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CAPAM 2013

The Changing Regulatory Paradigm & the Road Ahead

The Experts' Voice





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Foreword

The Indian capital market, which has a long history spanning over 100 years, is passing through a very interesting phase. The Indian government and the regulator have initiated several far-reaching reforms in the financial sector in the last six months, some of which have been pending for a long time now. These include the new Companies Act, the passage of the Pension Fund Regulatory and Development Authority (PFRDA) Bill, regulation of the commodity futures market being placed under the Finance Ministry, the report of the Financial Sector Legislative Reforms Commission (FSLRC) and the re-promulgation of the Security Laws Amendment Ordinance. There have also been various other changes in the regulatory climate (enacted or proposed) that will have an impact on the capital markets.

The 10th edition of our flagship Capital Markets Conference (CAPAM) aims to analyse some of these changes and reforms, the opportunities and challenges they would present for different stakeholders and to explore the way forward to widen and deepen the Indian capital markets. This year's Conference publication titled 'The Experts' Voice' is a compendium of papers prepared by members of FICCI's Capital Markets Committee. These papers go beyond just analysing the impact of the recently enacted and proposed regulations and lay down the implications for the Indian capital markets and delve into possible solutions to some of the challenges that may also arise. The articles cover the entire expanse of the capital markets including, equity and bond markets, asset management, corporate governance, recent regulatory changes such as the Companies Act, various SEBI regulations, Real Estate Investment Trusts (REITs), infrastructure financing and private placements. Our endeavor, as FICCI, would be to build on these further and develop a concrete road map for the sector's progress.

FICCI's Capital Markets Committee comprising key players is chaired by Mr. Sunil Sanghai, M.D., Head of Global Banking, India, HSBC and co-chaired by Mr. Anup Bagchi, M.D. & CEO, ICICI Securities Ltd. The Committee has had detailed discussions with the Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI), Ministry of Finance and other market participants on the direction that the Indian capital markets needs to take. This paper is a culmination of these deliberations. We believe that CAPAM is the ideal forum for disseminating these thoughts to a wider audience and gather views to further enrich our work. But for the timely and whole-hearted support of the dedicated members of the FICCI Capital Markets Committee, this task would not have been possible.

We hope you will find this publication insightful.

Naina Lal Kidwai
President
FICCI

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Corporate Governance: Has the pendulum swung the other side?

Mr. Sunil Sanghai, Chairman, FICCI's Capital Markets Committee and M.D., Head of Global Banking, India, HSBC

Corporate governance and increased transparency have assumed increased focus in recent times among investors and regulators alike. Protection of minority shareholders forms a key element in this regard, and this is further evidenced by recent changes introduced via the new Companies Act, 2013 as well as various SEBI regulations/ circulars released over the last 12 to 18 months. These changes aim to address issues highlighted through certain precedent situations where promoters or controlling shareholders of companies had attempted to enforce specific corporate actions that were not necessarily perceived to be in the best interest of the company and/ or its minority shareholders.

While these changes are welcome, regulators and law-makers would need to be careful to ensure that these are not perceived negatively by promoters as being regressive in terms of doing business in India even the right way. The question increasingly being asked is whether the regulatory pendulum has swung too far the other way in efforts to protect minority shareholders.

This article briefly examines the evolution of corporate governance in India, the rationale for increased protection of minority shareholders, a summary of key regulatory changes recently introduced and potential challenges that lie ahead.



Summary of evolution of corporate governance in India

The need for effective corporate governance in India gained importance post liberalization in the 1990s. In 1998, a code called 'Desirable Corporate Governance', based primarily on the Anglo-Saxon Model of Corporate Governance, was released for guidance. The code looked into various aspects of corporate governance, including role of independent directors, limits on number of directorships, various corporate disclosure and creation and responsibilities of an audit committee.

While the code was voluntary, a number of its recommendations were subsequently reiterated in the Kumar Mangalam Birla Committee Report on corporate governance for listed companies and incorporated by SEBI in early 2000 as a new clause(Clause 49) in the Listing agreement of the Stock Exchanges. The clause was further amended based on recommendations of the SEBI appointed Narayan Murthy Committee with regards to the responsibilities of an audit committee, quality of financial disclosure and requiring boards to assess and disclose business risks in the company's annual reports among others. Many of the Committee's recommendations seemed in response to certain corporate scandals witnessed in other parts of the world, in particular the USA.

Some of the key requirements of the revised Clause 49 are highlighted below:

- Composition of Board of Directors: If the Chairman is a non-executive director, 1/3rd of the board should be independent, else half of the board should be independent

- Audit Committee: Listed companies must have an audit committee of the board with a minimum of three directors, two-thirds of whom must be independent
- Financial disclosure
  - Listed companies must periodically make various disclosures regarding financial and other matters to ensure transparency
  - The CEO and CFO of listed companies must (a) certify that the financial statements are fair and (b) accept responsibility for internal controls
  - Annual reports of listed companies must carry status reports about compliance with corporate governance norms

Corporate governance based solely on international practices, however, had certain limitations in the Indian context. This was partly due to the fact that while in international markets, corporate governance primarily aimed to protect the interests of owners from negligent management, in India, it was required to protect the minority investors from manipulative owner / controlling shareholder practices.

The Satyam accounting scandal in 2009 (and the promoter's infamous 'riding a tiger' quote with regard to financial manipulation) demonstrated the need to further evaluate existing corporate governance norms in India, with many corporate bodies and industry groups subsequently putting forth a series of recommendations for protection of minority investors.

Taking these recommendations into account, the Ministry of Corporate Affairs (MCA) released a set of new Corporate Governance Voluntary Guidelines in 2009, which addressed issues such as the independence of the board; responsibilities of the board, audit committee, auditors and secretarial audits; and mechanisms to encourage and protect whistle blowing.

While the Indian Corporate Governance Framework was observed by SEBI to be in compliance with the OECD Corporate Governance principles of 2002 (considered an international benchmark for policy makers, investors, corporations and other stakeholders worldwide), there remained a number of corporate actions that seemed to be 'unfair' to minority shareholders. Some of these are addressed in more detail in the section below.

Unfavourable precedent corporate actions

A key area of concern for regulators in the recent past has been in connection with the sale of assets and/or businesses ('slump-sale'). An emerging trend has been observed with domestic companies selling assets to multinational companies (MNCs) that were attracted by India's historically high GDP growth rates and strong demographic profile. While a number of these asset sales were executed at attractive valuations for the seller, it was observed that in most cases, minority shareholders did not enjoy much benefit accruing from these transactions. Domestic companies had therefore been able to sell core divisions, accounting for significant portion of their revenue, without compensating or providing an exit to minority shareholders (since there was no change in control in the company, the Takeover Code was not triggered).

In addition to slump-sale transactions, certain group promoters had previously looked to restructure group companies without factoring minority shareholders' interests. In a number of such situations, promoters' companies had allegedly used such mergers to either gain increased control over the company through higher shareholding / voting rights or realize significantly high valuations to their benefit. While the previous Companies Act protected



minority shareholders from being exploited in this manner by requiring companies to pass a special resolution (majority by at least 3/4th of total votes) in an extraordinary general meeting prior to proceeding with the restructuring, promoters were still able to successfully push through the resolutions. This was primarily on account of the sheer number of shares held by promoters and the inability of minority shareholders to be present at the time of voting on these resolutions.

Probably one of the more contentious issue in recent times, and one that minority shareholders believe is commonly practiced by MNCs, is that of royalty payments. Royalty payments had previously been restricted by Foreign Exchange Management (Current Account Transactions) Rules 2000, capped at five percent of domestic sales in case of technical collaboration and two per cent for the use of a brand name and trademark. However, with the Government removing such restrictions in early2010, there has been a visible spurt in MNCs increasing royalties from their Indian subsidiaries. This led to a decline in distributable profits of the Company, which minority shareholders believe resulted in an unequal distribution of wealth between the majority stakeholder and themselves. While royalty payments for technology / brands are common in international markets, inadequate disclosure by many companies in India in terms of benefits received from such parents' services have contributed towards minority shareholders' perception of such 'unfair' related party transactions. This is further accentuated in certain cases where companies have continued to pay royalty over a number of years despite not paying any dividends to shareholders during that period.

In this regard, the role of independent directors, their ability to influence such decisions in the best interest of all shareholders of the Company and whether they could be considered truly independent in their actions are additional key questions being asked by a number of minority investors. Apparent inaction by these independent directors combined with the significant shareholding held by promoters made it challenging for minority investors to have any say with regard to such corporate actions.



Recent regulatory changes

In response to the various issues highlighted above, the Government and regulators have introduced a number of changes in the relevant regulations and also via the recently approved Companies Act, 2013. Some of the key changes with regard to corporate governance requirements are covered in detail below.

Independent directors/ audit committee:

The Companies Act, 2013 further emphasizes the role of independent directors to safeguard the interests of all stakeholders. It has introduced provisions to ensure greater accountability, transparency in the selection and functioning of independent directors through stricter eligibility criteria, prescribed code of conduct and maximum permissible tenure period.

Independent directors are now to be appointed only from approved data banks maintained by institutions notified by the Central Government which may also prescribe procedure for their selection. Further, the tenure of independent directors has been limited to a maximum of two consecutive terms of five consecutive years with a cooling off period of three years thereafter. These measures would ensure that the independent directors are not entrenched in the company while also requiring them to be more diligent in their role for protection of minority shareholders.

The Act also strengthens the audit function in companies by clearly defining the roles and

responsibilities of the audit committee including recommending appointment of auditors and monitoring their independence and performance, approval of related party transactions, scrutiny of inter-corporate loans and investments, valuation of undertaking/assets etc.

Auditors:

The Companies Act, 2013 now requires rotation of audit firms of a company. An individual auditor must be rotated in every five years while no audit firm can be appointed for more than two consecutive terms of five years each (followed by a minimum cooling off period of five years).

Enhanced special resolution requirements:

Shareholders' approval through a special resolution is now required for a number of additional activities as compared to the Companies Act, 1956. Some of them are listed below:

- Issue of depository receipts/ partly or fully convertible debentures
- Removal of auditor before the expiry of his term
- Appointing more than 15 directors
- Reappointment of a director after completing a term up to 5 consecutive years
- Specifying lesser number of companies in which the director of a company may act as a director
- To sell, lease or dispose the whole or substantial part of the undertaking of the company
- To invest otherwise in trust securities the amount of compensation received by it as a result of any merger or amalgamation
- Related party transactions that are not in the ordinary course of business or not at an arm's length basis (related parties cannot vote)
- Appointment or continuation of employment of any person as an MD or Manager if the person is below the age of 21 or attained more than 70 years

Scheme of compromise/ arrangement/ amalgamation

As per the Companies Act, 2013, the decision on a scheme of compromise/ arrangement/ amalgamation can be considered in a board meeting only. A scheme cannot be approved by the board



just by passing a 'resolution by circulation' which was permitted under the earlier Act. Further, the Companies Act, 2013 has recognized the concept of voting through postal ballot, eliminating the need for physical or proxy presence. This change is expected to result in increased participation by minority shareholders and creditors who previously may have found it difficult to be physically present for such meetings.

Further, in an effort to increase transparency, the Companies Act, 2013 has made it mandatory for companies to share a valuation report prepared by an independent registered valuer as a part of the notice to be sent to the shareholders or creditors. Additionally, under Section 236 of the Companies Act, 2013, minority shareholders are now to be provided an exit option (even in the case of unlisted companies) either on the basis of a valuation report by a registered valuer or as specified by SEBI in case of listed companies. Finally, the creation of a National Company Law Tribunal to oversee such schemes and direct an appropriate exit mechanism for minority shareholders will strengthen minority shareholders' faith in overall corporate governance.

For schemes involving listed companies, in addition to the Companies Act, 2013, SEBI has also released detailed guidelines (through its circulars in February and May earlier this year) on the approval process to be followed. Under these guidelines, schemes involving merger of promoter/promoter group companies now require at least 50% of the votes cast by public (non-promoter) shareholders

to be in favor of the proposal, through postal ballot and e-voting for the proposal to go through. This will provide significant protection for minority shareholders.

Sale of an undertaking

The Companies Act, 2013 has also addressed the issue of slump-sales and ensures that companies do not divest significant portions of their business at the expense of minority shareholders by specifically defining 'undertaking' and 'substantially the whole of the undertaking'. Any sale involving higher thresholds than specified in the Act for the above definitions (more than 20% of company's net worth / more than 20% of the value of the undertaking respectively) now requires the company to obtain shareholder approval through a special resolution.

Related party transactions

The Companies Act, 2013 provides specific definition of a related party and has widened the scope of related party transactions. It also mandates shareholder approval through a special resolution for transactions above the specified limit, unless the transaction is at an arm's length basis and is in the ordinary course of business. This particular provision can potentially give minority shareholders some protection against the unfavorable royalty increases by the company to its promoter.

Recognition of contractual arrangements and pre-emptive rights

The Companies Act, 2013 further recognizes 'inter-se' shareholders arrangements on transferability of shares of public companies. Section 58 specifically provides that any contract or arrangement between two or more persons in respect of transfer of securities of a public company shall be enforceable. This key development was subsequently followed by SEBI permitting pre-emptive rights (including 'drag-along', 'tag-along', RoFR and RoFO) and put-call options in shareholder agreements. Together, these aim to protect minority investors by facilitating increased certainty on enforceability.

Conclusion:

To conclude, clearly there has been a need in India for enhanced corporate governance standards and protection of shareholder interests. The introduction of measures such as special resolution on various corporate actions (to prevent misuse of voting rights by controlling shareholders) has been a welcome step in this regard.

However, some of the measures such as not permitting controlling shareholders to vote on certain corporate actions (viz. mergers involving promoter group companies and related party transactions) have made it challenging for owners to execute key corporate actions.

Even for a delisting, while the controlling shareholder can vote, two-thirds of the public shareholders are required to approve the resolution. Such situations can give rise to speculation by some of the minority shareholders effectively blocking the desired resolution. For example, there have been cases in the recent past where public shareholders have rejected a delisting resolution, despite the acquirer willing to pay a significant premium to the floor price.

While still early days, the above instances make one further question whether the regulatory pendulum is swinging too far the other way to protect the minority shareholders.

Averting Subdued Growth Inertia

Mr. Anup Bagchi, Co-Chairman, FICCI's Caapital Market Committee and M.D. & CEO, ICICI Securities Ltd.

