FICCI

CAPAM 2014

Revitalizing Indian Capital Markets: Role of Foreign Investments & Domestic Institutional Investments

The Experts' Voice



October 8, 2014 – Mumbai

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Foreword

It has been the endeavour of FICCI's Capital Markets Committee to help develop a concrete road map for the progress of Indian Capital Markets. In this regard, we appreciate the regulators' and the newly elected government's efforts in proactively working with market participants and other stakeholders to revive economic growth and restore overall investor confidence in the country. FICCI's Capital Markets Committee, over the last couple of years, has engaged closely with the policymakers in the financial sector and suggested ways to revitalize India's capital markets. The Committee comprises of very senior members from the industry who have, over these years, helped us with their inputs and valuable time and for this, we are truly thankful. This year's Capital Markets Conference (CAPAM), in its 11th edition, organized under the aegis of this Committee, aims to focus on the role of foreign investments and domestic institutional investments in revitalizing the Indian capital markets.

Based on the theme of the conference, this year's conference publication titled 'The Experts' Voice' is a compendium of papers prepared by the members of FICCI's Capital Markets Committee. The compendium is truly a reflection of the changing times that Indian capital markets are witnessing; the articles herein go far beyond just analysing the impact of the recently enacted and proposed regulations in the sector by analyzing possible solutions and suggesting novel ways of restoring investor confidence in India.

This publication is divided into four broad categories. The section on regime for foreign investments deliberates on the overall policy framework for FDI and Foreign Portfolio Investors (FPIs) in India including taxation issues and approval process and the incremental steps that may be considered to improve the overall foreign investment climate. The second section focuses on the role of domestic institutional investors including mutual funds, insurance funds and pension funds in channelising domestic institutional money into capital markets. The articles in this section review the steps being taken to encourage domestic savings and channel such investments into capital markets. The third section focuses on real estate and infrastructure financing in light of the recent policy announcements on Infrastructure Investment Trusts (InvITs) and Real Estate Investment Trusts (REITs) norms. These articles explore India's potential to emerge as a favoured destination for REITs and InvITs and identify key steps that may be taken to encourage active participation of domestic and foreign investors. The last section provides a glimpse of the extensive policy and regulatory work that this Committee has painstakingly undertaken in recent years.

We would like to take this opportunity to thank the regulators, the government, our Committee members and their teams, without whose whole-hearted and untiring support, putting together this compendium, the various representations and the meetings would have not been possible.

We hope you will find this publication insightful.



Sunil Sanghai
Chairman
FICCI's Capital Markets Committee



Anup Bagchi
Co-Chairman
FICCI's Capital Markets Committee

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The right PPP model can open the tap on FDI into India

Sunil Sanghai, *Chair, FICCI's Capital Markets Committee and MD, Head of Banking- India, HSBC*

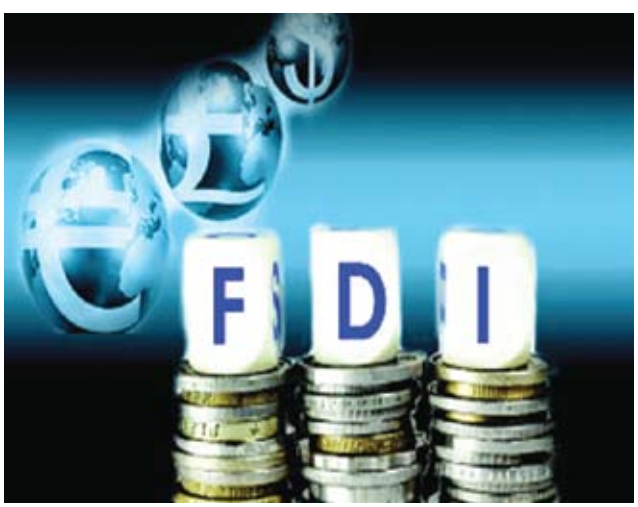
"Make in India" definitely seems to be the panacea for many burning issues plaguing the country today, be it the need for employment generation or providing economic fillip. Apart from providing a favourable environment from an infrastructure and policy perspective, the key to "Make in India" dream come true is to draw foreign direct investments (FDI). In the last five years, India received approximately US$130bn in terms of FDI. It would be an understatement to say that this number can be doubled in the next similar period.

India's more liberal FDI policies, business friendly environment, favourable demographics, low-cost manufacturing base and strong growth potential, will attract increased FDI inflows in India. In the recent past, we have seen a lot of positive policy announcements to encourage FDI in some key sectors like the railways and defence. There are clear signals of increasing FDI trend. This year, FDI was at US$7.23bn in the quarter ended June 2014 - a 34% increase over last year. Total FDI for FY15 is expected to be around US$30bn.Highest FDI received in a year was US$43bn which was in 2008. I believe India has the potential to grow FDI significantly beyond these levels.

One area that can be leveraged to attract significant FDI can be mega projects including power and infrastructure taken up under the PPP route. In fact, these mega projects may not see the light of day without the support of FDI. So what can be done to make these mega PPP projects more enticing for FDI?

India is one of the largest markets for Public Private Partnership in the world. At the end of FY2013, PPP projects worth Rs 1.31 lakh crore had already been commissioned while another Rs 10.61 lakh crore were under implementation or in the pipeline. While PPPs have been largely successful in India, is the current PPP model appropriately structured to attract FDI?

As of now, large amount of PPP projects are stalled across various sectors and the primary reason for the same is the current PPP model. Irrespective of sectors, risk-profile or history of projects, the model which has evolved over years tries to push more and more revenue risk on private parties while trying to increase payouts to the government. While this works well for the government monetarily, the model gives the short straw to private developers who have no option but to abandon the project if they are not able to make ends meet.



I believe the major constraints around the present model are

1. Inordinate delays in handing over land and approvals: Recent concession agreements require hand over of 80% land during award of concession. However, delay in hand over of balance 20% can also disrupt the project as usually it is the difficult land parcels that are not handed over in the first place.

2. Projects becoming unviable for private parties due to aggressive bidding: Extremely aggressive bidding for road projects during 2010-2013 on account of availability of cheap capital, entrance of foreign and new domestic players; and EPC contractors bidding to ensure their order books are full.

3. Such unviable projects could not find financial closure as banks were not convinced about credit worthiness.

4. Lack of flexibility in renegotiating contracts even in cases of material adversities: As seen in case of UMPPs, projects became unviable due to extraneous factors. In such cases, lack of a mechanism to renegotiate contracts has led to disputes and delay of projects.

5. Transfer of higher risk to private developers than can be handled: PPP models which provided for fixed annual payouts by private parties irrespective of their own collections were quick to fail when private parties discovered that the projects did not have cashflows to support the payouts, and hence projects were unviable.

It may also be noted that the objective of government behind any project is not only monetary, it is also to see that the project is developed in the most efficient, timely, and cost effective manner and that it improves living standards of public.



Large projects require large capital and can attract FDI into the country. However, a sub-optimal PPP model results in an entire sector becoming unattractive for investors including FDI. A well-defined PPP model must be based on the following four principles:

- **Feasibility and development -** Public authority or the government should take the sole responsibility for checking feasibility of the project, all clearances and approvals, and 100% land acquisition.

- **Risk allocation –** It is highly critical to allocate risk in a manner that the party best equipped to handle a particular risk takes charge of such risk. For example, a private developer can handle financing or construction risk. However, it may be a tall order to ask such parties to handle land acquisition risk, or revenue risk in a green-field project where there is no track record of revenues and has large uncertainties around pick-up of revenues.

- **Rewards proportionate to risks –** Rewards, compensation and revenues to private parties must be proportionate to the risks taken. Disproportionately high rewards as compared to risk assumed leads to overcrowding and extreme competition. In case of low rewards, private parties may abandon projects.

- **Exit/ capital recycling -** Providing private developers a path to exit is key to allowing capital being recycled into newer projects.

We understand that there is significant thought being spent on a new PPP model which attempts to address the above principles. Certain sections are also considering reverting to the EPC basis of constructing projects of importance in order to (i) get the projects done on time; and (ii) to regenerate investor and private developer's confidence. It remains to be seen to what extent the government is able to design new PPP model and address the issues.

In conclusion, a new optimized PPP model which addresses the concerns of private developers and makes mega PPP projects attractive for investors can also attract significant FDI. Over the past few years,India's FDI has stagnated around US$30-35bn mark which is a fraction of what China draws every year. India's total FDI in last 14 years from FY2000-July 2014 was US$228bn, which is lesser that what China drew in one single year of 2013 when it got US$258bn. However, China's FDI ten years back was around US$40-50bn which is comparable to India's FDI of today. It is not unimaginable that India's FDI numbers also have the potential to become comparable to China's over the years provided that the government continues the good work around improving FDI policies and making the environment more business-friendly environment as well as sorting out the all-important PPP model.

