Overview of the Report of Working Group on Foreign Investments

29th July 2010

U.K. Sinha
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

Recommendations
- 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

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<tr>
<th>Month</th>
<th>Gross buy</th>
<th>Gross sell</th>
<th>Net buy</th>
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<td>70,592</td>
<td>68,010</td>
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<td>Aug 2008</td>
<td>48,914</td>
<td>49,792</td>
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<td>Sep 2008</td>
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<td>68,310</td>
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<td>Nov 2008</td>
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<td>Dec 2008</td>
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<td>36,979</td>
<td>1,945</td>
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</table>

### FII activity at times of domestic stress

<table>
<thead>
<tr>
<th>Event</th>
<th>Event Date</th>
<th>Net FII Flows (Rs. Crore)</th>
<th>Percent to mkt. capn.</th>
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<tbody>
<tr>
<td>Parliament attack</td>
<td>12-12-2001</td>
<td>-91.0 T-1 78.8 T-1 90.4 T-1</td>
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<td>Gujarat riots</td>
<td>27-02-2002</td>
<td>141.8 T-1 178.8 T-1 -2.9 T-1</td>
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<td>UPA government</td>
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<td>Mumbai attacks</td>
<td>26-11-2008</td>
<td>-436.0 T-1 holiday 419.4 T-1</td>
<td>-0.015 T-1 NA 0.015 T-1</td>
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</table>

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 FII 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

- **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

Foreign jurisdiction

- Foreign Investor
  - Provides all required documents for KYC
  - Fills all required forms

- DP branch (agent)
  - Checks all documents and forwards them to head office in India

India

- RBI & SEBI
  - Comprehensive foreign investment regulation manual
  - Records transactions for foreign investors
  - Opens respective accounts

- Depository
  - Bank
    - Obtains documents from DP and perform KYC checks
  - Stock broker
Recommendations

- Create Qualified Foreign Investors (``QFI'') as a single class of investors for all portfolio investments
  - Depository Participants (``D P s''), 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 up to 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
Recommendations

**KY 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**

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

**II 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**

In 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
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
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
The working group examined the quality of governance in the G-20 countries based on following indicators:

- Voice and accountability
- Rule of law
- Political stability
- Control of corruption
- Government effectiveness
- Economic freedom
- Regulatory quality
- Political freedom

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<th>Governance Indicators</th>
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<th>Russia</th>
<th>South Africa</th>
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<th>Turkey</th>
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<td>-0.51</td>
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Source: World Bank Governance Indicator Database
### Current Account Flows to GDP

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Change (Percent to GDP)

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Source: CMIE Business Beacon, IMF International Financial Statistics

### Gross Investment Position (excluding reserves)

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Source: Lane and Milesi-Ferreti (2007)