India has been struggling with a dwindling economy registering decade low growth of 4.4% during the June 2013 quarter, rising inflation and steep currency devaluation. The depleting macro situation has built enormous pressure on the government to introduce urgent and bold measures to revive the economy. In the backdrop of the last global financial meltdown during September 2008, economic growth had sunk to a mere 3.5% in Q4FY09, post a life-time high growth of 9.3% in FY08. However, the threat of a slump in the domestic economy was credibly averted through liquidity infusion in the form of rate cuts and tax sops, which boosted overall demand. The stimulus measures led to a sharp recovery in economic growth to 8.6% in FY10, bettered in FY11 with 9.3%.

The clamour for introducing a similar stimulus is picking up pace to revive consumption demand. Nonetheless, the government should avoid giving in to this temptation not only because government finances and inflation scenario are far weaker this time around but also because stimulus led demand pick-up is not a sustainable solution to the present slowdown. Increased liquidity and cheaper availability of credit may prop up consumption demand in the short-term. However, it will also fuel already soaring inflation. Moreover, depleting tax buoyancy would strain the government's ability to counter future slowdown threats. Instead, in such turbulent periods of appalling growth, spending on infrastructure projects needs to be prioritised to aid job creation and revive economic growth.

Private sector lead infra spending during booming times

Investment in infrastructure is one of the paramount needs for sustainable economic growth. Both private and public sector have jointly shouldered the responsibility of infrastructure creation in the past few years. In fact, private sector investment in infrastructure has picked up in recent years contributing ~37% of the estimated spend of Rs 19.1 lakh crore in the Eleventh Plan Period (2007-12) against a target of 30% of originally projected investment of Rs 20.6 lakh crore. Also, there was a marked increase from their share of 22% in the Tenth Plan.

Investments during the Eleventh Plan period were about 93% of original projections while the private sector outperformed their target with 113% achievement and the public sector could achieve only 84%. The most notable outperformance was seen in the telecom (135%) and electricity sectors (164%). These comprised 50% of the total Eleventh Plan period spend, of which the private sector contributed 57%. The over achievement of the private sector spending has partly compensated for the underperformance of public sector in the past.

Increasing share of Private Spending in total Infrastructure Spending

(Rs Lakh Crore)	10 Five Year Plan	11th Five Year Plan		12th Five Year Plan
	Actual achieved	Original Estimates	Actual Achieved	Origional Estimates
Total Expenditure	8.4	20.6	19.1	56.3
Public (Centre+State)	6.5	14.4	12.0	29.2
Private	1.9	6.2	7.0	27.1
Contribution from private Sector (%)	22	30	37	48

Source: Planning Commission

Private Sector overachieving infrastructure spending targets in 11th Plan

(Rs Lakh Crore)	Original Estimates	Actual achieved	% Achievement
Public Spending	14.4	12.0	84
Private Spending	6.2	7.0	113
Total	**20.6**	**19.1**	**93**
Breaking of Provate Spending			
Electricity	1.9	3.0	164
Telecommunication	1.8	2.4	135
Others	2.6	1.6	62

Source: Planning Commission

Urban Infra & Railway to take preference with higher share of public investments

However, currently, with several of the past infrastructure projects stalled due to regulatory and environment hurdles, the private sector is suffering due to time and cost overruns and a mounting debt profile. This has not only hurt the viability of business prospects but also severely dampened investor confidence, thereby jeopardising future investments in long gestation infrastructure projects. Consequently, the government target of meeting 48% of planned investment of Rs 56.3 lakh crore in the Twelfth Five Year Plan (2012-17) through private sector investments may not fructify. This puts the onus of taking the lead in future infrastructure investments back on the public sector.

Telecom and power sectors are already past their peak investment cycles with huge capital expenditure incurred in yesteryears. Railways and urban infrastructure are the next two big opportunities, which need to be tapped. Investments in crucial sectors such as railways fell short by a staggering 25% of the targeted investments in the Eleventh Five Year Plan. Railways are the backbone of our logistics infrastructure and provide a cost effective and efficient model for transport, which highlights the need for further augmentation of rail capacity in the country. Railways, along with MRTS, require an investment of Rs 6.5 lakh crore (11.6% of the total Twelfth Five Year Plan) of which 76% contribution is required from the public sector.

Secondly, investment in urban infrastructure has historically been neglected despite urban India contributing ~80% of our GDP. Our investment in urban infrastructure has been mere 0.7% of GDP in the past decade as compared to over 2% for China. Augmenting investment in this sector is significant to help urban infrastructure keep pace with increasing urbanisation. In contrast, during the Eleventh Plan period, India spent an average of ~2.5% of its annual GDP towards subsidies (including petroleum bonds), which are recurring and do not boost long term growth. The same resources, if deployed efficiently in creating urban infrastructure, can be more productive by aiding inclusive and sustainable growth.

As per the High Powered Expert Committee (HPEC) under the Ministry of Urban Development, an estimated investment of Rs 39.2 lakh crore is required in urban infrastructure over the next 20 years. Of this, about 44% investment is required in urban roads, 21% in water supply, sewerage, solid



Stagnating Equity Pool of Insurance and MF

Rs Crore	FY08	FY09	FY10	FY11	FY12	FY13
Total Life Insurance AUM	847,687	934,030	1,288,946	1,482,549	1,618,544	1,786,665
Life Insuarance Equity AUM	238,271	199,966	446,881	507,434	473,000	464,849
Equity AUM as % of Total AUM	28.1%	21.4%	34.7%	34.2%	29.2%	26.3%
Life Insurance Premium Collected	201,351	221,785	265,447	291,605	287,072	282,722
Equity and ELSS AUM in MF	172,472	108,244	198,120	195,323	182,076	172,508

Source: IRDA, Life Insurance Corporation of India, AMFI

Capital raising during the eleventh five year plan period

Rs Crore	FY08	FY09	FY10	FY11	FY12	During 11th Plan Period	FY13*
Right	32,518	12,638	8,319	9,503	2,375	65,353	7,007
Equities	79,739	14,272	54,875	57,667	12,857	219,410	13,050
Total from Capital Markets	**112,257**	**26,910**	**63,194**	**67,170**	**15,232**	**284,763**	**20,057**
VC Funding	14,061	-16,779	32,264	5,521	6,720	41,787	-3,866
Private Equity^	37,595	16,223	37,210	43,156	40,940	175,124	31,008
ECB and FCCB^	103,101	78,179	84,205	110,945	165,732	542,161	174,352
Net FDI#	63,800	100,100	86,000	51,551	103,200	404,651	107,712
Bank Incremental Credit	430,725	413,635	469,241	697,290	697,290	2,708,181	697,290
of which to Infrastructure sector	60,770	64,672	109,916	146,767	104,245	486,370	98,800
Grand Total	***761,539***	***618,267***	***772,114***	***975,632***	***1,029,114***	***4,156,667***	***1,026,553***

**Right Issue Equities and VC only for 9MFY13,*

^converted to INR based on average exchange rate of the respective fiscal Private Equity FY08 represents CY08 and so forth, FY13 represents figures for Jan-June 2013

#Net FDI may include some PE & VC investments

Source: RBI, SEBI, VCC Edge

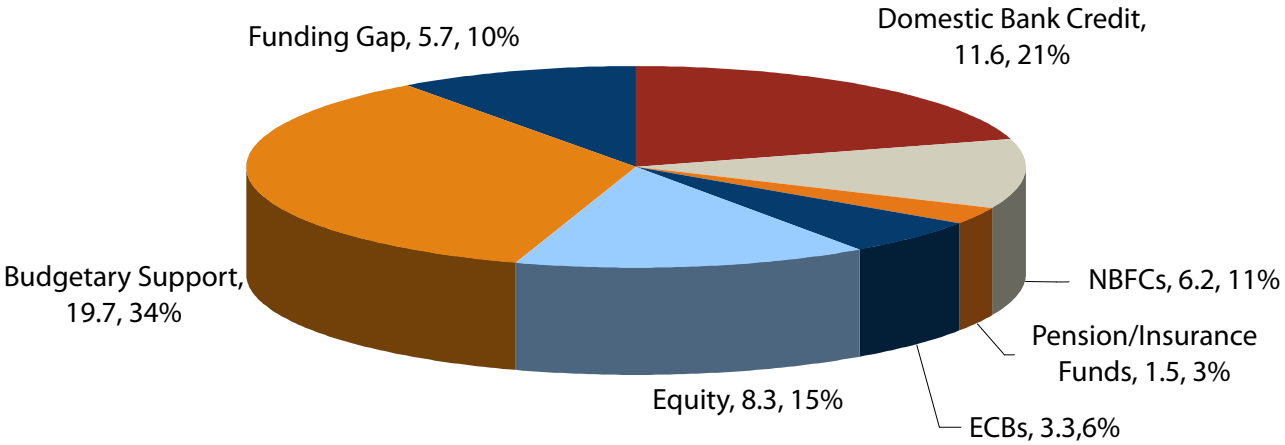
waste management, storm water drains and street light while another 14% is required in transport related infrastructure.

Funding to align with changing capital market dynamics

The funding of the ambitious Twelfth Five Year Plan would be a challenge for all stakeholders given the low mobilisation of savings into investments. Nonetheless, infrastructure spending during this period is envisaged to be back ended, which provides comfort in the current economic scenario, wherein the recovery in growth rates may be gradual. Major funding is expected from the budgetary support, which is likely to contribute 35% (Rs 19.7 lakh crore) of the planned Rs 56.3 lakh crore, compared to 45% in the Eleventh Five Year Plan. Debt from commercial banks, NBFCs, insurance companies and external sources would contribute ~41% in line with that in the last Plan. The balance 15% (Rs 8.3 lakh crore or US $ 135 billion at current exchange rates) would be funded through equity & FDI as against 14% in the earlier Plan.

In five years ending FY12, about Rs 2.8 lakh crore was raised from equities and rights issue, averaging about Rs 56000 crore each year while only Rs 20000 crore was raised during the first nine months of FY13. Life Insurance Premium collected is more or less stagnant over the past three years, while the Equity AUM as a percentage of Total

Funding the Twelfth Five Year Infra Spend (Rs lakh Crore)



Insurance AUM has come down significantly in the last five years. Also, the Mutual Fund Equity AUM has also been on a declining trend. Venture Capital and Private Investments have grown; however, they remain lumpy and may not be directed towards the targeted infrastructure investments.

In contrast, we have received FDI amounting to $89.5 billion (Rs 4.0 lakh crore) over the same period, and another $55.3 billion (Rs 2.3 lakh crore) has been raised by the way of External Commercial Borrowings (ECB), a good portion of which flows into infrastructure. Funding from these sources helped private sector in supporting total private sector capex of Rs 7.0 lakh crores during the Eleventh Five Year Plan period. Looking at the current subdued scenario, it may not be possible to raise same proportion of resources from the capital markets going ahead, which makes us more dependent on external funds in forms of FDI.

The government has followed a strategy to increase the county's attractiveness and facilitate FDI in various sectors. It has already allowed 100 percent FDI in infrastructure sectors like Telecom, Electricity, Road and Highways, Ports and Civil Aviation along with increasing the FDI limit in single and multi brand retail and asset reconstruction firms. It is therefore likely that the government may allow FDI in railways sector for development of new and existing network. Additionally, other measures such as relaxation of ECB norms would go a long way in garnering ~ $135 billion (Rs 8.3 lakh crore) and ~ $310 billion (Rs 18.9 lakh crore) in equity and debt respectively, required to be raised in the 12th Plan.

Conclusion

In the current scenario of slowdown, the government has to play an active role to formulate policies to stimulate growth. Government establishments across the globe have resorted to either stimulus measures in the form of inducing liquidity and tax breaks or increasing public expenditure, in a bid to steer their respective economies out of the current turmoil. For a developing economy like ours, it is more sensible to focus on reviving infrastructure spending. This would double up as the new growth driver, besides removing supply side bottlenecks and aiding job creation.

Corporate Bond Market in India

Mr. Sandip Biswas, Group Director (Corporate Finance and M&A), Tata Steel Limited

Debt capital market is an important source of funding as it provides corporates with a financing avenue complimentary to bank finance. With stringent capital adequacy requirements under Basel III and a volatile macroeconomic climate, bank loans are getting harder to get by the day and this lack of bank finance acts as a speed breaker to productive economic activity. A well-developed corporate bond market becomes important in such an environment as it helps to reduce dependence on bank funding and provides an alternative funding source to corporates. Corporate bonds score over traditional bank loans on a number of aspects as illustrated below:

- The debt covenants put by banks make bank financing a lot more restrictive than bond issuances.
- Bonds provide a very good investment alternative to investors looking for fixed yield.
- It helps to diversify and spread the risk of default over a number of investors rather than severely damaging a particular bank's balance sheet and credibility.
- Provide investors with a good avenue for relatively risk-free investment and thus, stimulate financial savings in the economy.

To further emphasize the importance of bonds, it is surprising to know that bond issuances benefit almost every stakeholder. Since a credit rating reflective of healthy balance sheet is a pre-requisite for bond issuances, they provide companies with an incentive to keep their financial health in check. This makes the equity holders benefit from sound financial practices and operational efficiency too. Bond issuances are often used as a signal for financial strength. The government also benefits from deepening of bond markets, since apart from giving a general boost to infrastructure financing, more participants and instruments enable it to borrow more cheaply as spreads reduce.

Indian Context

India's financial sector is dominated by banks, which account for over 60% of total assets of the financial sector. A well-developed corporate bond market is required to facilitate the long term funding requirement of the infrastructure projects as well as other corporate endeavours.The lack of depth in the corporate debt market restricts the channelization of capital towards the infrastructure sector, which is not able to raise long term funds efficiently from the capital markets. To put this into practice, there is a need to plan a structural shift from a bank-dominated financial system to one that is more diverse, in which corporates can easily access finance from debt capital markets. This can be achieved by developing a sound and active corporate bond market.