Regime for Foreign Portfolio Investors

Ashishkumar Chauhan, *MD & CEO, Bombay Stock Exchange Ltd.*

Foreign Portfolio Investors (FPI) Regulations seek to introduce a risk-based approach towards investor Know Your Customer (KYC) requirements, ease the entry process and reduce timelines for investor participants.

The FPI Regulations put into effect several recommendations made by the *"Committee on Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments"* chaired by Mr. K.M. Chandrasekhar in 2013.

Under the FPI regime, Securities and Exchange Board of India ("SEBI") has harmonized foreign institutional investors ("FIIs"), sub-accounts and qualified foreign investors ("QFIs") regimes into a single investor class – foreign portfolio investors ("FPI") and provide a single window clearance through designated depository participants ("DDPs").

FPI Regime

SEBI (Foreign Portfolio Investors) Regulations, 2014 have been notified on January 7, 2014. As per SEBI Circular dated March 28, 2014, SEBI has decided that FPI regime shall commence with effect from June 1, 2014. Salient features of the Regime are as under:

1. FIIs, Sub-accounts and QFIs merged

FIIs, Sub-accounts and QFIs are merged together to form the new investor class, namely Foreign Portfolio Investors, with an aggregate investment limit of 24%, which can be raised by the Company up to the applicable sectoral cap.

2. Existing FIIs, Sub-accounts and QFIs

All existing FIIs and Sub Accounts can continue to buy, sell or otherwise deal in securities under the FPI regime.

All existing QFIs may continue to buy, sell or otherwise deal in securities only till the period of one year from the date of notification of the FPI Regulation. In the meantime, they have to obtain FPI registration.

3. Role of DDPs

DDPs authorized by SEBI (as per prescribed norms) would henceforth register FPIs on behalf of SEBI subject to fulfilment of KYC (Know Your Customer) and due diligence norms. DDPs carry out necessary due diligence and obtain appropriate declarations and undertakings before registering an entity as FPI.

DDPs are either Authorized Dealer Category-1 bank authorized by Reserve Bank of India, or Depository Participant or a Custodian of Securities registered with SEBI. Existing SEBI approved Qualified Depository Participants who were registering the QFIs, but not meeting the DDP eligibility criteria, can operate as DDP only for a period of one year.

4. Exclusions from the FPI Regime

Non-Resident Indians (NRIs) and Foreign Venture Capital Investors (FVCI) are excluded from the purview of this definition.

5. Deemed FPIs

All existing SEBI registered FIIs are deemed FPIs in the FPI Regime.

Categories of Foreign Portfolio Investor

Category	Includes
Category I	Government and Government related investors
Category II	1. Appropriately regulated broad based funds 2. Appropriately regulated persons such as banks, asset management companies, investment managers/ advisors, portfolio managers 3. Broad based funds that are not appropriately regulated but whose investment manager is appropriately regulated 4. University funds and pension fund 5. University related endowments already registered with SEBI
Category III	All other investors not eligible under Category I and II (such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices)

- A Broad-based fund is a fund established or incorporated outside India, which has at least twenty investors with no investor holding more than forty-nine percent of the shares or units of the fund.
- If the broad based fund has an institutional investor who holds more than forty nine per cent of the shares or units in the fund, then such institutional investor must itself be a broad based fund.
- Underlying investors will also be counted to ascertain broad based criteria in the case of entities which have been set up for the sole purpose of pooling funds and making investments.

DDPs and Custodian of securities

- Existing qualified depository participants and custodians of securities registered/ approved by SEBI before commencement of FPI Regulations shall be deemed to have been granted registration as DDPs under the FPI Regulations, subject to payment of the specified fees.
- FPIs shall mandatorily appoint a custodian of securities before making any investments.
- The custodian shall ensure that combined holdings of all FPIs in the same investor group remains below ten per cent of the issued capital of the investee company at any time.
- DDPs shall ensure that FPIs submit an undertaking along with a certificate from a chartered accountant to an authorised dealer certifying that all taxes have been paid or funds have been set aside to meet the tax liability before remittance of any sum out of India.

Registration of FPIs

The FPI Regulations shift the onus of registering an FPI with SEBI to DDPs.

SEBI will continue to process FII and sub-account registration applications up till March 31, 2014, which has been extended up to May 31, 2015.

An applicant desirous of FPI registration should, inter alia, satisfy the following conditions:

- It should not be resident in India or a Non-Resident Indian.
- It should be a resident of a country:
  - whose securities market regulator is a signatory to IOSCO's Multilateral MOU or a signatory to a bilateral MOU with SEBI;
  - whose central bank is a member of the Bank for International Settlements;
  - against whom the Financial Action Task Force (FATF) has not issued any warnings
- It should legally be permitted to invest in securities outside the country of its incorporation or establishment or place of business.
- It should be authorised by its Memorandum of Association and Articles of Association or equivalent document(s) or the agreement to invest on its own behalf or on behalf of its clients.
- It must be a fit and proper person as prescribed.

FPI Investment Restrictions

FPI Regulations state that a single FPI or an investor group shall purchase below ten percent of the total issued capital of a company.

Unlisted Shares

- FPIs are not allowed to invest in unlisted shares.
- However, all existing investments made by the FIIs/Sub-accounts/QFIs are grandfathered. In respect of those securities, where FPIs are not allowed to invest, no fresh purchase shall be allowed as FPI. They can only sell their existing investments in such securities.
- An exception has been made by permitting them to invest in unlisted non-convertible debentures/ bonds issued by an Indian company in the "Infrastructure" sector, as defined in the External Commercial Borrowing Guidelines.



Government Securities

- FPIs are permitted to invest in Government Securities with a minimum residual maturity of one year.
- However, FPIs have been prohibited from investing in T-Bills.

Fixed Income Securities

- FPI can invest in privately placed bonds if it is listed within 15 days.
- The same debt allocation mechanism that is in place for FIIs/QFIs will be followed for FPIs.

Offshore Derivative Instruments

- FPIs can issue, subscribe to or otherwise deal in ODIs, directly or indirectly, only if such ODIs are issued to persons who are regulated by an appropriate foreign regulatory authority, and the ODIs are issued after compliance with 'Know Your Client' (KYC) norms.
- Unregulated broad based funds which are classified as Category II FPIs by virtue of their investment manager being appropriately regulated shall not deal in ODIs.
- Category III FPIs also cannot deal in ODIs.

- FPIs shall ensure that further issue or transfer of any ODIs issued by or on behalf of it is made only to persons who are regulated by an appropriate foreign regulatory authority.
- Outstanding ODIs shall be deemed to have been issued under the corresponding provision of the FPI Regulations.

Participation of FPIs in the Currency Derivatives segment

- FPIs are permitted to trade in the currency derivatives segment of stock exchanges, subject to terms and conditions prescribed by SEBI and RBI.
- The clearing corporation shall provide details on the FPI's day-end and day's highest open positions at end of day to the custodians of the FPI.
- The custodians of the FPI shall aggregate the positions taken by the FPI on the currency derivatives segments of all the stock exchanges and forward such details to the designated bank of the FPI.

Position Limits:

- Position limits for Stock Brokers (bank and non-bank), Category I & II FPIs:

Currency Pair	Position limits
USD-INR	15% of the total open interest or USD 100 million, whichever is higher
EUR-INR	15% of the total open interest or EUR 50 million, whichever is higher
GBP-INR	15% of the total open interest or GBP 50 million, whichever is higher
JPY-INR	15% of the total open interest or JPY 2000 million, whichever is higher

- Proprietary positions of non-bank stock brokers & Position limits for Clients and Category III FPIs

Currency Pair	Position limits
USD-INR	6% of the total open interest or USD 10 million, whichever is higher
EUR-INR	6% of the total open interest or EUR 5 million, whichever is higher
GBP-INR	6% of the total open interest or GBP 5 million, whichever is higher
JPY-INR	6% of the total open interest or JPY 200 million, whichever is higher

- Stock exchanges shall impose appropriate penalties for violation of position limits by stock brokers / FPIs / domestic clients.



India's Investment Regime and its New Government: Looking Positively Ahead

Haigreve Khaitan, *Partner;* ***Sameer Sah,*** *Principal Associate and* ***Rishi Shroff,*** *Associate, Khaitan & Co.*

Contemporary law relating to investment in India

In the backdrop of India's General Elections concluded in May 2014, which saw a change in government based on strong promises of robust economic growth and development, it is expected that the coming years will see healthy foreign investment into the countryand India's financial and legal regimes will be amended so as to effectively catalyse and promote inward fund flow. India's current foreign direct investment policy, one of the four routes in which foreign investment may be made aims at creating a 'lasting interest' in a domestic enterprise in order to supplement domestic capital, technology and skills. The recently introduced foreign portfolio investment route has simplified the erstwhile regulations governing 'foreign institutional investors' and 'qualified foreign investors' looking for short term financial return. The third mechanism is the Indian 'foreign venture capital investor' regime, which is intended to provide early stage venture capital to certain sectors and the fourth is a broad based procedure to permit non-resident Indians to invest in shares and debentures.

