	0.62	-0.68	0.32
	2008	0.51	-1.72	-0.97	0.68	0.59	-0.19	0.45
Political Stability	1998	-0.4	-0.09	-0.83	-0.88	0.14	-1.03	-0.87
	2008	-0.12	-0.32	-0.62	-0.04	0.41	-0.73	-0.99
Government Effectiveness	1998	-0.12	-0.3	-0.41	0.95	0.39	-0.17	-0.16
	2008	-0.01	0.24	-0.32	0.75	1.26	0.2	-0.03
Rule of Law	1998	-0.27	-0.36	-0.85	0.14	0.74	-0.08	0.23
	2008	-0.3	-0.33	-0.91	0.12	0.79	0.09	0.12
Corruption	1998	0.1	-0.31	-0.83	0.6	0.21	-0.22	-0.31
	2008	-0.03	-0.44	-0.98	0.3	0.45	0.1	-0.37

Source: World Bank Governance Indicator Database

Annexure - Selection of Comparable Cohort (2/2)

Current Account Flows to GDP

(Percent to GDP)

Country	1990	2000	2008	Change 1990 to 2000	Change 2000 to 2008
India	8	31	71	23	40
Brazil	23	36	42	13	6
South Africa	39	52	73	13	21
South Korea	61	80	118	19	38
Turkey		81	154		74
BSST average	41	62	96	21	34
China	31	48	64	17	16
Russia		75	65		-10

Source: CMIE Business Beacon, IMF International Financial Statistics

Gross Investment Position (excluding reserves)

Country	1990	2000	2008	Change 1990 to 2000	Change 2000 to 2008
India	30	42	85	12	43
Brazil	40	80	103	40	23
South Africa	52	144	175	92	31
South Korea	34	79	135	45	56
Turkey	35	77	101	42	24
BSST average	40	95	128	55	33
China	38	70	113	32	43
Russia		173	179	–	6

Source: Lane and Milesi-Ferreti (2007)