Challenges faced by Indian Bond Market

a. Lack of depth: A comparison with developed and other developing markets illustrates that the Indian corporate bond market is still in its infancy stage. Corporate bonds account for only about 4% of the country's GDP, compared with 70% in the US and



49% in South Korea. The argument also holds true when we look at relative use of long term sources of finance for corporates. Corporate bonds account for nearly 80% of total long term debt financing by corporates in the four developed economies of USA, Germany, Japan and South Korea. The lack of corporate bond financing in India is explained by the Indian companies' preference for bank finance, equity markets and ECBs to finance their needs.

b. Highly fragmented: Bulk of debt is being raised through private placements. A narrow investor base can never lead to a flourishing, well-developed market as it weakens the two pillars of any financial market, wide investor base and liquidity.

c. Limited Issuers: Not only the investor base, but also the issuers are restricted to a few well-placed corporate houses, leaving no space for small and medium enterprises to gain access to this market. What keeps these small companies away from the bond issuances is also the high costs of issuance.

d. Lack of transparency: Similarly, the lack of transparency in trades ensures that investors stick with the 'Big Boys' with creditable corporate governance history and not risk their money in smaller non creditable companies.

e. Limited liquidity: Trading is concentrated in a few securities, with the top five to ten traded issues accounting for the bulk of total turnover. The secondary market is also miniscule in size, accounting for only 0.03% of the total listings. Thus, the market suffers from deficiencies in products, participants and institutional framework.

Current Situation

A lot of action is being taken to ensure that the bond market is utilised to its full potential. There have been steps to develop bond market infrastructure and instruments. There were two attempts to develop interest rate futures in 2003 and 2009. Initially, there was lack of liquidity as only two underlying long-term government securities were deliverable. But now with the market size having changed and physical settlement being allowed, things are beginning to look positive. Repo in corporate bonds was allowed in March 2010, which



was followed by an expansion of eligible securities. The applicability of credit default swaps was also expanded. Simultaneously, stock exchanges developed trading platforms for transactions in debt securities. Also, multiple rating agencies have come up for debt securities. The government has also taken steps to ensure that the long-gestation infrastructure projects are half-funded by corporate bonds. All the above mentioned steps have helped develop a good launch pad for the corporate bond market to gain popularity.

Enablers for development of bond market

Given its potential, the corporate debt market needs more attention of the policy makers.

- Retail tax breaks could be given to make debt a more attractive investment and widen the investor base.
- Insurance companies and pension funds could be allowed to invest in corporate bonds, on the basis of rating rather than on issuers' category.This would widen the scope of their investment, giving a boost to well-performing debt.
- Reducing transaction costs can make public bond issues attractive compared to private placements.
- Another way by which an active bond market could be developed in the country is through a gradual reduction in the proportion of

Government securities that banks can 'hold to maturity' (HTM). Declaring a government security as HTM helps banks avoid mark to market pricing. If banks are absolved from MTM for HTM in corporate bond category too, it will force them into more diversified assets, including SME corporate bonds, giving them the required stimulus.

- FIIs should be tapped even more efficiently by projecting Indian Corporate debt as a safe investment, providing good returns. International organisations can play an active role even as promoters of bonds. For instance, the International Finance Corporation (IFC) has recently launched a $1 billion offshore rupee bond, which will help diversify the offshore rupee market and provide an alternative source of funding for Indian corporates.
- Opening up of the domestic bond markets to gain entry to benchmark indices (JP Morgan and others) for emerging market debt could attract billions of dollars in investment. Qualifying for bond index inclusion could trigger around $20-30 billion of foreign capital inflows which could finance a large chunk of India's current account deficit, help stabilise the currency as well as restore business confidence.

Conclusion

There is an urgent need to encourage public issuance of bonds and to restrict private placement.



Recent data has shown positive signs. While 2011-12 saw a 31% increase in issuance to Rs. 2.51 trillion ($50.2 billion) compared to 2010-11, growth accelerated further by 39% in 2012-13 with issuance volumes reaching Rs.3.5 trillion ($70 billion).The country would need to further ease rules on registration, documentation and settlement mechanisms for the entry of foreign institutional investors (FIIs) in the Indian debt market and permit them to invest more in government debt.Thus, although the problems have been identified and a few steps have been taken, the Indian corporate bond market today needs an impetus, made up of structural changes in the tax, transaction and investment rules, a rethink in the government bond holding structure, steps to boost secondary market liquidity, more investor education and confidence and a slight change in India Inc's financing instincts.

Changing Regulatory Paradigms: The Road Ahead

Mr. Varoon Chandra, Partner, AZB & Partners

One of the fundamental drivers of growth in an economy is the availability of capital to industry. Capital needs to be available at a reasonable cost. Capital also needs to be available through a process that is reasonably efficient – both in terms of time as well as effort required to be spent by a company and its management. Traditional sources of capital have included financing by banks and financial institutions, fund infusions (by promoters and other investors such as private equity and venture capital investors) and last but not the least, capital markets. However, over the past year, we have seen these sources of capital dry up to an extent. Banks have become more cautious of lending, private equity investors have become more discerning about investee companies and valuations and the capital markets have seen significant volatility, resulting in fund raising transactions becoming extremely difficult to execute.

Given the recent economic downturn, governments across the world have been attempting to attract capital into their economies. At the same time, regulators have not forgotten the lessons of the sub-prime crisis and are reluctant to have too "light touch" an approach to regulation of the financial sector. It is therefore a difficult tight rope for a regulator to walk – how to make its jurisdiction an attractive destination for foreign capital, while at the same time retaining sufficient regulation so as to ensure against systemic failures.



India has its own particular issues to deal with. Aside from the global economic situation, investors have at times expressed reservations with respect to investing in India – political uncertainty, corruption, ambiguity in regulations and delays in obtaining regulatory approvals are some of their key concerns.

In light of this background, Indian regulators have, over the past few months, introduced a number of key changes in regulations. Some of these changes have been long awaited and are extremely welcome. However, a few have introduced uncertainties where they did not exist before, the impact of which needs to be thought through. Some of the key changes have been dealt with below.

Put & Call Options

While put and call options have existed in private arrangements between shareholders, the enforceability of such options has always been a matter of debate. The uncertainty in enforceability of put and call options in shares of public companies in India arose from the provisions in the Securities Contracts (Regulation) Act, 1956 requiring contracts for the sale and purchase of securities to be "spot delivery" contracts. In an environment where exits for such investors are heavily dependent on cooperation from the Indian promoter, this uncertainty was discouraging for investors.

In order to address this uncertainty, SEBI has recently permitted persons to enter into contracts for sale or purchase of securities containing (i) pre-emption rights (including right of first refusal rights, tag-along or drag-along rights); and (ii) options for the sale or purchase of securities (where the title to the securities is held by the selling party for at least one year from the date of the contract and the contract is settled by way of actual delivery of the

underlying securities). Put and call options can now be incorporated into agreements entered into by shareholders and/or the articles of association of the company and would now be enforceable. There are still a few issues that need to be considered with respect to put options, for example, whether a put option in the articles of association of a company undertaking an IPO would be permitted to continue subsequent to the completion of the IPO. However, overall, this is a welcome change that should significantly increase the legal sanctity of exit rights provided to an investor.

Foreign Portfolio Investors

At a board meeting held on October 5, 2013, SEBI has approved the draft Foreign Portfolio Investor regulations ("FPI Regulations"). These regulations seek to merge existing Foreign Institutional Investors ("FIIs"), sub-accounts and Qualified Foreign Investors ("QFIs") into a new investor class known as Foreign Portfolio Investors ("FPIs"). The regulations segregate FPIs into three categories: the first includes government and government-related foreign investors; the second relates to regulated broad-based funds, regulated entities such as university funds, endowments and pension funds, etc.; the third category covers all investors who are not eligible to invest under the first two categories. While FIIs and sub-accounts are permitted to continue trading securities under the FPI regime, QFIs can continue trading in securities from a period of one year from the date of notification of the FPI Regulation, in which time they would have to obtain registration as an FPI entity. The FPI Regulations further permit SEBI-approved depository participants to register FPIs on behalf of SEBI. It has been clarified that FPIs are allowed to invest in those securities, where FIIs are currently allowed to invest.

This move by SEBI has been seen as a means to address concerns of foreign investors who believe that entering the Indian market is a time-consuming and compliance heavy process. The FPI Regulations are intended to make India a more attractive investment destination and put in place easier entry norms and a cost-effective operating framework for



eligible foreign investors. For instance, under the FPI Regulations, the regulator has simplified the investment process by delegating registrations to SEBI-approved depository participants, as opposed to requiring registration with SEBI itself.

While this change should incentivize foreign investors to enter the Indian markets, it remains to be seen how soon and how comprehensively the FPI regime is implemented. Given that the FPI Regulations themselves are not public as of the date of this article (October 24, 2013), it further remains to be seen whether, for instance, there will be a cap on the quantum of investment FPIs are permitted to make in Indian securities. Further, SEBI will need to adopt an approach synchronized with other regulators (mainly, the Reserve Bank of India and Indian income tax authorities) to amend existing laws governing foreign investments and bring them in line with the proposed FPI regulations. If this can be achieved efficiently, this should have the effect of sending a positive message to the international community with respect to India as an investment destination.

Definition of "Control"

The concept of "control" over a company has traditionally been interpreted as requiring the ability to positively direct the management or operations of a company, typically, by owning a majority of the voting shares of the company and / or having the power to appoint a majority on the board of directors of the company. However, for the purposes of the

SEBI takeover regulations, the definition of "control" was expanded further to also include the right to control the management or policy of a company by virtues of "management rights or shareholders agreements or voting agreements or in any other manner".

SEBI interpreted this definition to also include within it affirmative / veto rights that are typically obtained by financial investors in their portfolio companies. The Securities Appellate Tribunal ("SAT") did not agree with this view in its ruling in the case of *Subhkam Holdings*, which said that as long as such rights were merely protective, they would not amount to "control" for the purposes of the takeover regulations. This ruling, at the time that it came out, was welcomed by the financial investor community. However, unfortunately, when the case was appealed to the Supreme Court, the appeal was disposed off while keeping this question open, and expressly stating that the ruling of the SAT would not have any precedent value.

While this debate was applicable only in the context of listed companies, in August of 2013, the Government also amended the definition of "control" under the Consolidated FDI Policy to provide for a similar definition, thereby extending its application to all companies. As a result, investee companies are now faced with a situation where, by virtue of foreign financial investors being granted standard affirmative rights, such investee companies could be construed as being foreign controlled, regardless of the equity stake held by such investors, thereby subjecting these companies to restrictions on downstream investments that would not otherwise have been applicable. This is a change that could



have a significantly adverse impact on transactions by financial investors, from the point of view of the investor and the investee company.

Conclusion

It is evident from the above that the regulators in India are attempting to take steps to encourage investors to think of India as an attractive investment destination. Another example is the recent press release by the Government permitting unlisted Indian companies to list overseas through the ADR / GDR route. However, once again, the rules for the implementation of this decision are yet to be released. The shift in the regulatory paradigm therefore seems for the most part, to be moving towards showing the international community that India is indeed "open for business". As always though, the key will lie in how well these measures are implemented, and whether there will be the appropriate level of coordination between Indian regulators in such implementation.

Financial sector development in India and the road ahead

Reforms in the financial and capital markets could boost GDP growth and the development of better job opportunities across various verticals.

Mr. Vikrant Gugnani, Executive Director & CEO - Broking and Distribution Businesses, Reliance Capital Limited

In the two decades since the Indian markets began traversing the long road to financial sector reforms, although much has been achieved, a significant amount still remains to be done. And hindsight based upon past happenings makes it clear that in events concerning the financial sector and capital markets, supervision is imperative.

Let me hasten to add, though, that by 'supervision', one does not mean a maze of stifling regulations and restrictions. Rather, one refers to a more holistic definition of supervision whereby it is ascertained that every entity in the financial and capital markets adheres to specific standards that ensure the system is being followed for the betterment of all and to the detriment of none.

Supervision Can Prevent Crisis

Let us not forget that the lack of supervision created crisis twice during the past few years. In the first case, the US subprime and derivatives crisis triggered a global meltdown. In the second instance, the NSEL (National Spot Exchange Ltd) payment crisis led to 15,000 investors losing about Rs 5,400 crore.

Proper supervision in both cases could have prevented the crises from occurring in the first place. In both cases coincidentally, had the prescient advice of the present RBI Governor Raghuram Rajan been heeded, these could have been pre-empted. Unfortunately, Rajan only became a hero after the horses had bolted, since people lacked the foresight to take his warnings seriously.

Where the US derivatives crisis was concerned, Rajan's warning was direct, delivered during a November 2005 address titled, *Has Financial Development Made the World Riskier*?[1] US Treasury Secretary Lawrence Summers then mocked Rajan for being a "Luddite". The world paid a heavy price for believing Summers and disbelieving Rajan.

Regarding the NSEL crisis, had Indian regulators implemented financial reforms via the roadmap spelt out by Rajan (as chairman of the Committee on Financial Sector Reforms, whose report was titled, 'A Hundred Small Steps'), the spot exchange crisis could perhaps have been averted.

Unfortunately, the 2008 financial crisis created the feeling that India had been protected from the worst due to its conservative approach and the lack of reforms was therefore a blessing in disguise. Though



[1] Meet Raghuram Rajan, the new RBI governor, Hindustan Times, 07 August 2013

the first inference is partly true, the second is wholly untrue, as Rajan himself pointed out.[2]

Honestly, the path to developing a vibrant, thriving capital market in India does not lie in less reforms and more conservatism. Rather, it lies in instituting healthy reforms backed by transparency and diligence to inject a strong dose of stability into the markets presently roiled by uncertainty from a sliding rupee, volatile oil prices, persistent headline inflation and doddering growth.

Reforms Propel Growth

In this context, it is welcome news that the RBI is considering the grant of banking licences at more frequent intervals as well as creating the relevant reforms for free entry of banks. It is such reforms that will hasten inclusive development, rather than a maze of hurdles that hinder growth.

I believe reforms are crucial in all conditions and geographies. Entities refusing to reform, innovate and change will soon be as dead as the dodo. In fact, financial sector reforms are the key that can propel India's growth into a higher trajectory by promoting an efficient, well-regulated market. One cannot ignore the fact that progress across the modern world has always been propelled by reforms – be it China in the 1980s, India in the 1990s or other nations at various points of time.



For accelerated GDP growth, it is important for governments to get out of business and focus on the business of governance. Coupled with reforms in various sectors, including banking, finance and the capital markets, such measures will impart immense stability to the markets.