Some positive reflections on India's investment regime

Although Indian foreign investment law has been gradually liberalised over the years, it continues to be prescriptive in nature in so far as it prohibits any investment in a sector that it does not expressly 'permit'. As a result, time and again, specific approvals may be required and some investors have expressed concerns on the timelines involved. The government interface does not end with the approval process as Indian laws are administered by several government regulators, and in some cases, these roles may overlap as well. The lack of jurisdictional delineation between them may cause confusion. However, this issue is actively being addressed by the new Government as the new Government is promoting harmonious action and thinking. Particularly in the financial sector, this issue was recently discussed by the Financial Sector Legislative Reforms Commission 2013 (FSLRC), which proposed a 'Unified Financial Agency', to subsume existing regulators like the Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA), Pension Fund Regulatory and Development Authority (PFRDA) and the Forward Markets Commission (FMC).While such a Unified Financial Agency in its proposed "Avatar" risks becoming a regulatory behemoth, this may be very progressive for the sector provided adequate operating synergies are introduced.

Political considerations, the 'Sectoral Approach'

Until recently, frequent political considerations and the thin line between law and policy continuedto haunt India's foreign investors and one has witnessed such instances troubling sectors such as retail, e-commerce, defence and real estate.With the coming of the new

Government, it is expected that the benefits of sector specific regulation will be organically moulded into a formulation that suits the modern financially integrated world economy. Examples include the recent liberalisation in FDI in defence and railways, and the impending liberalisation in FDI in the insurance sector. Undeniably, India's conservative approach for sectors such as real estate and financial services has stood the country in good stead through global meltdowns. What India now requires from the new Government is a broad based road map that clearly delineates its strategy for economic growth. This must then be supportedby legislations that withstand popular politics and encourage long term foreign investment.

The Time Value of Money

One of concerns with India's contemporary investment regime is the delay sometimes caused by governmental red tape. Investors remain concerned that 'in India, things take too long', and law makers ought to evolve methods to decide on investment proposals more promptly.The Government is also addressing the problem of lack of coordination and the involvement of collective bodies (such as the National Advisory Council and the Planning Commission) in policy making is being reduced substantially thereby reducing friction and increasing efficiency. Bureaucrats are being encouraged and empowered, and the message is flowing from the top to eradicate red tapism and procrastination. In this content, the Reserve Bank of India (RBI) recently released a Citizen Charter prescribing indicative timelines for exchange control approvals of up to ninety days for most proposals. This will help give investors some visibility on timelines, provided that the RBI follows these timelines in vanilla matters. It is expected that eventually, most other regulators will follow suit and follow similar processes.In the coming days it is also hoped that reporting requirements will be simplified and the regulators will consider making them all encompassing so as to deal with unpredicted eventualities as well. In theory, non-complianceinvites the strictest penalties; whereas on certain occasions, non-compliance may have been caused by a bona fide belief and acceptance of one set of practice.

Where do we go from Here?

India is at the cusp of an important time in its political history. After 30 years, the people of the country handed a clear governance mandate to one political party by providing the party absolute majority in the general elections. This change in Government has given, Indian and multinational businesses alike, cause for hope in what was being touted as an era of policy paralysis. The New Government's strong mandate has brought with it great potential of increased foreign investment into India. This presents Indian policy makers and market regulators with an incredible opportunity to mend and improve foreign investment and allied legislations so as to mark a general improvement in the investment environment. India already has well-developed banking and stock market infrastructure, and is continuously trying to improve corporate legislations by enacting new laws (such as the Limited Liability Partnership Act, 2008) and re-inventing the old ones (the Companies Act, 2013 and the impending introduction of the Direct Taxes Code) in order to improve its regulatory environment. What is now expected is better inter agency cooperation and the creation of a transparent and predictable structure that is consistent across investment streams. The country is relooking at existing fragmentary and piecemeal efforts and studying the recommendations of the FSLRC and the Mayaram Committee in order to establish fresh comprehensive policies that truly assist inbound investment without destroying India's primarydomestic interests.Without a doubt, there is buoyant and very positive investor sentiment, and markets are abuzz about the good days ahead.

India's Foreign Investment Regime

Vikas Khemani, *President & CEO, Edelweiss Securities Ltd.*

Post opening up in early 90s, India has attracted fairly decent amount of interest from the global markets. Starting as one of the frontier markets and establishing herself as one of the most prominent emerging markets in nearly two decades; it has been a very interesting journey. Indeed we have had our shares of challenges and hiccups. When we started we had very little existence of FDI and almost no existence of portfolio investors. Over the last two decades, we have received almost USD 400 bn of investments in both categories, which covers almost all of country's current foreign exchange reserve.

The market structure, regulatory environment, tax structure, ease of access/exit are the most important things for portfolio investors. On most of these issues, we have done a good job given the complexity and size of the task. From open pit system and physical settlement and moving on to one of the most advanced transparent trading and settlement system is a great achievement, which many developed markets also have not been able to achieve. However, we continue to have some issues which have unnerved investors in the past, be it portfolio investors or FDI.

Marker structure & governance:

Investors with transparent market structure and proactive governance tend to attract institutional investors. With Foreign Portfolio Investment (FPI) guidelines, long standing issues of controlled access have been relaxed and delegated to private custodians. Now Indian markets are practically open for all foreign investors to invest. However, we need to make the markets more efficient with product innovation. Post introduction of derivatives, no major successful product has evolved. Plenty of efforts need to be put in, in order to make new products such as third party warrants, customised derivatives products or existing products like bond market vibrant and interest rate market successful.

A lot of work has happened in the areas of disclosures and corporate governance. Some of the recent measures undertaken by SEBI and cited in the Companies Act make minority shareholders more powerful. This will go long way in reducing risk premium of market and thus attract more investors. However, some framework needs to be built to promote institutional activism for non performing management.

It will also be advisable to remove some of the constraints which otherwise do not serve any purpose. For e.g. while cap on foreign ownership of various sub segments restrict free flow of capital, it may not help. FIIs should not own more than 20% of PSU banks, when the sector is otherwise open. Likewise,



fungibility in FII and FDI limits is not allowed, which I think serves no purpose.

Consistent Policy Framework

Most investors are asset managers and manage third party money; hence it becomes very important for them to have consistency of policy. Any abrupt and sudden change in policy of investee countries can impact their business model and hence, most large investors stay away or ask for higher risk premium wherever policy framework and its consistency is not perceived. India has witnessed some such events like GAAR on taxation front, P Notes, FDI in retail and 2G related issues on policy front. Such events create discomforting perception and increase the risk weight, making cost of capital for the country very high. There has to be a balance between long term and short term pros and cons of any policy decision. This became a huge concern in the recent years and current government seems to have focused on this one.

There is no doubt that post recent elections, India is at the top of emerging market pack in terms of opportunity and conviction. Currently, most of the



macro economic factors, political factors and business cycle are favouring a strong growth environment, which will create huge investment opportunities. The government and regulators should attempt to make our investment climate conducive and market structure very robust.

Today, many large global investors (sovereign funds, pension funds, PE funds) are looking towards India with a lot of hope and possibilities. India, for once, has the opportunity to be a part of the developed markets and this opportunity is for us to seize.

Foreign Investments in India - Fulcrum to India's Growth

***Naresh Maheshwari**, Chairman, Farsight Group of Companies and President, Depository Participants Association of India (DPAI)*

In India, there was a time when foreign capital used to be discouraged through imposition of various quantitative, qualitative and sectorial limits. It was always perceived as being capable of influencing our economic freedom, sovereignty and social ecology. Probably the century old experience of East India Company was always on the minds of policymakers. However, in 1991, the Government realized that the ever increasing demand and expectations of the citizens cannot be fulfilled by indigenous capital. It was rightly recognized that there was no option but to raise resources abroad. The key was how to balance expectations of the fund providers, i.e. foreign investors with the local issues like protection to small and medium scale industry, employment and the environment.

The New Economic Policy stimulated foreign capital inflows into India. It reached peak level of USD 41902 million in 2008-09. It started oscillating in the years to follow. After reaching another high at USD 46556 million in 2011-12, it reached USD 34298 in 2012-13, a decline of 26% was witnessed,despiteacute shortage of capital and the government and the industry always craving for foreign investment.The flow of FII has shown a mixed trend, during the year 2008-09 as there was a negative flow of FII. When flow of FII and FDI are compared, the flow of FII is less than flow of FDI in to India.[1]

The Government of India has been actively taking steps to pursue a more open door policy for foreign investment. For instance, in August 2013, the government increased the FDI limits in twelve sectors, including telecom and insurance. But despite the fact that India offers a large potential market, possesses pool of talented, educated and skilled workforce, has relatively low labour costs and liberal democratic political structure, the FDI inflows into India have remained low in comparison to other emerging markets.There was a large scale restructuring of indirect foreign investment. Efforts were also made to consolidate and unify provisions relating to FII, Portfolio investment, NRE investment, sub-account investment, etc. Similarly, simplification efforts were undertaken in secondary debt or equity market.With the change in government, FII investment has been major contributor to the growth of sensex.