Paucity of reforms creates conditions for aberrations such as the NSEL payment crisis, which further dents domestic and foreign institutional investor confidence. Consequently, retail investors shy away from the stock-markets, instead preferring to park funds in non-productive assets such as gold, further compounding the country's current account deficit. Markets that are not well-oiled with reforms would hardly be in a position to withstand the hard shocks of a double-dip recession should this spread across the globe.

Accelerating Development

The other benefit of reforms is that they trigger the growth of new jobs and additional investment avenues across various verticals. As empirical evidence indicates, reforms have always been the handmaiden of growth and development. Moreover, financial sector reforms exert an exponential effect on other industries since such benefits directly or indirectly underpin productivity increases in multiple verticals.

The RBI's push for more bank licences will be especially beneficial for rural India, which accounts for almost 70% of the population but is largely outside the banking system's ambit. As a result, poverty levels are exacerbated, with limited scope for alleviation. Once banking services are available in hinterland areas, it will open up a slew of opportunities for rural citizens, beginning with access to formal credit sources at reasonable rates of interest.

In times of distress, lack of credit at low interest rates has perennially pushed poor people into the clutches of usurious moneylenders, who have enslaved entire families for generations. The spread of formal banking services into India's interiors

[2] RBI Governor Raghuram Rajan's report to be lynchpin of financial sector reforms, The Economic Times, 16 September 2013

would put an end to to such nefarious practices and slowly bring alive the slogan of 'Mera Bharat Mahaan'.

Presently, though public sector banks are mandated to open branches in remote regions, there is no incentive to lend to poor people due to a cap on interest rates. Instead, banks focus on lending to priority sectors such as agriculture. Interest rate ceilings on small loans are, therefore, clearly counterproductive. Rather than creating restrictive clauses, reforms facilitating the entry of more private banks, alongside the easing of restrictions on PSU banks will ensure healthier competition whereby lending small amounts in rural areas becomes viable.

Simultaneously, reforms are required in the stock, bond and money markets to promote higher levels of transparency and due diligence in all trades. In such markets, supervision is necessary since self-regulation or self-discipline as a regulatory mechanism is bound to fail. Even a single big failure can have disastrous consequences for all stakeholders, as has been often witnessed in the past.

Supervision of the stock markets helps safeguard the interests of small shareholders, who are more susceptible to malpractices, while ensuring that huge acquisition of shares and takeover of companies



always happen within the ambit of rules and regulations. Regulatory supervision is also required in the derivatives market since the scope for unfair trade practices is higher here. Reforms are also necessary to ensure higher levels of transparency so that people entering into derivatives and other complex contracts have better awareness about the enhanced risks in specific dealings, rather than being led up the garden path.

Eventually, robust reforms and crucial supervision in the financial and banking sectors will ensure better risk management that will attract small investors back into the market, while reassuring FIIs that India is indeed a safe investment destination.

Suggestions for Enhancing Capital Markets

Mr. Ananth Narayan, Co-Head of Wholesale Banking, South Asia, Standard Chartered Bank

Capital markets have multiple stakeholders – savers, intermediary institutions, borrowers, regulators and the public at large. As with any ecosystem, there is a broad common cause across all stakeholders – and there are also the disparate narrow interests of individuals and groups within.

This article is an attempt to put together a few suggestions that I believe would further our common interest as stakeholders in capital markets.

Few stakeholders, if any, would disagree with the following as objectives for the Indian Capital Markets ecosystem as a whole:

- To build a robust and dynamic market, that enjoys credibility and macroeconomic stability, by recognising, measuring, disclosing and providing tools for management of risks
- To broaden market pipes, that allow for wider participation, freer and larger flow of funds and information between relevant stakeholders

For meeting some of these common objectives, I have put together a few suggestions in terms of market tools, governance, and regulatory changes.

A) Market tools:

1) The need for a term structure of interest rates (term money market).



This is not just a cliché. A term money market is essential to allow efficient flow of tenor money across stakeholders, to ensure recognition, measurement and management of balance sheet risks (split across liquidity, interest rate and credit risks), and to bring transparency into capital markets pricing.

Suggested measures to foster this term money market are:

a) Banks base rates should be linked to a common interest rate benchmark.

Every institution should express their base rate as a spread over a common benchmark. This could be T-bill or GOI bond yields, CD rates, or 3-month MIBOR rates. Settling on any particular common benchmark can be left to stakeholders, perhaps through bodies such as FIMMDA/ FICCI.

All term deposit and lending rates should be linked to these base rates, and therefore to a common benchmark across institutions.

This measure would help (i) provide a common benchmark for all stakeholders (ii) allow for improved transmission of rates (iii) provide the real sector a benchmark against which to manage their interest rate risks (currently, they see high basis risk between the base rates and the interest rate swap/ futures benchmarks available) (iv) incentivise intermediaries to commence a term money market anchored to the same benchmark

b) Grow the term repo market

RBI has made an excellent start with the introduction of auction based term LAF repos with banks. This should be further extended, with a gradual reduction in the overnight LAF. This is one way of weaning banks away from the comfort of overnight markets.

Alongside this, we need the inter-institution repo market to develop as well. This has been another source of constant debate – on why this market (along with IRF, CDS etc.) has failed to take off in India. In my opinion, it is a combination of easing

some basic regulations around this, and breaking the inertia of banks towards doing anything different. On the latter, a RBI term LAF repo, along with better credibility around balance sheet risk metrics would perhaps help counter this inertia.

2) Interest rate options

This is hardly, if ever, talked about.

The reality is, banking and user balance sheets are already saddled with large unrecognised volatility risks – and these risks are only growing. Every long tenor mortgage with a fixed or absent pre-payment penalty or items with non-trivial puts and calls has an inherent volatility risk. The duration of a bank's portfolio would rise and fall with interest rates – and this can only be hedged by them purchasing options. It is important that the risks are properly recognised, measured and accounted for.

It is high time we look at these risks and needs, and take steps to start the options and volatility markets, alongside the term money market.

B) Improving market governance and credibility

Some suggestions on this rather touchy topic are as follows:

1) Consistent standards for recognising and measuring balance sheet risks

There is a need for consistency in standards for measurement and disclosure of interest rate, credit and liquidity risks, for users and for intermediaries. As an example, balance sheet gap risks – measured through value at risk (VaR) or earnings at risk





(EaR), suffer from multiplicity of approaches that vary from institution to institution. In addition, they raise questions of relevance and accuracy, given the lack of an actionable term money market to express those risks against. I am not certain that there are adequate, credible, accurate and consistent measures, disclosures and management of balance sheet risks.

2) Credible and consistent revaluation methodologies

There is a need to have credible and consistent revaluation methodologies for capital market instruments, across loans and bonds. For instance, the same bond may be valued differently by different players across banks, funds etc. In addition, for certain classes of instruments, the valuation rates may simply not be credible – such as a few state government bonds being valued at 25 bps over GOI yields, when the secondary markets (or even primary auctions) for like instruments are quite removed from those levels. There is also considerable debate about valuation of some less liquid corporate bonds and PTCs.

Bringing consistency and credibility could entail some teething issues and one-time impact (which institutions can well bear today). In the long run, this would foster greater market credibility and depth.

C) Regulatory changes and clarity required

This is another touchy topic – will again offer a few bullet suggestions.

1) Recognition of set-off and netting, at least against entities under Companies Act

While it could be argued that there is ambiguity on the tenability of netting for exposures to entities set up under Acts of Parliament (including public sector banks), there is NO ambiguity in respect of tenability of netting against entities registered under the Companies Act. There are Supreme Court cases and precedents that stand testimony to the tenability of netting for entities under Companies Act.

However, the RBI requires banks to reckon exposures on a gross basis, including against entities registered under Companies Act. This is currently a huge impediment for the growth of the foreign exchange (FX), interest rate and credit derivatives market in India – a market that is an essential supplement to a vibrant capital market.

2) Unintended consequences – exempt Basel 3 CVA for end users (non market makers)

From January 2014, banks are to increase Risk Weighted Assets (RWA) on their OTC derivatives, by computing a Basel 3 Credit Value Adjustment (CVA) against each trade. Particularly for long tenor trades (such as FX hedges for ECB borrowings), the impact is quite high.

This increase in RWA arguably makes sense in open markets, where OTC derivatives can be used by entities for speculative purposes, potentially increasing systemic risk. However, in India, every end-user needs to have a valid underlying exposure to deal in OTC derivative markets. In fact, open exposures (particularly imports and FCY loans) are a huge systemic risk issue in India, acknowledged by RBI. CVA (and even CCR) on end users ends up having unintended consequence of severely penalising hedging by users with higher costs, and instead, incentivising open risks.

There is a strong case in the Indian context to



exempt end user OTC derivatives that are by definition risk reduction trades, from Basel 3 CVA. Transactions with institutions (other market makers) could attract Basel 3 CVA, but transactions with end users need to be exempted.

3) Accounting for basis trades

There are cases where in the name of conservatism, accounting norms prevent efficient markets. One particular market and regulatory peeve has been that IRS yields have consistently quoted at below risk free GOI yields. Indian banks should be able to bridge this anomaly by buying bonds and paying IRS – except that accounting in a sense comes in the way. Accounting requires that any mark to market gain in bonds needs to be ignored, while the corresponding loss in the IRS does need to be recognised. Such asymmetrical treatment needs to be done away with – alongside building a credible revaluation framework.

Through this paper, I have attempted to put together a few disparate asks and suggestions that in my view could help further the common cause of deeper & robust Indian Capital Markets. The journey and the debate to invigorate and deepen these markets will continue.

Real Estate Investment Trusts

Mr. Shachindra Nath, Group Chief Executive Officer, Religare Enterprises Ltd.

The recent SEBI initiative to introduce comprehensive regulations for the Real Estate Investment Trusts (REITs) in India is a timely decision and is expected to receive significant institutional investor support and interest. We believe REITs are critical for the development of the real estate industry and capital markets.

Globally, REITs have been instrumental in improving transparency, governance standards and the professionalism of investments in real estate market and one can expect the same to happen in India as well. The U.S. REIT market is the oldest and largest market globally. The first REIT was listed on a U.S. stock market way back in 1961. As mentioned in the table below, the Netherlands in Europe was second to establish a REIT market in 1969, followed by Australia in 1971. The global REIT market has witnessed significant growth in the past 20 years and since then, more than 20 countries have adopted REIT legislation or an equivalent.

Evolution of the Global REIT Market	
1960	USA and Netherlands
1970	Australia
1980	-
1990	Canada, Belgium, Turkey, New Zealand
2000	Japan, South Korea, Singapore, South Africa, France, Greece, Taiwan, Brazil, Thailand, Hong Kong, Bulgaria, Malaysia, Israel, Germany, UK, Italy
2010	-
Future	India*

Source: The Association for Real Estate Securitisation and CFA Institute
**SEBI has issued draft regulations on REITs in India in 2013*

REITs are investment vehicles that invest in a diversified pool of professionally managed real estate assets. The steady rental stream and stable capital gains are the key characteristics that make them attractive investments. Investors are able to get exposure to stable income stream and capital growth of the underlying assets without the risk of large capital outlay. It also provides the benefits of greater liquidity as compared with investing in the underlying real estate assets. Also, typically, another attraction of REITs is their yield or the annual coupon. REITs usually have high payout ratios which are mostly governed by the government regulations or are incentivized by taxation requirements.

With savings rate among the highest in world, Indian consumers have a tendency to save and invest in property and gold and we have the view that REITs will enable the industry to tap into this savings pool in a liquid format. The investors will benefit from an attractive, transparent and well regulated investment product. For the real estate developers and builders, introduction of REITs will result in increased supply of easy and cheap credit for this sector.

With increasing demand of high yields and stable capital returns, investors across the world in the recent years are increasingly investing in REITs. REITs have been a key driver towards development of the real estate sector globally. REITs have been hugely successful in the markets where they have already been introduced.

We believe that success of REITs in India will be driven by the inclusive long term growth story of India. With increasing population and urbanization, the demand for residential space is set to grow. Further, higher income levels and easy financing options in the market will propel the growth of residential real estate market in India. Also, the demand for commercial space is increasing with liberalization of the Indian economy and foreign investment in India.

Religare Health Trust Trustee Manager is the first professional REIT manager from India to list and manage a business trust listed on the Singapore Stock Exchange. Based on our experience, REIT helps to unlock capital and enhance returns on equity for core operators and helps business concentrate on their core activity. Creation of REIT would unlock

the intrinsic value of the real estate and therefore free up capital. It would substantially improve the return ratios on the capital invested. Margins would expand overtime as core business returns and growth would outstrip the gross yields to be paid to REITs. An asset light model would further make the business model scalable.

We appreciate the recent SEBI initiative to introduce comprehensive regulations for REITs in India. We are fully supportive of a forward looking regulatory framework which allows REITs to operate under regulatory ambit, encourage self-discipline and provide better governance. We believe that with these draft regulations, the SEBI has drawn upon some best practices prevalent across various jurisdictions and the legislations of the regimes where REIT structures have been successful, with some tweaking from an Indian economic perspective.

Moreover, these regulations for REITs have been introduced at an opportune time when most of the real estate developers are debt-ridden and are struggling to raise money for future growth. REITs would allow real estate developers to monetize their developed, revenue-generating assets by off-loading them to REITs. In our opinion, REITs will provide real estate developers and real estate private equity investors a secondary market exit route. We understand that introduction of REITs will help the unorganized rental sector to boost with increasing supply of foreign funds for the sector.

Based on our experience, we believe that the draft regulations could do away with the requirement for the Sponsor to hold a minimum stake in the REIT. This will promote and encourage professional REIT Managers in India. Further, having the condition



for sponsor to hold minimum stake in the REIT at all times puts a ceiling on the size of REIT since Manager may not be able to do any follow-on offers in which Sponsor is not contributing further capital because its shareholding will get diluted below 15% limit. Also, removing the condition would help the sponsor to recycle the capital after the lock in period. The regulations could also include more clarity on tax issues around REITs and full tax transparency to enable REITs to maximize distributions to unit holders.

We do believe that a well thought out mechanism will provide platform for retail and institutional investors to invest in real estate properties, with the benefits of a regulated structure and risk diversification. These regulations once implemented will ensure that investors have adequate information to monitor performance.

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Basel III for Indian Banks: The Capital Conundrum

Ms. Rupali Shanker, Director, Financial Sector Ratings, CRISIL Limited

India's banks have issued two Basel-III-compliant, Tier-II bonds so far. And CRISIL has rated both instruments. CRISIL's ratings reflect the likelihood of timely servicing of interest and principal on these instruments. The ratings also factor in risks rising from the additional features in these instruments that distinguish them from non-equity capital instruments under Basel II. CRISIL estimates India's banks will need to raise Rs. 4.7 trillion as capital over the next five years to comply with the Basel-III norms. The recent issuance of Basel-III-compliant, Tier-II bonds by two Indian banks is a first step towards raising the required capital, and towards tapping the bond markets for banks' capital requirement.

The Reserve Bank of India (RBI) has implemented Basel-III capital regulations for India's banks with effect from April 1, 2013. CRISIL believes that the guidelines will structurally strengthen India's banking sector by enhancing both the quantity and quality of banks' capital. Moreover, with the introduction of a capital conservation buffer, banks will be in a stronger position to absorb potential losses during financial exigencies.

CRISIL estimates that India's banks will need to raise around Rs. 2.7 trillion and Rs. 2 trillion as Tier-I and -II capital, respectively, by March 2018 to comply with the Basel-III norms. The main challenge for banks will be in raising the non-equity Tier-I capital, which now carries higher risk attributes; the ratings on these instruments will, therefore, be a few notches lower than under Basel II. This will mean that the market's appetite for these instruments will be limited. It is, therefore, critical that the bond markets be developed for Basel-III-compliant non-equity Tier-I capital instruments, and that India's banks adopt strong measures to conserve capital and improve accruals.

Tier-II capital, however, should not be difficult to raise. The ratings on Tier-II capital instruments will be the same as, or close to, the Basel-II lower Tier-II ratings, given that the ratings adequately factor in risks inherent in these instruments.

CRISIL believes that the period till March 2018 that RBI has provided for banks to migrate fully to Basel-III regulations is sufficient for them to raise the required capital. The challenges in raising non-equity Tier-I capital, notwithstanding, Basel III will structurally strengthen the banking sector. In addition, RBI's strong regulatory supervision will ensure that the banks are cushioned against potential shocks, and that systemic risks are reduced.

Basel III: The challenges for Indian banks

The phased transition to Basel-III (refer to Table 1) capital regulations reduces the challenges that India's banks will face during the migration. Between April 2013 and March 2018, India's banks will need to raise Rs.2.7 trillion as Tier-I capital—of which around Rs.1.3 trillion will need to be equity capital, while the remainder may be raised as non-equity capital (refer to Table 2).

Given the capital support that the Government of India continues to extend to the public sector banks,



Table 1: The phased transition to Basel-III capital regulations

(As a % of RWA)	1-Apr-2013	31-Mar-2014	31-Mar-2015	31-Mar-2016	31-Mar-2017	31-Mar-2018
Common Equity Tier 1(CET1) [A]	4.50%	5%	5.50%	5.50%	5.50%	5.50%
Min Capital conservation buffer (CCB) [B]	-	-	0.625%	1.25%	1.88%	2.50%
Min CET 1 + CCB [A+B]	4.50%	5.0%	6.125%	6.75%	7.375%	8.0%
Non-equity Tier I [C]	1.50%	1.50%	1.50%	1.50%	1.50%	1.50%
Min Tier 1 [A+C = D]	6.0%	6.5%	7.0%	7.0%	7.0%	7.0%
Max Tier 2 [E]	3%	2.50%	2%	2%	2%	2%
Min Total Capital [D+E = F]	9%	9%	9%	9%	9%	9%
Min Total Capital + CCB [F+B]	9%	9%	9.625%	10.25%	10.875%	11.50%

Table 2: The equity and non-equity component in the capital requirement

Tier I capital requirement (Rs. trillion)	Total equity capital	Non-equity Tier I
Public sector banks	0.9	1.2
Private sector banks	0.4	0.2
Total	**1.3**	**1.4**
** Over 5 years upto March 2018; net of internal accruals and adjusted for phase-out of existing instruments under Basel II*		
Key assumptions	**Total equity capital ratio as on March 2018**	**Non-equity Tier I as on March 2018**
Public sector banks	8.00%	1.50%
Private sector banks	10.00%	0.50%

and the proven capital-raising ability of private sector banks, raising Rs.1.3 trillion as equity capital by March 2018 should not pose challenges for these banks.

The key challenge, however, will be for banks to raise Rs.1.4 trillion as non-equity Tier-I capital over the next five years.

Raising the non-equity Tier-I component

The Basel III guidelines stipulate that non-equity Tier-I capital instruments have the following equity-like features:

- Availability of full discretion on coupon payment at all points of time,
- High capital threshold for potential coupon non-payment, and,
- Introduction of principal loss at a pre-specified trigger.

The stipulations for full coupon discretion and principal loss absorption were not part of the Basel-II norms for non-equity Tier-I capital. CRISIL believes that their inclusion in Basel III will significantly increase the instruments' risk attributes, and reduce their acceptability among investors.

Although the availability of full coupon discretion to banks represents potential risks for investors, the banks are unlikely to exercise this discretion in the normal course of business. However, if the total equity capital of a bank falls below the threshold set by the regulator, the likelihood of coupon non-payment increases.

The guidelines mandate that banks conserve capital by not distributing the distributable surplus

entirely. The restriction becomes applicable to a bank if its total equity capital ratio slips below 8 per cent. A higher proportion of distributable surplus will need to be conserved if the equity capital declines further to lower levels (refer to Table 3). Payment of coupons on non-equity Tier-I instruments is through distributable surplus from earnings; it is, therefore, likely that these coupons will not be paid in full if the equity capital level reduces to less than 8 per cent. Given that the average equity capital level for the banking system was around 9 per cent as on March 31, 2013, the difference with the regulator-specified minimum capital level is low. This substantially increases the risk of non-payment of coupon on these instruments in a stress scenario.

Table 3: Capital conservation ratio as a proportion of earnings

Total Equity Capital ratio	Minimum capital conservation ratios (as a per cent of distributable surlus)
5.5 per cent - 6.125 per cent	100 per cent
> 6.125 per cent - 6.75 per cent	80 per cent
>6.75 per cent - 7.375 per cent	60 per cent
>7.375 per cent - 8.0 per cent	40 per cent
>8.0 per cent	0 per cent

For non-equity capital instruments issued by India's banks, it is for the first time that a principal loss absorption feature has been introduced. The main objective of the feature is to ensure that non-equity Tier-I instruments are available to banks in stress to absorb losses. As per the guidelines, if the bank's equity capital breaches the pre-specified trigger of 6.125 per cent, the principal component on the non-equity Tier-I capital will be either written down or converted into equity. Loss of principal, due to write-down or conversion of instruments into equity on breach of the trigger, can lead to significant losses to investors.

Factoring the increase in risk attributes of Tier-I instruments under Basel III, CRISIL's rating on these instruments could be a few notches lower than that under Basel II.

Investor appetite expected to be limited

Investor appetite for non-equity Tier-I capital instruments may be limited, given the significant increase in risk attributes on these instruments, and the lower ratings. Moreover, the pricing differential between Tier-I and -II instruments under Basel III will be high at between 100 and 150 basis points, and may reduce the attractiveness for issuer banks. This could result in a major deficit in the minimum non-equity Tier-I capital requirement of India's banks, and may have to be met by raising equity capital, which can be challenging for banks. Nevertheless, raising capital through non-equity Tier-I capital instruments may continue to be cheaper than raising equity capital.

Enablers for banks to meet the Tier-I capital requirement

Development of bond markets

To help banks tide over the challenges in raising capital, it is imperative that the corporate bond markets be developed. The range and depth of investors in such instruments may be expanded through a structured bond market development plan. This could include:

- Realignment of investment policies of long-term investors, to make them eligible for investing
- Innovative solutions by the government, such as introduction of a holding company concept for public sector banks; the holding company can look at investing in these capital instruments and build market confidence in them.
- Exploring the overseas investor market to raise non-equity Tier-I capital

Focus on capital conservation and improving accruals

The governmental and regulatory interventions alone will not suffice to help banks raise capital, unless the banks themselves adopt measures, such as the following:

- Capital conservation through offloading of large exposures, where the risk-weighted

capital allocation is high. For instance, public sector banks have large infrastructure exposures that may be refinanced by infrastructure debt funds (IDF) or entities such as India Infrastructure Finance Company Ltd.

- Focus on improving profitability and internal accruals—this is important for public sector banks given their modest internal accruals and large exposures to assets with sizeable risk-weighted capital allocations. Even an improvement by 10 basis points in return on average assets will reduce the capital requirement by around Rs.80 billion annually for the banking sector.

Raising the Tier-II component

CRISIL estimates that India's banks will need to raise around Rs.2.0 trillion by March 2018 as the Tier-II component in the capital requirements under Basel III. However, this will not be a challenge for India's banks.

The RBI guidelines on Basel III do not restrict banks from servicing the coupon or dividend on Tier-II instruments. However, they require banks to write off or convert Tier-II instruments into equity upon occurrence of the trigger, called the Point of Non-Viability (PONV).

The PONV trigger for loss of principal on Tier-



II instruments is a new feature introduced through Basel-III guidelines. CRISIL, however, believes that the PONV trigger is a remote possibility in the Indian context. The robust regulatory and supervisory framework and systemic importance of the banking sector will ensure adequate and timely intervention by RBI to avoid a bank becoming non-viable. Due to the strong supervision by RBI none of the scheduled commercial banks have gone into liquidation in India. The inherent risk associated with the PONV feature is adequately factored into the rating of banks. The rating on Basel-III compliant Tier-II capital instruments may, therefore, be the same, or close to the rating of lower Tier-II instruments under Basel II.

Private Placements

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Introduction

"Private placements" are offers of securities that are exempt from the more onerous legal and regulatory requirements that are applicable to "public offers", the primary amongst which is the obligation to register a "prospectus". There are several instances where the question arises whether a particular offering of securities is a "private placement" or a "public offer".[1] Recently, the Supreme Court considered this question in the case *Sahara Real Estate Corporation Limited v. Securities and Exchange Board of India*[2]. Probably with a view to bring in better clarity to the issue, the new Companies Act, 2013 has introduced a more precise definition of a "private placement".

Policy considerations

The policy behind prospectus and registration requirements is to provide offerees with a standard package of information about the company and the offering. These requirements, coupled with strict liability in case of a failure to comply with these requirements, ensure that offerees receive all the information that they need to make informed investment decisions.[3] Private placements are exempt from these requirements because of the expectation that offerees in a private placement have access to all such information that they require to make informed investment decisions and it would be inefficient, if not superfluous, to impose prospectus and registration requirements for private placements.

Public offers vs. private placements under the Companies Act, 1956

The Companies Act, 1956 (the "1956 Act") did not define the term "private placement"; however, it did make a distinction between offers of securities that were made to the public, and those that were not. An Offer[4] of shares or debentures could be considered to be "private placements", i.e., not made to the public[5]:

(i) if the offer could be regarded:

(a) as not being calculated to result, directly or indirectly, in the shares or debentures becoming available for subscription or purchase by persons other than those receiving the offer or invitation; or (b) otherwise as being a domestic concern of the persons making and receiving the offer or invitation, (the "subjective test"); and

(ii) if the offer was made to less than 50 persons (the "objective test").

An offer could be considered a "private placement" only if it satisfied both the subjective test and the objective test.

Public offers vs. private placements under the Companies Act, 2013

Explanation II to Section 42(2) of the Companies Act, 2013 (the "2013 Act") defines a "private placement" as "*any offer of securities or invitation to subscribe to securities to a select group of persons by a company (other than by way of public offer) through issue of a private placement offer letter and which satisfies the*

1 See for instance: Nash v. Lynde, 1929 AC 158; Rattan Singh v. Managing Director, Moga Transport Co. Pvt. Ltd., AIR 1959 P&H 196.

2 (2013) 1 SCC 1.

3 Securities and Exchange Commission v. Ralston Purina Co., 346 US 119 (1953) ("Ralston Purina"). See also: William K. Sjostrom, Jr., "Rebalancing Private Placement Regulation", 36 Seattle U. L. Rev. 1143 (2013).

4 For the purpose of securities offerings, "offers" includes invitations to offer.

5 Section 67, Companies Act, 1956.

conditions in this section". Section 42(2) provides the defining condition for an offer to be considered a "private placement". According to Section 42(2), an offer may be considered to be a private placement if it is made:

(i) to such number of persons not exceeding fifty or such higher number as may be prescribed[6] (excluding qualified institutional buyers and employees of the company being offered securities under an employee stock option scheme), in a financial year; and

(ii) on such conditions (including the form and manner or private placement) as may be prescribed.

The Draft Rules prescribe other objective conditions with respect to private placements, including, a limit on the number of offers that can be made in any financial year (four), in any quarter (one), the minimum time gap between each offer (60 days)[7] and the value of securities under each offer (not less than Rs. 50,000)[8].

Absence of a subjective test

The 2013 Act and the Draft Rules have done away with any subjective test for determining whether an offer of securities is a public offer or a private placement. While certainty in application of any legal requirement is welcome, an objective test based largely (if not only) on the number of offerees may exclude from the definition of public offers several indented beneficiaries of the prospectus and registration requirements. We submit that this objective test must be accompanied by a subjective test which takes into account whether the offerees have access to (or the ability to obtain) all the information that may be necessary to make an informed investment decision. This is particularly critical where, at 200 offerees, the threshold for a public offer is very high.

The maximum number of offerees in a private



placement excludes "qualified institutional buyers" and employees of a company subscribing to securities pursuant to an employee stock option scheme. The effect of the exclusion of qualified institutional buyers from the number of offerees is that any offering, if made only to qualified institutional buyers, will not be considered to be public offer, irrespective of the number of offerees and whether or not such offerees have access to information to make an informed investment decision. It seems that the reason for such exemption is the apparent sophistication of qualified institutional buyers. Courts in the United States have considered this issue in the past and have consistently concluded that the supposed sophistication of offerees will not suffice to render a transaction private if they are given no information on which to exercise their skills.[9] Similarly, there is no assurance that employees of a company subscribing to securities pursuant to an employee stock option scheme will have access to the kind of information that they would need to make an investment decision.