Attracting Larger FDI Inflows in India- Problems and Challenges

"Doing Business 2014", a report co-published by the World Bank and International Finance Corporation brings out the differences in business regulations and their implementation across economies and summarizes the prevailing business atmosphere precisely. This study covers 189 countries, ranking

[1] Reserve Bank of India Database; FII data from various reports of DIPP, BSE & NSE

them on 11 indicators viz, ease of doing business, starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protect inginvestors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency. India is reportedly performing well only on two indicators, namely, getting credit and protecting investors. India's performance on three indicators, namely, starting a business, dealing with construction permits and enforcing contracts represented a dismal picture of the investment climate in India. These are further aggravated by following factors.

Weak infrastructure: India suffers from poor transport links, inadequate power supply, poor roads, and frequent power cuts, water and sewerage problems and so on. It is estimated that each day each Indian company is losing Rs. 40,000 due to power cuts and 61% companies suffer more than 10% loss in production. Acute shortage of warehousing and cold storage facilities results in deterioration of 40% perishable products.

Complicated tax structure: It is feared that top 30 corporations listed in BSE Sensex had USD 7 billion clogged in tax law suits which indirectly means non-clarity about various provisions. India's indirect tax regime is also very complex, imposing several taxes such as central sales tax, VAT, service tax, central excise duty, octroi etc. and calls for a number of compliances increasing the burden on companies. Moreover, there is a lack of uniformity in the tax provisions across the country. Policy of taxation with retrospective effect also vitiated the business environment.

Restrictive labour laws: Age old labor legislations drafted keeping in view unskilled labour still continue. Advent of technology has made them totally irrelevant and obsolete as manual work has been shifted to automatic equipment and therefore skill sets of required labors keep on changing.

Red Tapism and corruption: Yet another handicap



that India suffers from is red tapism and corruption. Multiplicity of authorities, non- integrated ministries, regulators add woes to the investors. Investors are not clear whether any approval given is final or will be subject to some other law. The new government has already taken up many steps to address these issues.

Non- availability of free and integrated financial markets: Although the government has allowed currency futures, interest- rate futures and other derivative products where risk can be hedged. Yet, these are subject to limits on exposure, non- liquidity and currency outflow.

What to do now?

1. **Encouraging Greenfield projects:** It is a fact that India's volume of FDI has increased largely due to Merger and Acquisitions (M&As) rather than Greenfields projects, which in other words means no extra value addition. M&As not necessarily imply infusion of new capital or technology into a country. Business friendly environment must be created on priority to attract large Greenfields projects. Regulations pertaining to land acquisition and environment clearances have to be simplified and more transparent so that abundance opportunity in Greenfield Projects can be utilized.

2. **FDI in education sector:** Educational institutions not only lack infrastructure but also the quality of teachers. New techniques of education which include large simulated and practical exercises based on behavioural sciences require enormous funds to develop. If we have to regain the old charisma of Takshila and Nalanda universities, lot of investment is required which can be contributed handsomely by FDI.

3. **Manufacturing Sector:** "Make in India" has been rightly accepted by the new Government as its buzz word as this sector suffered the most in recent years. One of the reasons is inadequacy of capital to compete with cheap and unrestricted import with over- indulgence of Inspector Raj. Problems are further aggravated by not having matching technology and business friendly environment.

4. **Removing Geographical Disparities:** The issues of geographical disparities of FDI in India need to be addressed on priority. Many states are endowed with rich minerals but lack proper initiatives. States has to provide a free and friendly law and order environment by becoming a partner to Central Government for attracting foreign investments.

5. **FDI in Infrastructure:** The identification of priority infrastructural projects should be based on the Government's socio economic development objective. The commercial viability of the project is always an important consideration, but cost sharing can also be used to ensure the construction of less profitable projects based on requirement and public interest. Long term planning by the Government allows it to better co-ordinate infrastructural developments and optimize the FDI impact.

6. **Development of Indirect Foreign Investment:** India has a well developed equity market but does not have a well developed debt market. Steps should be taken to improve the depth and liquidity of debt market as many companies may prefer leveraged investment. Of late, there has been bout of reform and liberalisation measures done to revive investors' confidence and flow of foreign funds to India Inc.According to market experts, sectors such as food and beverages, financial services, pharmaceuticals and biotechnology, among others, are attractive to FIIs therefore these sectors can be made more encouraging.

7. **Changes in IPR (Intellectual Property Rights):** In order to improve technological competitiveness of India, FDI into R&D should be promoted. Various issues pending relating to Intellectual Property Rights, Copy Rights and Patents need to be addressed on priority.

It is important to keep in mind that FDI on its own is not a panacea for rapid growth and development. What India needs is to put in place a comprehensive and all inclusive development strategy.

Time to focus on Non-Growth Drivers of India's FDI Attractiveness

Deep Mukherjee, *Senior Director- Corporates, India Ratings & Research Pvt. Ltd.*

The story so far: Aggregated global FDI inflow fell to USD 1,392.4 bn in 2012 from USD1762.6 bn in 2008. However, this does not fully explain the around 45% fall in FDI inflow to India over the same period. FDI inflow to India as a proportion of global FDI inflow fell to 1.7% in 2012 from 2.4% in 2008 and 3.1% in 2009. Estimates (Source: OECD international Direct Investment database, IMF) for 2013 suggest that India's share in global FDI may have inched up to 2.3%, however the absolute dollar value of inflow may not be significantly higher than 2012.

The factors generally considered to be the determinants of FDI inflows in a nation are (a) size and rate of growth in economic activity (b) availability of physical infrastructure (c) human development and income distribution (d) ease of doing business and (e) politico-legal system. While the first three parameters give prospective investors an idea of the likely returns on their investments, the last two factors impact the risks to the expected returns.

It looks like that the stakeholders are focusing on improving growth parameters (of course nothing wrong with that), but a relatively limited focus has thus far been placed on reducing the real or perceived risk of investing in India.

Growth, the least of our problem: Among the factors driving FDI attractiveness, India continues to be among the most attractive nations with respect to factors such as economic activity and growth. This is despite its anemic economic activity is last several years. The government and India Inc. with their concerted efforts would sooner or later improve growth that may cause FDI inflow to improve incrementally. However, a doubt remains whether the quantum of FDI inflow in India would surpass that of Brazil or come closer to China's as and when global FDI flow surges.

Infrastructure development has remained a core focus of the Indian government for last 15 years. While execution has been somewhat inconsistent, one may be hopeful of the actual results given the current focus.

Similarly, despite the perceived 'chaos' of democracy, governments across the political spectrum have exhibited maturity and ensured broad continuity with respect to critical policies.

The all-round anguish and anxiety that India Inc. has exhibited for low growth numbers or on missed infrastructure development target are rarely if ever extended, with same intensity, to issues such as the overburdened Indian legal system. The problem



is well acknowledged but solutions have not been pursued with high level of determination and urgency by any government thus far. As if these are not enough, the ease of doing business with Indian entities faces an enhanced level of challenge from a host of extraterritorial regulations emanating from the US and Europe.

Urgency of legal infrastructure development: The over-burdened legal systems increase the difficulty of contract enforcement to levels not seen in most G-20 nations and emerging nations with whom India competes for FDI. Factors such as delay in and high cost of contract enforcement, limited credit safety and corruption increase the real or perceived risk of an Indian investment, which may cause investors to seek higher returns to price in some of these risks. If India is unable to churn out over 7% yoy growth, the attractiveness may thus be reduced since investors may choose a low risk destination despite that having much lower growth prospects.

The improvement of legal infrastructure is at least as important as the development of physical infrastructure, but possibly, way more complex. While the government has allowed for arbitration by courts of other jurisdictions, this is at best a temporary solution. The development of legal infrastructure may require the deployment of a large number of legal personnel, possibly larger physical infrastructure for courts and last, but not the least, simplifying laws themselves. This may not be as capital intensive as the development of physical infrastructure, but it requires strong political will and political capital, which may not be lacking in the current government.



Of course, benefits from such an exercise play out over decades and possibly may cause some short term pain. However, any improvement of legal infrastructure is expected to improve India's standing in 'Ease of Doing Business'. Additionally, purely human parameters such as rule of law, social equality and regulatory quality may further unleash the economic potential of the nation, thereby enhancing its attractiveness as an FDI destination.

Extraterritorial regulatory Impact: Extraterritoriality refers to the applicability or exercise of sovereign laws outside the territory. The word is often used in the context of how some rules, regulations and conventions formed either in a specific country or by an international body impact (often adversely) other countries (usually emerging ones). The challenge presented by some extraterritorial regulations has been gradually creeping up. If the problem is not recognised and addressed, India's attractiveness as an FDI destination may be significantly affected.

Several practices, which may be business norms in India and many emerging nations particularly those related to the unorganised and informal sector, may fall foul of rules such as Foreign Corrupt Practices Act (FCPA) of US, 1977 as well as UK Bribery Act 2010. Particularly affected may be the sectors where there are significant requirements of acquisition of land or of government clearances.

FCPA prohibits offering a bribe to a non-US government official for the purpose of furthering business interest. These rules are applicable to the companies incorporated in the US as well as to those registered with US stock exchanges (but incorporated outside US). In essence, an overwhelming majority of large global corporates are covered under the Act.

The company is liable if any of its officer, director, employee or third party agent is involved in an act of bribery.

Sample this – Alcatel-Lucent S.A (incorporated in France) had to pay penalties to Securities and Exchange Commission (SEC), USA, to settle a bribery investigation which may have occurred in Costa Rica, Honduras, Malaysia and Taiwan.

The UK Bribery Act of course goes to a higher level altogether. Here, senior officers, of the corporate which is charged under the act, are guilty of the same offence. As such, they are charged with the organisation's failure to prevent acts of bribery. The actual act of bribery may be done, apart from its own employees, by individuals or other corporates with 'close connection' to the UK. If any commercial organisation which carries even a part of their business in the UK, and any person associated with such a corporate, commits the act of bribery even outside UK, the company may potentially liable for criminal action.

The way forward: Any global corporate striving for serious growth can ill afford to lose out on India. However, if India works on addressing some of these non-growth factors, the amount of FDI that it may potentially attract may be in the same order of magnitude as China's and possibly much higher than Brazil's.



Each of the efforts required is mostly in the domain of government. These steps such as expanding legal infrastructure, expanding judicial staff, improving e-governance and the like would possibly require a vision of where we see a our legal system at 2025 (We have possibly missed the 2020 bus !). Similarly the sorry figure the nation cuts in terms of scams and corruption clearly would prove very costly in terms of attracting FDI. Addressing each of these issues requires huge political will as well as political muscle. While the current government definitely has the latter, one may reasonably expect that the political will may not be lacking. It's high time these non-growth issues are addressed as comprehensively as we, as a nation, are attempting to address the physical infrastructure issues.

Views expressed in this article are personal views of the author.

Foreign Portfolio Investors

***Kapil Seth**, MD and Head- India, HSBC Securities Services*

India's decisive election mandate has built enormous euphoria around the India growth story, triggering a new wave of optimism among global investors that could draw a flood of foreign funds into the country. This renewed optimism coupled with inflation targeting by the Reserve Bank of India and continued commitment to the fiscal targets has driven the equity markets to new highs.

And these hungry investors have more reason to cheer: the new Foreign Portfolio Investors (FPIs) norms for India-bound investments that have come into effect from June 1st - something that's happened in the right place at the right time, given that a new government has just taken up office with a decisive mandate, on the back of which there are clear expectations of accelerated implementation of policies.

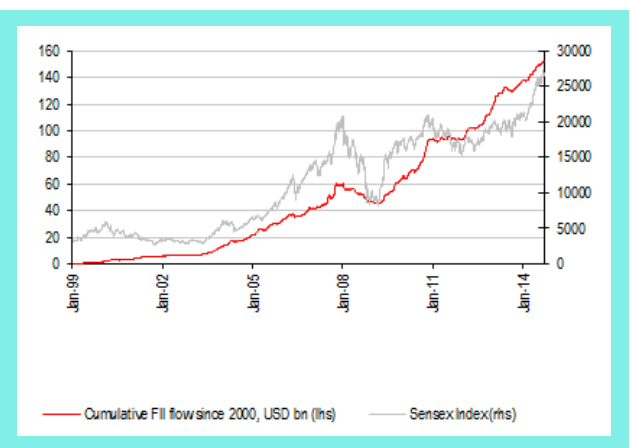
India has been on the radar of foreign investors for over two decades now. Between January 2012 and July 2014, a significant USD 56 billion of overseas funds has flown into Indian equities[1] . Foreign investors today hold about 20 percent of the total equity market in India, compared to 15 percent in 2011[2] .

Interest in India continues with Foreign institutional investors pouring USD 30 billion into India so far for 8 months in the calendar year period till Aug 14. These are large commitments for the Indian market. The graph below captures the foreign investments in to the market since 2000 and provides an indication of the extent of the correlation between the stock market index and FII/FPI activity.

Foreign investor flows are hence large stakeholders in India's success and also very important to the Indian economy aiding lower cost of capital, better asset prices in the Indian market and a vital ingredient to our forex reserves.

Historically, cash-rich foreign players, who coveted a larger share of financial assets in India, had expressed concerns over the time taken to register and invest in the country's capital markets.

The situation is set to change with the new FPI norms making things easier for overseas investors. The new set of rules replace the previous routes of Foreign Institutional Investors (FIIs) and Qualified Foreign Investors (QFIs), making the investment process both quicker and simpler with a risk-based approach to KYC.



[1] SEBI website
[2] Derived from data available in SEBI Bulletin & NSDL Website

These FPI norms are expected to bring about a similar change that a smoother and widened road brings to a difficult traffic situation. Whilst India's potential and its growth has attracted significant portfolio flows, the road travelled by investors has been challenging in parts and the FPI route is a step towards making this road a smoother highway facilitating faster traffic and accessibility to a larger number of vehicles.

FPI regulations permit a wider set of investors to access India including individuals, corporates, non-broad based funds, charitable trusts, family offices – overall making India open to any portfolio investor subject to the appropriate KYC requirements. These new rules have also amended the role of the capital markets regulator from an execution role to one of governance – an important development of the market infrastructure. The responsibility of issuing a license has been handed over to registered Designated Depository Participants (DDPs) who are, in turn, governed through the FPI rules and requirements. Hence, we now have multiple market participants currently registered and authorized to provide access to the market which is a clear shift from the previous centralization of this activity with the regulator.

Apart from enthusing a wider set of investors to consider accessing the Indian market, this change



importantly, signals to an even larger set of existing investors that their views have been heard. Foreign investors had shared their challenges with the prescriptive nature of documentation needed in India to establish KYC. The new risk-based approach to KYC for institutional regulated portfolio investors is in significant alignment with global norms and a result of the coordinated efforts across various departments and regulators. FPI rules and the simplification achieved on the KYC front are examples of how different departments of the government have coordinated and aligned their approaches to achieve a common goal.

While FPI regulations make a strong case for sustained improvement in the manner of access to the Indian markets, they have also made India more easily accessible to Banks and Investment Managers with the removal of structural access requirements, which should bode well for the corporate and government debt securities market.

The higher limit fixed at USD 81 billion for foreign investments in debt securities and its increasing utilization speaks a lot for itself. The move is set to deepen the fixed-income category of financial assets, which have traditionally been ignored by foreign investors. With expectations of an improvement in the underlying macro-economic data and currency stability, India has elicited wide-ranging discussions across new fixed income investors.

Implementation of FPI has also posed its own set of challenges with a large devolution of responsibility to market participants and need for clarity around various situations. However, the response of the market authorities with consistent market level detailed FAQs and resolving each specific situation to ensure that investor interests are protected and entry facilitated has not gone unnoticed. The success of this framework will depend upon how seamlessly the market are able to integrate their activities and provide

the right experience to the investors as part of their registration and investment process and execution experience aligns with the broader objective. Whilst jurisdictions which permit omnibus structures and low level of disclosures are easier to access, India with its segregated account structures and disclosures is still not the easiest market to access but has made strong steps. It is this directional movement which is important to sustain and to make sure that the road travelled by investors is consistently enabled for better speeds and efficiency.

India is not the only country that is widening its investor base and simplifying rules - even China introduced similar regulations in March 2013 through the Renminbi Qualified Foreign Institutional Investor scheme[3]. It allowed asset managers to launch funds directly into China if they had a presence in Hong Kong.

Hence, with increasing cross border portfolio flows and the competition for these flows from several jurisdictions, India must continue to focus on and make progress on deepening the market, delivering



on the reforms expectations, anchoring inflation and continuously evaluating to improve market infrastructure including through changing settlement cycles for fixed income to potentially meet timeline restrictions

FPI and its efficient implementation by market participants has the potential to make India even more attractive to overseas investors looking to float on the new wave of buoyancy.

3 http://www.china-briefing.com/news/2013/03/13/china-expands-rmb-qualified-foreign-institutional-investors-pilot-program.html

Global Investors Perspective – A Risk Assessment Approach

Shekar Viswanathan, *Vice Chairman and Director, Toyota Kirloskar Motor Pvt. Ltd.*

The typical investors perspective on any investment is centered around certain key parameters such as the IRR of the proposed project, the ability to access capital, the availability of raw materials, the infrastructure ruggedness, the availability of skilled manpower and other parameters that are too numerous to mention in the context of this article. The definition of a global investor is not restricted to the private equity funds, mutual funds or investors who participate in the financial markets but also those who engage in the investment of physical assets on the ground, be it in the construction of infrastructure like roads, ports and factories or in certain physical assets which are deployed in the airline or shipping sectors.