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[6] The draft Rules (the "Draft Rules") released for public comments by the Ministry of Corporate Affairs, Government of India, prescribe 200 persons (excluding qualified institutional buyers and employees of the company being offered securities under an employee stock option scheme) in the aggregate in a financial year, as the threshold for distinguishing between a private placement and a public offer. See Draft Rule 3.12(2)(b).

[7] Draft Rule 3.12(2)(c).

[8] Draft Rule 3.12(2)(d).

[9] Wellman v. Dickinson, 475 F.Supp. 783 (1979). This case itself was concerned with a tender offer; however, it followed the principles laid down in Ralston Purina to determine whether a transaction was genuinely private.

Disparity of information?

The 2013 Act and the Draft Rules require every company making a private placement to issue a private placement offer letter to each offeree. The form of such private placement offer letter[10] has not yet been prescribed; however, it would not come as a surprise if the private placement offer letter requires lesser disclosure than a prospectus. Does this imply that offerees in a private placement require lesser information than offerees in a public offer to make an informed investment decision? As stated above, the policy rationale for exempting private placements from prospectus and registration requirements is the expectation that offerees have access to all the information that they need to make an informed investment decision and not because they need lesser information than offerees in a public offer. Private placement offerees are free to negotiate for more information than that may be contained in the private placement offer letter. However, this, coupled with the absence of strict liability for a private placement letter of offer, makes the requirement of a private placement offer letter itself superfluous.

Conclusion

The objective of prospectus and registration requirements is investor protection through ensuring the availability of material information to make an investment decision. The 2013 Act and the Draft Rules dilute that requirement by exempting



transactions from the applicability of these requirements based on the number and sophistication of the offerees. They further purport to prescribe for private placement disclosure requirements that presumably will be lower those for public offers. We submit that exemptions from prospectus and registration requirements should be based on the offerees' access (or ability to obtain) information and not on a presumption that offerees in a private placement need lesser information than those in a public offer, even if such offerees are sophisticated investors. We hope that market practice develops where offerees in a private placement are also given as much information as offerees in a public offer, much as it has developed in the context of Rule 144A placements in the United States.

[10] Form No. 3.4. As of the date of writing this article, the draft of Form No. 3.4 has not been put out by the Ministry of Corporate Affairs, Government of India.

Distribution of Mutual Funds – Challenges & Opportunities

Mr. Sundeep Sikka, President & CEO, Reliance Capital Asset Management Ltd.

Background

The global financial services landscape has been changing rapidly since 2008 and this year has been no different. Indian financial services also faced their share of volatility. Amid this volatility and uncertainty in the markets, assets of the Mutual Fund (MF) industry grew by around 23% in FY 2013 and more than 6% in the first half of FY14. The Industry has shown a stable growth of more than 17% CAGR from 2009 to 2013, adding close to Rs 300,000 Cr over the years and now stands at more than Rs 808,000 Cr.

A strong MF Industry along with a well established advisory network is a crucial foundation to ensure stable and long-term inflows into the Capital Markets. As has been observed over the years in more developed economies, reliance on both active and passive fund management has been given preference by investors as against direct exposure to the markets.

Shift in investor preferences

In the last year or so, there has been a marked a shift in investor preferences. While the MF Industry was once equated with Equity, a vast majority of inflows over the year have come into the Debt category. This shows the underlying strength of the Industry - we have come a long way from being inextricably linked to the markets.



Given the high interest rate regime, the inflows this year were heavily skewed towards Fixed Income funds. Debt assets of ~Rs 28,000 Cr were added in the last 6 months ending Sep 2013. Excluding inflows in liquid category, debt attracted more than 94% of the Industry inflows this year.

Regulatory changes

The last year witnessed changes in regulations that aimed at improving distribution scenario and enhance penetration in Tier II locations and beyond.

SEBI permitted cash transactions in mutual fund schemes to the extent of Rs. 20,000 per investor per mutual fund in one financial year, there was a directive to set apart at least two basis points annually on daily net assets for investor education and awareness initiatives, and also permission to include a new cadre of distributors which includes postal agents, retired government and semi-government officials, retired teachers, retired bank officers etc. to sell simple products. To improve the geographical reach of mutual funds, asset management companies (AMCs) are now allowed to charge additional total expense ratio or TER (up to 30 bps) with respect to inflows beyond top 15 cities, subject to the satisfaction of certain conditions.

This is a snapshot of the regulations which are certainly a step in the right direction to ensure long-term and stable growth of the MF Industry. Changes like introduction of new cadre of distributors will go a long way to strengthen Mutual Fund distribution and improve participation.

Current Distribution Scenario

In a broader sense, the Indian population is under-banked and financial inclusion levels are low. Penetration of banking services across the country remains relatively low, particularly in rural areas. About 40% of the population (~50 Cr people) across the country is estimated to have bank accounts.

In comparison with developed economies, India is clearly behind on financial inclusion. For example, according to **a World Bank survey, India has 11 branches per 1 lakh adults as against 26 and 36 in UK and US respectively**. The **Mutual Fund industry** also follows this pattern where a majority of assets are sourced from top 15 locations. The **top 5 locations contribute as much as 75% of the Industry assets.** In light of this, SEBI has been keen to encourage penetration beyond the top 15 locations to ensure inclusion and equitable growth pan India.

Challenges

The smaller locations in India hold potential for tremendous growth, but also pose challenges that are unique to developing economies. Although financial savings are reasonable, there is **less clarity about the advantages of investing. Financial literacy** and general awareness of the investment options are lacking. A clearer picture about risks, return, pros and cons of various investment avenues would open up inflows in Mutual Funds. There is also a certain **tendency to equate Mutual Funds with Equity**, thereby ignoring several other products with less risk. Although concerns about inflation, retirement, financial health are present in these locations, the lack of financial awareness means that these concerns might not have led to investment decisions. What is required is change in investment culture that embraces all the avenues and tailors a portfolio according to the individual's needs**. A stronger advisor community** could help the investors with these decisions and improve penetration levels. In addition to these, the **potential to achieve long-term wealth has not been clearly communicated** to the investors. As an example, track record shows that the equity schemes that have been around or at least 15 years have given more than 23% CAGR returns to the investors.

Opportunities and way forward

Independent financial advisors (IFAs)

Independent financial advisors are an important link in the distribution of Mutual Funds. Compared to other industries like insurance, IFAs have the potential to widen the distribution network of Mutual funds. IFAs have a direct connection with investors and are responsible for product selection, asset allocation, monitoring, financial planning and more. Customer centric approach has been and will remain important in the financial services industry, especially in the Mutual Fund Industry. With 44 AMCs offering products across a variety of asset classes, the investors need the guidance of a financial advisor who can lead them to the right kind of products. This choice is based on several factors like risk profile, needs, financial goals, etc. An advisor needs to explain these along with the market environment, product features, and alternatives to the investor. Such a financial plan would therefore be unique to the investor and would require the advisor to build a portfolio from the investor's point-of-view. **The importance of financial advisory assumes greater importance given higher inflation and market volatility in India. Keeping this in mind, the investor's needs and risk appetite must be in the forefront before attempting to offer a choice of products**. A customer-centric investment strategy is also useful





to guard against consequences of market cycles. It has often been observed that investors lose confidence in product centric strategies during a downturn and may even sell-off. An ideal approach would be to act in the interest of the investor while maintaining transparency and simplicity in communication. In the long run, the success of the financial industry would depend on whether the investor expectations have been met and value has been created for them.

Investor awareness

The biggest challenge and the biggest opportunity of the Mutual Fund Industry is a strong and focused Investor Awareness Campaign. In the Financial Year 2012-2013, more than 12,000 programmes were conducted in around 480 cities. In the first half of this year, the Industry has conducted close to 6,000 programmes covering 193 locations. What is needed is the conviction of the AMCs to further increase the scale and scope of these programs with the long-term goal of achieving a powerful pull effect for the MF Industry.

Technology

The meteoric growth of mobile phones in India coupled with advancing mobile banking service provides an opportunity to cover rural markets and bring a larger number of investors to the Industry. Further, SMS transactions have the potential to significantly improve convenience and speed of transactions. Technology can not only improve the investing and advising experience, it will turn out to be a **big cost saver.**

New cadre of distributors

The introduction of as new cadre of distributors like postal agents, retired government and semi-government officials, retired teachers, retired bank officers, has the potential to be a game changer for the industry. Especially in smaller locations where even bank branches are sparse, these new distributors could give a leg up from the grass-roots level. A simpler registration process and sale of simple products are both beneficial to start the process of widening the distributor base especially in the Tier II and Tier III locations where it matters most.

Conclusion

For the MF Industry to reach new heights, the stakeholders have been looking for a conducive set of circumstances. **I firmly believe that we are there – the three Es as I call them are in place. The Enablers,** be it SEBI or other factors are working. Second is **Education** – while this will always be an ongoing process, the investor programmes and district adoption systems look promising. Lastly, the **Environment** which has to do with the performance of underlying assets. Building on the regulatory changes, we now need to step up our efforts keeping at the forefront, responsible Advisory and Awareness as our main objectives.

Could India's inclusion in global bond indices catalyse domestic debt markets?

Ms. Ashu Suyash, Chief Executive Officer, L&T Investment Management

It is widely known that the strength of an economy can be seen through its financial markets. And stronger financial markets can help build confidence on the economy whether domestically or globally. Indian equity markets are one of the most vibrant and liquid markets globally. While across countries, corporate bond markets are more popular than government bond markets due to availability of sophisticated instruments, the scenario is completely different in India. Here, government bonds dwarf the corporate bonds market as this segment finances the higher percentage of fiscal deficit of the country and also needs to be mandatorily held by banks. The primary market for government bonds has been through various reforms from following a process of administered interest rates to price discovery through efficient market mechanism. This segment has seen a high turnover and a sizable growth in the last five years. There is fairly well developed infrastructure for this market including state of the art Negotiated Dealing System (NDS) and our bond markets are the largest among the emerging markets.

However, if one looks at the shareholding pattern as on 30th June 2013, banks hold around 46%[1], insurance companies approx 19%[2] and the Reserve Bank of India (RBI) 17%[3]. These three total upto 82% while mutual funds hold a meager 0.7%[4] and FIIs 1.6%[5]. Banks are dominant players due to the high statutory reserve requirements and mandatory holdings of government bonds. As per the RBI regulations, banks need to hold 23% of their net demand and time liabilities in government securities. Furthermore, trading is concentrated in a handful of securities. As such, we have a very large and liquid government securities market, though liquidity is skewed towards a handful of benchmark securities.

To widen investor-base and promote secondary market liquidity, most countries look to encourage foreign investors' participation in domestic debt markets. In fact, gone are the days when external debt financing was the predominant source of finance. Emerging markets have increased bond issuance in local currencies and been able to reduce the mismatch between revenues (in local currency) and liabilities (mostly in US dollars). One of the key themes in Indian markets currently is about India's entry into widely tracked global benchmark indices for emerging market debt which could likely attract a sizable amount of investments. There were reports of the Finance Minister being in talks about getting the country added to the benchmarks used by investors. Why are we looking at global indices and what does it mean for India?

India is already a part of the JP Morgan Government Bond Index – Emerging Markets Broad in which all countries in the emerging markets are included irrespective of capital controls, taxes or access issues. Yet, India has not benefited from this index because almost no money is benchmarked to this index. JP Morgan Government Bond Index – Emerging Markets Global Diversified (JPMGBI – EMGD), one of the most widely tracked index was launched in 2006 and has 16 countries in the index and benchmarked assets of roughly $200-250 billion.



For local currency bonds to be included in this index, they must be government issued and regularly traded and have a fixed rate. Moreover, international investors should be able to readily access them. This index currently excludes India because of the capital controls that limit access to a majority of foreign investors. In India, the investment limit for FIIs in government debt is capped at $30 billion of which $5 billion is earmarked for sovereign wealth funds, insurance funds, pension funds etc. Recently, the regulator Securities and Exchange Board of India (SEBI) allowed FIIs to invest in government debt without purchasing debt limits till the overall investment reaches 90%.

A recent study by SEBI's Development Research Group on 'Foreign Investment in Indian Government Bond Market', said that there is foreign appetite for rupee denominated debt, but India has placed many restrictions on foreign investment in rupee denominated bonds. In contrast, the equity market has no restrictive investment limits. As such India's equity market capitalization is at par or better than most emerging markets. Furthermore, a Committee on Financial Sector Reforms chaired by RBI Governor Raghuram Rajan a couple of years ago had also recommended the steady opening up of rupee denominated government bonds and corporate bond markets to investors.

India's inclusion into the global indices could have a big impact on its local government debt market and eventually the economy. For one, as mentioned earlier, issuing rupee denominated sovereign bonds is always better than dollar denominated debt as this reduces currency risk for the issuing country. Apart from adding depth and liquidity to the market, a better price discovery mechanism could in due course help corporate bonds. Indian bond market is bigger than any other emerging market countries that form a part of the JP JPMGBI – EMGD. Moreover, its fixed rate bonds and zero coupon bonds are twice the size of the second largest market Brazil.

Furthermore, the inclusion could help India improve its cost of funding and at the same time lower the current account deficit and bring stability in the currency. The maximum weight of the countries



in JPMGBI – EMGD is capped at 10%. The size of outstanding Indian government bond markets is $550 billion. India's inclusion could generate a demand of $15-20 billion from investors who are benchmarked to the index. Depending on whether these investors are overweight or underweight the index, the flows could change but would largely be stable as they track benchmarks very closely. In addition, there could be potential new investors with other underlying benchmarks that would consider India as an attractive investment option.

Typically, inflows start ahead of the country's inclusion into the index. Romania was included in the JPMGBI – EMGD in March 2013 with a weight of 0.54%[6] against its market capitalization of $3.5[7] billion. Following the announcement in January, Romania raised a record $3.4[8] billion of local debt and by February foreign investors' holdings in the debt rose to more than 20%[9] from 5%[10] in November. Similarly, Nigeria's inclusion in the index was estimated to bring about $1.5 billion into the country. As of June 2013, foreign investors held roughly 22%[11] in Nigerian bonds. A comparison with other emerging market countries shows that India lags notably in the proportion of government bonds owned by foreign investors. As against India's 1.6%, foreign investors held 36%[12] in Mexico's sovereign debt and 14%[13] of Brazil. These two are the considered to be the largest markets but are half the size of Indian debt. Similarly, foreign investors held 47% [14]of Malaysia's local debt and 32%[15] of Indonesia's local debt.