The measurement and assessment of risk in a project is the first step in the investor's decision making process on a particular project or joint venture or business. The ability of the global investor to defease some of the risk inherent lies in investing either through **appropriate contractual arrangement** or through the **use of financial products** or to **distribute the risk** to other stakeholders involved. This will then dictate the amount of money he is willing to commit to a particular project – in many cases it will be a zero or one approach – if the risk cannot be mitigated adequately, then the investor may well decide not to invest at all.

With the above brief background, let us examine the global investor's current perspective on doing business in India, be it from the view point of the pension fund manager, the sovereign wealth fund or the investor who engages in the investment directly in physical assets, be it in infrastructure or plant and machinery or aircraft or ships.

It is also pertinent to examine, in brief, why it is important for India to be able to attract foreign investment, both direct and indirect. The Union Budget passed earlier this year by the new Government highlights a stark reality of the state of Government finances – not broke yet, but the GoI has to carry the burden of interest payments which is significant and growing. If India is to grow at a healthy GDP rate of 7 percent plus, the dependence on the inflow of foreign investment across all sectors of the economy is of paramount importance. India needs the foreign exchange to buy capital goods and oil, which is critical for the functioning of the economy. One must take note that while the FX reserves are at a healthy USD 300 billion plus (though it pales in comparison with China's nearly USD 4000 billion), India's foreign



currency debt is USD 400 billion plus. The head room for incremental external commercial borrowing is limited.

One of the key risks that intending investors look at is the stability of the currency. The Indian rupee suddenly devalued in 2012 and 2013 and went to a very high level of Rs.68 to the US dollar. Though part of the reason may be attributed to the US decision to taper the quantitative easing policy and scale back the extent of bond purchases, the fact remains that international investors had lost faith in India's real economy. Currency stability has since returned partly because of the dampener on gold buying and partly because the new government headed by Mr Narendra Modi inspires confidence with the global investor.

While emerging markets may offer an interesting currency play and in some situations, actually help in drawing in foreign currency, for the long term investor the stability of the currency, when no viable long term hedge is available, is of crucial importance. For India today, even with the Narendra Modi government in charge and a responsive RBI Governor, the talk of a stable Indian rupee has to be tempered with cold reality – the reality of sudden spurts in the oil price, the prospective US dollar interest rates, one off events such as border related problems with Pakistan and other global events may trigger a redirection of the capital flows leading to some FII outflow from the country. International companies that have invested for the long run would find it difficult to approach their respective Boards for further investment if the Indian rupee is not stable.

The approach of the global investor who is here for the long term will be to assess certain other operating risks such as labour risk, regulatory risk, change in law risk, and in many situations the risk of enforcing rights.

For labour intensive industries a critical play will be the ability and willingness for individual state governments to frame rules under the labour laws



to make it industry friendly – for example allowing women workers to work beyond the normal working hours or ensuring that employees do not strike work without requisite notice. Global investors also factor such issues into their decision making process. Intermittent stoppages of work increase the cost of doing business and business risk.

Regulatory risk is a key risk assessment made by international investors based on the industry they are investing into. For example, investors in the automobile industry make an assessment of fuel regulations and how they would affect the product line up – the recent notification of the Government of India to introduce fuel economy norms is a case in point. For the Indian government to introduce such legislation is very welcome from a national health point of view but if introduced without a workable timeline can prove very disruptive to the industry and the economy. Industry needs to be given time to develop engines of the required quality - the Indian government is seized of the matter and has now planned to introduce this legislation to take effect from 2017.

Regulatory risk in the form of the Competition Commission of India imposing its own assessment of industry situations and levying penalties does not make it any the more attractive for foreign investors to want to invest in India. While the CCI's avowed

objective is to prevent cartelization, open up channels of distribution so that the consumer is benefited and prevent unfair competition is no doubt laudable, the actions of the CCI may not end up eventually benefiting the consumer. In the case of the auto industry, the actions of the CCI will end up hurting the consumer since there is no enabling framework that will address the mushrooming of spurious parts and the CCI's insistence on distribution of spare parts through the unorganized retail sector will further endanger the safety of the consumer. While independent repair workshops will no doubt give the consumer wider choice, the consumer certainly cannot be left with a choice that cannot assure minimal standards of quality repair using genuine parts. The way forward will be for the GOI to have a certification process for independent repair workshops.

We have had in the past, in certain industries, a mushrooming of players – the airline and telecom industry comes into focus. While airlines have come up quickly, they have also disappeared on account of their inability to remain profitable and solvent. Many of them had leased aircraft and when they stopped operations, the owners of the leased aircraft wanted to repossess them – but repossession of aircraft was never easy for the owners given the number of approvals they needed and the inordinate delay before they could repossess the aircraft. This approach actually queers the pitch for the airline industry and the existing players – intending lessors then push up lease rentals merely to compensate for the risk of delayed repossession if that were to happen. This may not be the most obvious of risks but serves as an example of what it takes to attract investment on a sustainable and reasonable basis.

In conclusion there is plenty India needs to do to attract foreign investment – we have a new government under the leadership of Mr Modi and in that there is hope.

Channelising domestic savings into capital markets

Anup Bagchi, *Co-Chair, FICCI's Capital Markets Committee and MD & CEO, ICICI Securities Ltd.*

India has historically been characterised as a country with relatively scarce capital resources, dependent on foreign capital for funding growth. Barring a few large to mid sized corporates, which have the wherewithal to tap the foreign debt market or domestic equity markets, most businesses are dependent on high cost bank funding for capital requirement. However, the domestic saving rate in India at ~30% is ironically one of the highest in the world. The imbalance lies in the constituents of savings, which is skewed towards the physical form in either real estate or gold. Of the total domestic savings of Rs 30 lakh crores, the share of physical savings has increased to 68% from 52% about a decade ago.

Channelising domestic savings into financial markets to address the capital crunch is crucial for facilitating rapid development of an emerging country like India. Exposing households to a wider range of financial products and instruments is a prerequisite for effecting a change in investment pattern. Both the government and institutional investors like mutual funds, insurance companies, pension (retirement) funds and alternative investment funds have to play an active role in this.

To address the imbalance, efforts are required on both, (1) encouraging more savings among the un-banked by increasing financial inclusion and literacy and

Break-up of domestic savings

Year	Gross Savings (Rs. Crore)	Saving as % of GDP	Household savings (Rs. Crore)	Break-up of Household savings (net)	
				Financial Savings (%)	Physical Savings (%)
2012-13	3,044,098	30.1	2,212,414	32.4	67.6
2011-12	2,624,459	31.3	2,054,737	30.8	69.2
2010-11	2,621,742	33.7	1,800,174	43.0	57.0
2009-10	2.182,338	33.7	1,630,799	47.5	52.5
2008-09	1,802,620	32.0	1,330,873	42.9	57.1
2007-08	1,836,332	33.4	1,118,347	51.9	48.1
2006-07	1,485,909	34.6	994,396	48.7	51.3
2005-06	1,235,151	36.8	868,988	50.4	49.6
2004-05	1,050,703	32.0	763,685	42.9	57.1
2003-04	823,775	33.7	657,587	47.6	52.4

Source: RBI, ICICI Securities

(2) incentivising domestic institutions and households to divert higher proportion of existing savings towards financial savings. At the same time, the penchant towards gold and real estate investments needs to be curbed.

Encouraging financial savings through mutual funds and pension funds

The total AUM of the Indian mutual fund industry is $168 billion, about 0.09x of GDP. In contrast, the US mutual fund industry stands at $15.1 trillion, about 0.9x its GDP. Moreover, only 19% of the Indian mutual fund industry AUM is contributed by retail investors while households in the US account for nearly 90% of investments in mutual funds. However, around $11.7 trillion or 87% of total household investments in mutual funds in US are in long term funds, majority of which are parked in 401(k) retirement plans, individual retirement plans (IRAs) and annuity plans.

- Mutual funds offer an apt platform to channelise domestic savings in the financial markets. Even though there have been several efforts by SEBI to promote investment in mutual funds, they remain under penetrated in India with only 3.63 crore retail folio as on March 2014. Mutual funds should be allowed to offer tax efficient retirement funds. Even though the 2014 Union Budget indicated that mutual funds should be allowed to launch pension plans with tax benefits similar to NPS, further action on this is awaited. Options like higher lock in period and low expense ratio can be introduced to encourage long term holding in equity funds. This arrangement would be a win-win situation for all stakeholders (investors, AMC and distributors). In addition, regular investment in debt mutual funds through SIP should be promoted as an alternative to recurring deposits in post office.



- Secondly, the NPS structure and tax treatment need to be simplified for mass adoption. The current arrangement wherein only employer contribution gets the tax benefit makes managing investments cumbersome besides increasing the overhead cost in offering and managing such schemes, which has led to only a few corporates offering NPS investment option to employees. Moreover, the expense structure at a mere 0.0009% as management fees makes the promotion and distribution of NPS less lucrative. A similar plan offered in the US has a total administrative and management fees in the range of 0.4 - 2.0%. While the Employee Provident Fund Organisation (EPFO) manages about $100 billion from more than 8 lakh establishments and 41.7 million active subscribers, NPS even after five years of existence has been able to attract just around 235 companies with offerings to a limited set of employees. A suitable expense ratio (around 0.25 - 0.5%) and simpler tax structure wherein the employee himself invests and gets tax benefit like other investment deductions, will not only encourage regular investments but also incentivise distributors to promote NPS.

- Thirdly, the bond markets in India forming just 3.3% of GDP are under-penetrated and relatively under-developed with limited options available, restricting investor participation and liquidity. The share of corporate bonds to GDP is 10.6% in China, 41.7% in Japan and 9.3% in Korea. Efforts to increase market depth and encourage retail participation by introducing derivative products like CDS, interest rate futures, etc., allowing banks and large listed entities to raise money through NCDs and development of AIF category III (HNIs or savvy investors) are needed.
- Lastly, financial inclusion is equally important, which offers the twin benefits of offering structured, streamlined and credible saving option to the un-banked population and simultaneously makes a huge pool of domestic capital resources available for corporates. The government has already taken aggressive steps to spread financial inclusion by offering new banking licenses as also with schemes like Jan Dhan Yojana. With over two crore accounts opened, even small savings deposited by new account holders will facilitate channelisation of household savings into the mainstream banking system, which otherwise could have been utilised for cash transactions or diverted to either gold or real estate.



However, more efforts on this front are needed to tap the whole population. With only 620 million bank accounts among a population of 1.2 billion, a huge pool of savings remains out of the mainstream banking system. One of the options to further attract savings in the banking system could be to allow India Post to operate as a bank. With over 1.5 lakh outlets spread across the country, it can be a suitable engine to further entrench the financial saving practice.

Discouraging physical investments

As highlighted earlier, physical savings form a larger part of overall savings in India. This trend can be attributed to ease of converting unaccounted money into real estate or gold and certain tax policies, which encourage speculative demand in real estate. In order to attract household savings in productive financial assets and arrest the menace of diversion to black money in physical assets, a two pronged strategy is needed, which offers incentives for financial savings besides implementing stringent laws to monitor physical assets transactions.

- The real estate circle rates need to be revised more frequently and regularly to align them with prevailing market rates. In addition, the capital gains tax should be calculated on higher of transaction value and circle rate. This will discourage under reporting of transaction value and ultimately help reduce the unwarranted attractiveness of real estate as an investment destination. Secondly, the current law allows higher income tax benefit on the second house used for renting out than on the first house used for self occupancy. To curb speculative and investment demand in real estate, income tax provisions should be altered accordingly. This may include limiting tax benefits to only the first house.

- While the RBI and government have introduced several measures to curb gold import, which have helped tame current deficit to under 3%, it still remains the largest investment option in India with 800 – 1000 tonnes of gold being imported every year. The current gold holding of households and temples in India is in the range of 20000 – 25000 tonnes. Efforts are needed on this front to monetise a part of this holding to meet the capital requirement to fund economic growth. Reducing capital gains on converting gold to financial saving in addition to further steps to curb speculative demand in gold (capping the gold imports, higher import duty, etc.) are some of the measures that may make investment in this unproductive asset less attractive.

Conclusion

Channelising domestic savings into capital markets needs a holistic approach with the focus on incentivising financial savings and at the same time reducing the attractiveness of physical savings. Long term financial products like retirement and pension plan from mutual funds can be promoted through tax incentives for investors and reasonable expense allowance for



distributors. Development of debt markets to encourage corporates to raise money from retail investors, increasing financial literacy and discouraging cash transactions are other steps that will gradually divert savings towards the financial form. At the same time, the penchant towards investment in physical assets like gold and real estate can be curbed by plugging various tax loop holes, which either offer undue tax benefits or make such investments a haven for black money transactions. Moreover, innovative methods to monetise a part of the huge accumulated domestic gold holdings can be employed to fund the capital requirement of the next leg of economic growth.

Channelizing domestic savings into Capital Markets

Saurabh Sarkar, *MD & CEO, MCX-SX*

The Indian capital market had undergone significant changes on the regulatory and structural paradigm since 1990s but has not been commensurate with the changes in the product profile, range of services, capital mobilization, cost of raising capital, etc. This looks odd when compared with the developments in other emerging markets (including China). The very fact that India has only 20 million direct users of capital market compared to the 200 million registered Chinese depository users, underlines the distance our capital markets need to cover in order to make the Indian growth story more inclusive. Broad based market development has always been the theme around the world as more investors means more wealth creation and distribution in society and also better allocation of risk capital.

With healthy growth and increasing base of our population, the challenge before policy planners would be to turn the healthy economic growth trend of the past decade into an economically and socially sustainable phenomenon. Markets, as institutions which enable democratic interplay of economic forces, play a critical role in making economic growth inclusive and sustainable. In that way, markets can be natural allies of egalitarian and democratic systems. Capital markets in that respects are no exceptions at all. In a monetized economy, capital plays the critical role of allocating its resources among those activities that are economically most productive. In doing so, it would also enable all stakeholders of the economy benefit from the returns in proportion to the capital deployed by them. However, it is the ability of these markets to provide free and fair access at an affordable cost through various instruments that could match the investor profiles and expectations would decide if these markets would be able to achieve their critical objective of making market-led growth an inclusive process.

Though continuous steps have been initiated by the regulator for the development of markets yet the potential of the country is yet to be fully explored. The demographic dividend advantage is yet to be gained; also the "potential of savings" is going unnoticed; productive and innovative capacity and creative infrastructure facilities are yet not optimally utilized. Hence, what India needs is a sustainable growth approach with inclusive thought process. This would surely can able us to see forward India have an upright position in the global financial markets and also have a progressive economy. Hence, India needs more efficient and well developed and widely participated capital markets that would enable the growth transition to be a smooth process.

Participation of domestic pension funds

Indian Mutual fund industry is managing its AUM (Asset under management) of more than Rs 2.5 Lakh crores (Investment in Equity) as on March 2014. If the pension fund is allowed to invest in Equity to the tune of 10-20% of its investment, the incremental corpus would be less than Rs. 1 Lac crores. This incremental corpus appears, considering the size of mutual fund AUM, to be manageable with ease. Pension funds

could start to allocate a portion of their fund, to be invested in equity, through the existing mutual fund. By doing so, the risk of corporate governance will be minimized at two stages, one, the entire equity portfolio of the pension fund will be managed by an AMC registered with Capital Market Regulator (Well Governed) and the investment of entire corpus may be restricted to PSUs (Existing and prospective listed companies) and top companies forming part of SX40, Nifty and Sensex. Such investment of the pension funds in Equity would generate an annualized excess return of at least 100 basis points more for the entire corpus. Later, the equity allocation could be increased in a phased manner and investment may be broadened to other listed and prospective listed companies as well.

Pension funds, alike other institutional investors provide means of risk pooling for smaller individual investors, thus providing diversification and enhanced risk-return opportunities. Their superior capacity to absorb and process information and their ability to transact in large volumes, not only lowers the cost of intermediation but also benefits investors and businesses and financial institutions alike. In addition to providing better risk management and lower transaction costs, their long-term liability structure allows pension funds to invest in and contribute to the development of longer-term securities markets. They not only contribute to better transparency and governance but also to the overall improvement of market microstructure and market efficiency.

Product innovation

Further, the entire capital markets infrastructure especially Stock Exchanges, should be encouraged to innovate. Innovation, particularly of the disruptive nature, though seldom popular with regulators, (in any field) is required to break barriers and open new doors by creating new segments. The case for sensible innovation cannot be any stronger than it is in the case for building financial inclusion. While unbridled innovation is probably a bigger threat than opportunity there certainly is a case for allowing stock exchanges to innovate. Modern stock exchanges are unique entities. They are required to balance their regulatory role with their status as profit making commercial organizations. There is a crying need for the regulators to allow stock exchange some leeway with innovation. The current regulatory environment, sadly, does not encourage innovation. Every contract related to any "permitted to trade" within limitations laid down by statute stock exchanges should be encouraged to develop and offer exclusive products so that lot of innovative products i.e. hybrid products, fixed income products etc. may be brought to the markets. The investors would have varied choice in terms of products based on their risk appetite, investment principles, regional and sectoral preferences etc. The principle of one size fits all may not help in enhancing market penetration and Channelizing domestic savings into Capital Markets. Varied choices of products based on the investor's preference would also play a greater role in enhancing the exchange's reach to far flung area of the country to offer investment solutions to citizens of the country. Exchange traded products are developed and offered in regulated and transparent manner. Isn't it better that highly regulated



institutions like banks and exchanges are given some space to innovate instead of some dubious "entrepreneur" operating under a regulatory blind spot? This may even spare us from recurring scams which plague our financial system and keep us away from our goals of financial inclusion. Forgery with investors may also not arise and that may build investors' confidence in the capital market, a road to greater market development. But the straightjacket of uniform contracts and products needs to be removed! This will remove many of our teeming millions to get out the clutches of loan sharks and Ponzi operators. The retail investor is not a mythical creature, a retail investor is a thinking person looking for customized choices. One deserves a patient hearing from our regulatory ecosystem.