Although the RBI Governor Raghuram Rajan has hinted that there have been talks about bringing India into some of the bond indices globally, he indicated that the Central Bank may not want to accept no limits at this point, but there could be intermediate positions that could be arrived at.

Evidence shows that countries that have been included in global bond indices have benefited from the foreign flows through increase in their foreign currency reserves and at the same time added stability to their bond markets. The key reason is that the investors in these government bonds are long term investors including the likes of PIMCO, Aberdeen, Ashmore etc who have government bonds as core holdings in their portfolios and track their benchmarks very closely. The outflows that India saw in the month of May and June this year was primarily due to hedge funds and arbitrage funds and lack of long term investors. Finally, as the Index keeps growing over time, even at a 10% constant rate, India would benefit from a steady stream of money. Such flows are very crucial to a country like India and it will be excellent if this initiative goes on a fast track with policymakers.

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Companies Act: Raising the bar on governance for listed companies

Mr. Sai Venkateshwaran, Head-Accounting Advisory Services, KPMG India and Mr. Jamil Khatri, Global Head-Accounting Advisory Services & Deputy Head -Audit, KPMG India

India has the largest number of listed companies in the world, with the Bombay Stock Exchange, with over 5000 companies listed, being the largest in the world in terms of number of companies listed; 25 per cent more than the second largest exchange and almost twice the number of companies listed on leading global exchanges like London Stock Exchange and Nasdaq. One might wonder if this is a reflection of the entrepreneurial acumen of Indians or the depth of India's capital markets. The answer is that it is neither of these, but rather a reflection of the fact that India has at some point in its journey of economic growth, allowed easy access to public capital.

A cursory analysis of the success or failure of the companies that accessed public capital shows that it's a medley of sorts. The Satyam scam came as a wakeup call to both investors and regulators in India, and while it may be an aberration, it was in some sense an amplification of some of the market realities, where there have been multiple instances of falling standards in financial reporting and governance. In all of these instances, it's ultimately the stakeholder interests, including those of minority investors that have been compromised.

The erstwhile Companies Act 1956 (the 1956 Act), which had been in existence for over fifty years, appeared to be somewhat ineffective at handling some of these present day challenges of a growing industry and the interests of an increasing class of sophisticated stakeholders. Capitalizing on the wisdom of 57 years and in particular learning from these experiences over the past decade, the Companies Act 2013 (the 2013 Act) promises to substantively raise the bar on governance and in a comprehensive form purports to deal with changes required on several fronts.

This is a landmark piece of legislation and likely to have far-reaching consequences on all companies operating in India, in particular on listed companies, especially as a result of changes discussed below.

Investor protection

Related party transactions: Considering the level of abuse of related party transactions in the past, the 2013 Act has made significant amendments making this a significant focus area, with rather onerous requirements. Firstly, the ambit of related parties has been widened significantly, now covering directors and key management personnel, including senior management personnel of the company, its holding, subsidiary or associate companies, together with their relatives, without any consideration of whether the relative is financially dependent on the individual or not. The process of approval of related parties has also undergone a change, with all transactions that are not at arm's length or in the ordinary course of business being subject to Board approval and in most cases, also subject to shareholder approval by special resolution, where related parties cannot cast a vote, making it a supermajority of the minority



shareholders. SEBI is also considering a similar requirement for a vote by minority shareholders when approving managerial remuneration.

Insider trading and forward dealings: The 2013 Act prohibits directors and key managerial personnel from any forward dealings in shares or debentures of company, its holding, subsidiary or associate companies. The 2013 Act also now introduces provisions to prevent insider trading and brings in severe penalties for non compliance, which may include imprisonment of upto 5 years or fines upto INR 25 crores or three times profits made, whichever is higher; or both.

Class action suits: Shareholders can now file a class action suit against the company for any fraudulent, unlawful or wrongful act; or improper or misleading statements, which are prejudicial to their interests. There are multiple remedies available, including demanding compensation from the Company, its Directors, its auditors, or any expert or advisor or consultant engaged by the Company. Such suits can be initiated by 100 members or depositors or those holding 10 per cent of the shares or deposits.

Fraud deterrence: The 2013 Act has also introduced a very wide definition of fraud, covering a wide range of acts of omission or commission, concealment of fact; or abuse of position, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss. There are severe penalties including fine of 1 to 3 times the amount involved in the fraud and imprisonment of 3 to 10 years. The fraud provisions have been referred to in several places in the Act, including in the context of providing misleading information or concealment of facts provided in a prospectus, or for obtaining credit facilities from a bank or financial institution or in any return, report, certificate, financial statement, etc. The SFIO has also been made a statutory body under the 2013 Act with significant additional powers.

Whistleblower mechanism: The 2013 Act also now mandates all listed companies to establish a vigil mechanism to enable employees and directors



to report concerns. This was only a voluntary requirement under the listing agreement.

Use of IPO funds: As per the 2013 Act, if after completion of an IPO, the company wishes to change the object of the utilization of the issue proceeds, they would be required to pass a special resolution and also those objecting shall be offered an exit by promoters or controlling shareholders.

Wider responsibility for the Board

Duties of directors: The duties of directors have been codified and they are now answerable to a wide range of stakeholders including employees, the community, protection of environment, etc apart from their duty to shareholders. There are significant penalties for contravention of these duties, and the directors could also be subject to liability from class action suits, etc.

Independent directors: The concept of independent directors has been introduced in corporate law for the first time with a more stringent definition than that in the Clause 49 of the listing agreement. The 2013 Act also contains a Code of Professional Conduct imposing stringent responsibility and accountability. They are also prohibited from receiving any stock options as part of their remuneration. Independent directors are also required to be rotated every 10 years and are appointed for a term of 5 years each time. Their liability though is rightfully restricted to acts carried out with their knowledge, attributable through Board processes and with their

consent or where they have not acted diligently.

Audit committee responsibilities: The responsibilities have been significantly enhanced and the audit committee has been made responsible for various matters such as approval of related party transactions, monitoring inter-corporate loans and investments, undertaking asset valuations, evaluation of internal financial controls and risk management systems, monitoring independence and effectiveness of auditors, etc.

Reporting framework

Internal controls reporting: The 2013 Act also requires the Directors Report for listed companies and Auditors Report for all companies to comment on whether the company has adequate internal financial controls system in place and whether they are operating effectively. For this purpose, the term "internal financial controls" means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business. As can be seen from the definition, it covers all internal controls, including those relating to operational areas (unlike for example the Sarbanes Oxley Act, 2002 in the U.S. which limits the scope to internal controls over financial reporting). This would therefore cover an evaluation of the efficiency of operations of the Company. This could be quite onerous for companies to comply with, if it is to be applied the way the law is currently written.

Consolidated financial reporting: In addition to the requirements under the listing agreement, the 2013 Act now requires companies to present consolidated financial statements even if they do not have a subsidiary, but only have joint ventures or associates. The 2013 Act has also now amended the definition of subsidiary and associate, which is different from that under the Accounting Standards, leading to different assessments of parent-subsidiary relationships between the Act and the Accounting Standards.

Restatement of financial statements: Last year, SEBI had announced that it may require restatement of financial statements of listed companies, where the auditors had issued a qualified opinion, and had laid down the process for evaluating qualified accounts. However this directive from SEBI was not consistent with the requirements of 1956 Act. The 2013 Act however, now provides an enabling legal framework for SEBI or any other regulatory authorities to apply for restatement of a company's financial statements if they believe there was fraudulent financial reporting or mismanagement of affairs of a company. The Directors of a company can apply for restatement of financial statement if there is non-compliance with accounting standards/ form of financial statements, etc.

Auditor accountability

Mandatory auditor rotation and tenure of appointment: The 2013 Act recognizes that very long audit firm tenure creates, at a minimum, the perception of impaired objectivity, and has introduced mandatory rotation of audit firms to help address this perception. Accordingly, auditors now get to serve as auditors for a maximum period of 10 years, comprising 2 terms of 5 years, post which the firm needs to maintain a cooling off period of 5 years.

Auditors' reporting responsibilities: Under the 2013 Act, the audit has a role akin to that of a whistleblower, and if they have a reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees, they are required to report the matter to the Central Government. The draft rules have



restricted this reporting to material frauds, but nonetheless, remains a very onerous reporting responsibility considering that they are expected to report on suspected frauds as well.

Further, the auditor is also required to report on certain additional matters in his audit report including on 'financial transactions or matters' which have any 'adverse effect on the functioning of the company', which is very wide in its scope. They would potentially be looking at the propriety of transactions and possibly stepping into an area well beyond the remit of what an auditor is required to do, and also possibly outside their area of expertise.

Easier restructuring

The process of restructuring including mergers and capital reduction schemes has been simplified under the 2013 Act. Further, under the 2013 Act, merger of a listed company into an unlisted entity is permitted so long as an exit opportunity is provided to the shareholders of the listed company. The 2013 Act also provides for minority buy-out, where the majority shareholder owns over 90 per cent of the shares in the company. The 2013 Act also permits two-way cross border mergers in certain notified jurisdictions. It has also introduced the concept of fast track mergers between a holding company and its wholly owned subsidiary.

Inclusive agenda

As per the 2013 Act, companies with a specified net worth or turnover or net profit are required to mandatorily spend 2 percent of their average net profit towards specified CSR activities. Under the draft CSR rules, net profit is defined to mean 'net profit before tax' as per books of accounts and shall not include profits arising from branches outside India. Companies shall give preference to the local



area and area around them where they operates for spending the amounts earmarked for CSR activities. The company would need to explain reasons in its Board report if it is unable to spend the required amounts.

Summing up

In summary, these changes are significant steps in helping Indian companies raise their bar on governance, and if implemented in the right spirit, would be great opportunity for companies to enhance value. These changes are also good in the long run for the healthy functioning of the capital markets. However, whether all these legislative changes are implemented in the right manner and followed up with decisive enforcement is to be seen, and that would be the real test. As practice evolves, it would be important for the Ministry of Corporate Affairs to ensure that there are adequate safeguards against abuse, and ensure that various stakeholders, including government agencies and government officers implement the legislation in the spirit with which it has been made rather than misuse the letter of the law.

FSLRC and its Recommendations

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Introduction

India's economic progress, which is largely dependent on its financial sector, presents itself as a source of immense economic opportunity for the world. The far-reaching changes in the Indian economy since liberalization in the early 1990s have had a deep impact on the Indian financial sector. This sector has been one of the fastest growing sectors in the Indian economy which, has witnessed increased private sector activity including an explosion of foreign banks, insurance companies, mutual funds, venture capital and investment institutions. The various steps taken by the government and the regulators since liberalisation to meet the challenges of a complex financial architecture have ensured that the new face of the Indian financial sector will culminate in a strong, transparent and resilient system.

It is well established that there is a positive correlation between the financial sector and real economy. The financial crisis of 2008, triggered by the sub-prime crisis in the USA led to a sizeable decline in GDP of many other countries. A collapse in the financial systems of a country will inevitably lead to the real economy of not only the country, but also of its geographicneighbours and trading partners to nosedive. More over, any financial market is typically characterised by a mélange of savvy investors, first time investors, financial products of various complexities sold through numerous sophisticated sellers, making it necessary for the financial sector to be regulated.

Review of the Existing Legislative Framework

One can argue that the cause for rethinking our current legislative framework has its roots in the global economic and financial crisis of 2008, that forced not just India but almost all countries to question the first principles of their respective financial laws. Frameworks that were believed to have aided the growth and development of advanced financial systems suddenly found themselves at a loss in preventing the financial crisis or its contagion. True, this was not the first financial crisis that the world had encountered, but it can be argued that it was probably more damaging than its predecessors largely because of the extent of sophistication financial markets had reached and the extent of contagion due to inter linkages in financial systems.

This too we know that this will not be the last financial crisis that the world witnesses. It will happen again, at a different time and for different reasons because financial innovation will happen. Increasing or decreasing the magnitude of regulations before, during or post crisis to counter its impact may not be the most prudent way ahead, especially if the current regulatory framework is not good. Post the 2008 crises, the second Warwick Commission was set up to study the financial regulatory framework and in 2009 they released the report on 'Warwick Commission on International Financial Reform: In Praise of Unlevel Playing Fields.' This report rightly points out that there are good regulations and bad regulations and that while good regulations may not be able to prevent future crises, it should be able to make crises "…less frequent, shallower and with less spill over onto the welfare of ordinary households."

The Indian financial legislative framework, as it stands today, is the result of a century's repository of vintage laws and fitful amendments and ordinances issued in retrospect in a piecemeal fashion. As the FSLRC report aptly puts it, the result of this approach to law has the, "…Unintended consequences (of) regulatory gaps, overlaps, inconsistencies and regulatory arbitrage." The Government of India constituted the Financial Sector Legislative Reforms Commission (FSLRC) on 24th March 2011 to rewrite and harmonise financial sector legislations, rules

and regulations, many of which are rather archaic and outdated and require urgent review given the scope for and extent of development in the Indian financial sector.

One readily recognizes the need to remove ambiguity, regulatory gaps and overlaps among various financial sector legislations. These will, no doubt, make the regulatory architecture more coherent and dynamic and help cater to the requirements of a large and fast growing economy in tune with the changing financial landscape in an inter-connected financial world. The Commission, through its draft Indian Financial Code, aims to do just this. The Code is a bold step forward that not only aims at rewriting the laws of the financial land but more importantly looks to revamp and rewrite the principles upon which a regulation or law is formulated.

Summary of Key Recommendations of FSLRC

The Commission, using a consultative approach, has conscripted its regulations in a draft Code on nine broad components. Many specific regulations recommended by the Commission fall under one or many of these components. The Commission has attempted to harmonise existing laws through a non-sectoral multi-disciplinary approach to law making. The Code follows a principle based approach as opposed to a rule based legislative regime. This is different from our current practice of law making where independent regulators issue regulations that are largely sector specific and therefore rule based. The basic concept behind this draft Code was to create a piece of legislation that would broadly cover and regulate the central principles of financial markets and leave the specifics to the independent regulator. would broadly cover and regulate the central principles of financial markets and leave the specifics to the independent regulator.

Nine Components of FSLRC:

- Consumer Protection
- Micro-Prudential Regulation
- Resolution Mechanism
- Capital Controls
- Systemic Risk
- Development and Re-distribution
- Monetary Policy
- Public Debt Management
- Contracts, trading and market abuse

1. Structure, functions and powers of the regulator

Financial regulators present a unique situation in which the legislative, executive and judicial functions all lie with the same authority. While there is a strong case for independent regulators, it also means expectinggreater accountability from them. Advisory councils will be created to advice the board of the regulator. The Commission has also envisaged a framework in which the regulators will be funded primarily through fees levied on financial firms. Regulators will also be assessed from time to time on various parameters, such as, time taken for granting an approval; efficiency of internal administration, and; successful implementation and prosecution of laws, to name a few.

Functions of the Regulator:

- Issue regulations and guidelines for business as usual and for exigencies
- Remain accountable to the Parliament
- Allow for judicial review of their regulations
- Grant permissions and approvals
- Gather and share information on market participants
- Conduct investigations
- Lay down consequences for violation of law and law down monetary penalties

The Code also details the basic functions of the regulator. By far the most drastic recommendation from the Commission has been the constitution of a single super regulator. The reasoning given is that the current regulatory framework is too fragmented with multiple regulators and regulatory overlaps. The Commission calls for the merger of SEBI, IRDA, PFRDA and FMC and the creation of a Unified Financial Agency (UFA). The RBI will continue to remain outside of this structure for the first few years atleast.

Judicial review of laws and legislations will be undertaken by the creation of the Financial Sector Appellate Tribunal (FSAT). The FSAT will be responsible for listening to all the appeals pertaining to finance.

2. Micro-prudential regulations

Micro prudential regulations are aimed at protecting consumer concerns. It will also go a long way in checking systemic risk, though this will largely be the responsibility of macro prudential regulations. Micro prudential regulations are typically made at the firm level and may therefore be viewed as intrusive. The Commission therefore recommends that micro prudential regulations be applied only where necessary and in a proportionate manner and mostly only to systemically important institutions. Some of the firms that may fall out of the ambit of micro prudential regulations are hedge funds, private equity funds, venture capital funds and small and semi-formal mutual savings schemes at a local level.

As financial systems grow and develop, lines between sectors begin to blur. Bearing this in mind the Commission envisages a non-sector specific micro prudential framework that will also minimize regulatory overlaps.

Powers of Micro Prudential Regulations:

- Regulation of entry
- Regulation of risk taking
- Regulation of loss absorption
- Regulation of governance, management and internal controls
- Monitoring and supervision

3. Capital controls

Capital controls are restrictions on the movement of capital across borders. The Commission lays down the framework of law and public administration through which capital controls can work. The Commission acknowledges that, in the current Indian context, a distinction must be made between strategic and tactical capital controls. While the former involves defining a 'credible framework of rules of the game which can be used by foreign investors to decide their investment strategy', the latter would be 'situation specific - to be imposed when particular circumstances arise and withdrawn when they abate.' Consequently, the Commission recommends that capital controls be available for policy purposes as a temporary measure during macroeconomic crises.

Under the current framework, the Foreign Exchange Management Act, 1999, codifies the existing approach to capital controls. It differentiates between current account transactions and capital account transactions. The Central Government makes rules in consultation with RBI for current account transactions, and the RBI in consultation with the Central Government makes regulations in relation to capital account transactions. This approach has led to a complex web of rules and regulations on capital controls spread across many laws. The resulting deficiencies have led to multiplicity of laws and multiple artificial investment vehicles created by the regulations (FIIs, FVCIs and QFIs) and the absence of legal process, judicial review and clear and consistent drafting. Policy pronouncements and regulations are rarely accompanied by statements of policy and purpose, making it difficult for stake-holders to deduce a regulator's intention. The failure to grant an approval by the RBI or the Foreign Investment Promotion Board is 'conspicuous by its absence,' the Commission notes. Capital controls regulations, as currently articulated, are ambiguous and inconsistent, which increases the transaction costs for investors.

The Commission under the new framework recommends the following:

- The rules on capital account transactions for all inbound flows including outflows that arise as a consequence of these inflows, will be made by the Central Government in consultation with the RBI. The regulations on capital account transactions for all outbound flows will be made by the RBI in consultation with the Central Government.
- Creation of a single investment vehicle for investment in India i.e., qualified foreign in-

vestors (those foreign investors who meet the customer due diligence criteria prescribed by the Central Government)

- A sound legal process while making rules for capital market transactions and while granting approvals. Decisions should be transparent, with explicit reasoning and within specific and reasonable time limits.
- The decisions of the Central Government and the RBI will be subject to a two-tier review. Also, violation of any rules, regulations or conditions of approval by any person will be subject to a two-tier review.
- Ensuring compliance of provisions on capital controls, rules and regulations is placed with the RBI. Under conditions of full capital account convertibility, these functions will be placed with the Central Government.
- The RBI will provide guidance and compound matters in relation to capital controls.

4. Systemic risk

The Warwick Commission in their report discuss at great length the role of systemic risk in maintaining the integrity and stability of financial systems, for even under the watchful supervision of micro prudential regulations, the financial system can be easily inundated by systemic risk. The Warwick Commission report acknowledges the challenges of developing a macro prudential legislative framework that looks at the system as a whole and does not focus only on the institution. For the FSLRC too, this was a formidable task.

Macro prudential regulations typically take into consideration the collective behavior of financial institutions and the systemic implication of the same. Systemic risks are endogenous in nature and very often the challenge lies in identifying these risks and drafting suitable macro prudential regulations to address them. Failure to do so results in turning the financial system fragile.

FSLRC defines systemic risk as "…risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy."

Post the recent financial crisis, the USA established the Financial Stability Oversight Council and the EU established the European Systemic Risk Board to monitor systemic risks in their respective financial systems. The FSLRC, under its new framework, makes similar recommendations.

- Establish an agency to identify, monitor and mitigate systemic risk and to improve coordination between multiple regulatory agencies. The Financial Stability Development Council (FSDC) would be strengthened and given autonomy to perform this function.
- Create a unified database of the entire financial sector to assist the FSDC in conducting research on systemic risk. This will be the Financial Data Management Centre (FDMC).
- FSDC to conduct research to develop indicators to monitor and mitigate risk and regularly disseminate progress reports on database and results of research.
- FSDC to identify systematically important firms (SIFIs) and bring them under heightened supervision through micro-prudential regulation (by regulators) and the resolution corporation.
- Implement system wide measures such as counter-cyclical capital buffer applicable to the entire financial system or atleast to large parts of the financial system.
- Crisis management to be done by the Central Government in consultation with the FSDC.

5. Monetary policy

Currently, the monetary policy is laid down by the RBI. While adopting a consultative process to draft the monetary policy is encouraged, a framework would have to be drafted that would maintain the independence of the Central Bank. Forgoing this independence may subject the Central Bank to pressures to cut interest rates, notes the Commission. The objective of the monetary policy, as laid out by the Commission, is broadly threefold:

- The Central Government, in consultation with the central bank Chairperson, would release a Statement establishing the specifics of its predominant objective, as well as other secondary objectives (if any).

- The Statement would also define what constitutes a substantial failure in achieving the objectives.
- The Statement would be released into the public domain.

The Commission also recommends the creating of a Monetary Policy Committee (MPC). This Committee will allow RBI the requisite independence in decisions relating to monetary policy. It would also help bring about a consultative process through the contribution of the Committee's members.

The MPC will comprise of one Chairperson, one executive member of the Board, five external members of which three will be appointed by the central government and two by the central government in consultation with the Chairperson. Members will have access to RBI's research department which would allow them to take informed monetary policy decisions. External members will not have any management or operational role within the central bank. The Chairperson will retain the right to override the decision of the MPC in exceptional circumstances, but with an explanation/statement released to the public explaining the intent.

6. Public debt management

Under the current framework, public debt is managed by both RBI and the Central Government. While RBI manages the market borrowings of the Central and State Governments, the Central Government manages all external borrowings. The Commission identifies the following gaps in the current system of operation:

- No agency undertakes cash and investment management
- Information relating to contingent and other liabilities is not consolidated
- There is no comprehensive detailing of the liabilities of the Central Government

To this end, the Commission recommends the setting up of the Public Debt Management Agency (PDMA). The PDMA will work based on the objective of minimising the cost of raising and servicing public debt over the long-term within an acceptable level of risk at all times. This objective will guide all of its key functions, which include managing the public debt, cash and contingent liabilities of Central Government, and related activities.

Functions of PDMA:

- Manage public debt
- Cash management
- Manage and execute contingent liabilities
- Manage and maintain research and information systems
- Foster and help grow the market for government securities

The Agency will have a two-tiered arrangement guided by an Advisory Council and run by a Management Committee. It remains an agent of the Central Government, to which it will be accountable for its actions and results. A regular consultation and feedback process between the agency and the Central Government and RBI will take place throughout the agency's exercise of its functions.The Management Committee will seek the opinion of the Advisory Council in matters relating to strategy and policy. The Advisory Council must provide opinions on any matters that are referred to it. It may also make recommendations, of its own accord, on any activities of the PDMA, it finds relevant.

The draft Code creates a specialised statutory PDMA that is equipped to manage the liabilities of the Government in a holistic manner. The PDMA will ensure that all views are taken on record, and that there is co-ordination between fiscal policy, monetary policy and public debt management.

7. Foundations of contracts and property

Financial laws do not operate in isolation and operate in tandem with the laws of the land. For the draft Code to be truly effective, certain laws which do not necessarily fall under the ambit of financial law too have to be amended. The Commission asks for modification on:

- Insurance laws in which certain legal principles require greater clarity
- Securities laws where legal enforceability and contractual obligation have to be safeguarded

With regard to capital markets, the Commission has made key recommendations in the following four areas:

a) Defining securities

It has never been easy to define securities. Acknowledging the thought process of the Working Group on Securities that identifies securities to be a public good, the Commission defines securities in two parts. First, it is a freely transferable financial interest and the second through an illustrative list of such securities, to which the government may add as developments and innovations in the financial markets take place.

b) Ensuring legal certainty in enforceability of financial derivatives

Financial derivatives contracts have been defined by the Commission as *"…transactions, where parties agree that one party will pay the other a sum determined by the outcome of an underlying financial event such as an asset price, interest rate, currency exchange ratio or credit rating."* Under the current framework, owing to Section 30 of the Indian Contract Act, 1872, that renders all wagering contracts non enforceable, there exists problems in the enforceability of derivatives contracts. For this, certain exceptions have had to be carved out under the current framework. The Commission therefore recommends that a more clear exception to the general applicability of Section 30 of the Contracts Act be specified.

c) Central clearing for over the counter (OTC) derivatives

Going by international practice, the Commission also recommends that a framework be developed that would allow for central clearances of OTC derivatives trading and that the regulator should have sufficient authority and discretion to allow for this as and when the need arises.

d) Definition and regulation of Infrastructure Institutions.

The Commission identifies a new set of financial infrastructure institutions that are often considered as the mainstay of financial systems and whose functions do not particularly fall within the usual activities undertaken by other financial firms.

Based on this, the Commission has the following recommendations for Infrastructure Institutions:

- These must be governed in a manner that is in line with prudential regulations.
- They must also protect the interests of the consumer
- As these institutions are held to be central to the financial system, they should be considered as systemically important and will therefore have to be closely monitored.
- As many of these institutions enjoy considerable market influence, the regulator must ensure that this market influence does not become discriminatory.
- Certain Infrastructure Institutions should be allowed to track market abuse and enforce against it without undermining the role of the regulator.

Different types of Infrastructure Institutions:

- Multilateral Payment Clearing System
- Exchanges
- Clearing and settlement
- Title Storage
- Counter party default management
- Storage of transaction data

8. Consumer protection law

The first objective of financial regulation has always been consumer protection. Consumers of financial services are often more susceptible to fraud than other consumers due to the complex product offerings available and the asymmetry of information that often exists between the buyers and sellers of these products. The Commission is of the view that the existent financial law does not prioritise consumer protection. Hence it calls for the creation of a unified consumer protection law that could contain three components of (a) set of rights and protection, (b) enumerated set of powers, and (c) principles that guide what power should be used under what circumstance.

The unified consumer protection law will also protect consumers against unfair terms of contract, against misleading and deceptive conduct, give consumers the right to receive the requisite support to enter into suitable contract, the right to receive reasonable quality of service from providers and the right to data privacy and security. Similarly, regulators will also be empowered to impose a range of requirements for financial service providers, starting from disclosures to recommending changes in products and offerings to protect consumer interest.

To this end, the Commission also recommends the creation and setting up of a unified Financial Redressal Agency (FRA). This agency will have front-ends at every district in India where consumers will be able to submit a complaint on any financial product or service that they have availed.

Conclusion

There is no doubt that the draft Code is comprehensive in its vision of what India's financial sector legislative framework should look like. Some recommendations require greater inquiry, especially those that pertain to the creation of new financial institutions and those that reallocate existing duties to new institutions.

There is some reservation with regard to the extent of responsibility that is being transferred to the Ministry of Finance. One needs to consider this carefully since this could mean that regulatory oversight maybe influenced by politics.

Feasibility with regard to implementation and transitional issues will always exist, but one must not view the Indian Financial Code merely from the myopic point of view of implementation. Change is never easy and a complete restructuring of the financial sector's regulatory architecture much less. What one should be appreciative of are the principles upon which this draft Code has been conceptualised. It is difficult to argue against the need for a more transparent, accountable, advanced and contemporary financial legislative framework that can develop in tandem with the growing needs of a progressive economic and financial milieu. The ideology behind law making should change and this Code embodies this change. Whether its impact will be seen as a result of many daring across the board changes or through a series of incremental improvements to the current legislative framework only time will tell.

Views are personal and do not necessarily reflect that of FICCI

About FICCI

Established in 1927, FICCI is the largest and oldest apex business organisation in India. Its history is closely interwoven with India's struggle for independence, its industrialization, and its emergence as one of the most rapidly growing global economies. FICCI has contributed to this historical process by encouraging debate, articulating the private sector's views and influencing policy.

A non-government, not-for-profit organisation, FICCI is the voice of India's business and industry. FICCI draws its membership from the corporate sector, both private and public, including SMEs and MNCs; FICCI enjoys an indirect membership of over 2,50,000 companies from various regional chambers of commerce. FICCI provides a platform for sector specific consensus building and networking and is the first port of call for Indian industry and the international business community.



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