Conclusion:

In a country with population of about 1.2 billion plus having a saving rate of equivalent to 32-33 percent, merely 2 percent of them are participating in Indian Capital Market throws structural opportunities that the market can achieve through increasing intermediation, positive innovation and market literacy.

Nearly 55 percent of savings are being routed into physical assets, which are unlikely to earn a real return as inflation levels are way higher. This composition clearly indicates that Indians are great at saving but lagging behind as investors.



Current intermediation by Stock Exchanges has not done enough to channelize domestic retail investors and their saving to the Capital Markets. Support to healthy Competition by policy makers and technology would be the key driver which will help in grooming the domestic investors from basics of capital market investments and through arming with necessary information as available with their institutional counterparts.

Indian capital markets have come a long way from its "old" and "traditional" image. It is gradually progressing to a modernized market, with several opportunities available. Indian markets are at stage of parallel development as well as evolvement. While efforts for increasing the financial literacy are being undertaken, the next obvious step for policy makers would be to widen the equity culture in the Indian economy and also to promote self-sustaining economic activities for long-term economic health of the nation.

The New Shareholder: Active, Engaged, and Online

Amit Tandon, *Founder & MD and*
Hetal Dalal, *COO, Institutional Investor Advisory Services India Ltd.*

India, today, is witness to a rising class of responsible and aware investors. Empowered by changing regulations, they are asking the right questions of managements and vocalizing their opinions by casting their votes. Companies need to take these investors seriously.

Increased engagement between shareholders and company managements are telling signs of the times to come.There is a greater amount of participation by both retail and institutional shareholders: the number of votes on shareholder resolutions has increased. Armed by the new regulation, the internet savvy investors' voice has become audible.

The engaged and active investor

Much like the earlier Indian political regime, corporate India was complacent because shareholders didn't care as long as they got returns. As some good citizens, there were some responsible investors that did vote on shareholder resolutions. An IiAS study showed that in the 2013 proxy season, Indian mutual funds voted (either FOR or AGAINST) on 61% of the 30,124 resolutions presented to shareholders: this was over 2x the votes cast in the 2011 proxy season (during which mutual funds voted on only 54% of the 16,043 shareholder resolutions).

The 2014 proxy season promises to be far more intense. Akin to the central government elections, this year, 'voter awareness and turnout' is better – and it has already brought about a change. Consider this:

- Maruti Suzuki was compelled to change the terms of its agreement with Suzuki Motor Company (Japan) on setting up its Gujarat plant following strong opposition from institutional investors.
- Tata Motors[1]' resolutions against clawing back the remuneration for three of its executives was defeated: almost 30% of votes were cast AGAINST the pay hike. To pass, the resolution needed a 75% FOR vote.
- 23% of Havells India's shareholders that voted, cast their voteAGAINST the payment of royalty and trademark charges to promoter-owned companies for the use of the brand 'Havells'. The resolution came very close to being defeated.

SEBI regulations have prompted institutional investors into action

In 2010, SEBI announced that mutual funds were required to disclose how they have voted on shareholder resolutions: this disclosure was to be made annually. Mutual funds have a fiduciary responsibility to their unit holders – therefore, they needed to act responsibly. Some mutual funds took

[1] Disclosure: Tata Investment Corporation Limited and Tata Motors Limited are a part of the Tata group. Tata Investment Corporation Limited holds equity shares in IiAS. IiAS recommended voting FOR on all three resolutions regarding remuneration.

notice and began voting on shareholder resolutions. Others remained passive and continued to abstain from voting.

To prompt resolute voting decisions, in 2014, SEBI asked mutual funds to publish the rationale for their voting decision. Additionally, SEBI shortened the reporting period – mutual funds were required to disclose their voting decisions on a quarterly basis. In making this change, SEBI effectively used disclosure as an enforcement tool: public dissemination of information creates an obvious comparability, thereby fostering an environment of competitive behaviour that serves shareholders and the corporate governance agenda.

E-voting has changed the number game

SEBI has mandated that all listed companies must enable e-voting on all resolutions through the depositories. Although this diktat is applicable from 1st October 2014, most companies have begun complying.

Earlier, in shareholder meetings, votes were counted by show of hands. This meant that for shareholders to cast their votes, they had to physically attend meetings. The BSE200 companies' registered offices are spread across 16 states (including union territories) and over 40 cities – can shareholders realistically be expected to be physically present?

So e-voting was introduced, which has allowed a dispersed set of investors to voice their opinion. While, e-voting has not materially increased voter turnout as yet, it has started to do so. But the real implication of e-voting is in the manner in which the votes are counted.

E-voting counts one vote per share held, which dramatically changes the counting from the show-of-hands method (of counting one vote per hand). More importantly, the implementation of e-voting means that all resolutions, even those which are presented only at shareholder meetings (and not via postal ballot), have to be polled. So, even if the same number of shareholders as before vote, the result could be different, given that the outcome will be determined by the number of shares. The vote of larger shareholders now counts, irrespective of their ability (or inability) to attend shareholder meetings.

Regulations have multiplied the power of the minority shareholder vote

SEBI guidelines, and in some instances, the Companies Act 2013, does not allow promoters or controlling shareholders to vote on transactions in which they have an interest: these transactions include all related party transactions (save where the transactions are with wholly-owned subsidiaries or between two government entities[2]), mergers and acquisitions with promoter-owned or promoter-controlled entities, and delisting resolutions. The revision in regulation has been brought in to give public shareholders a stronger voice; it enhances the power of public/ minority investor. Concurrently, promoters have become vulnerable in areas where their votes had a dominant influence.

The regulations imply that power of public shareholders' vote in such transactions is now significantly higher than the actual shareholding. For example, if the 'promoters' own 75% of the shares in a listed company and the public 25%, this 25% will account for 100% of the voting power for related party transactions. This gives one share a voting power of 4x: IiAS describes this exponential power of a single share as the 'Voting Multiplier.' This multiplier means public shareholders can now impact the outcome by vetoing transactions that they believe are unfair.

[2] Amendments to Clause 49 issued by SEBI on September 15, 2014

Table1: Recent examples of related party transactions where promoters are interested parties:

Company Name	Resolution	Voting outcome	Outcome under new regulation
Sesa Goa	Scheme of arrangement between Sterlite Industries, The Madras Aluminium Company, Sterlite Energy, Vedanta Aluminium and Sesa Goa.	20.9% voted against. The company did not provide the breakup of votes cast between classes of shareholders	Resolution would have been defeated as 88%[2] of the public shareholders voted against the proposal
Ambuja Cements, ACC Limited	Approve 'Technology and Knowhow fee' to Holcim Technology Limited	Ambuja Cements: 83% of the public shareholders voted against the increase in royalty. ACC Ltd: 88.6% of the public shareholders voted against the increase in royalty	Resolution would have been defeated.
Akzo Nobel	Three 100%-owned subsidiaries of Akzo Nobel NV (ICI Ltd. UK) to be merged with Akzo Nobel India	23.7% voted against the proposal	Resolutions would have been defeated as 54% of the votes cast were against the proposal[3]

[2] Assuming promoters were not allowed to vote on 479 million shares, leaving only 148 million shares which were considered valid votes. A total of 131 million shares were voted against the arrangement.

[3] Akzo Nobel NV held 56.4% of the equity at the time the resolution was proposed. Assuming these shares were not voted upon, the resolution stands defeated.

The initial success in defeating resolutions has energized the average voter. As with the general elections, the increased participation is evidence of the hope of retail and institutional investors that they have a say. Companies would be wise to listen to this murmur before it reaches a deafening crescendo.

REITs / InvITs- Addressing the financing Requirement for the real estate and infrastructure sectors

Tushar Sachade, *Co-Head - Private Equity, BBSR & Co. and*
Samip Barlota, *Director - Private Equity Tax Practice, KPMG India Pvt. Ltd.*

Background

The real estate and the infrastructure sectors have been at the forefront of the Government of India's agenda on account of their potential to propel economic growth significantly. Both the real estate and the infrastructure industry's growing need for additional sources of funds has been compelling enough to encourage the implementation of a special regime for these sectors in India. Accordingly, the Real Estate Investment Trusts ('REIT') and the Infrastructure Investment Trusts ('InvIT') regime have been introduced in India for the financing of these sectors keeping in perspective the unique dynamics of Indian economy.

India's real estate and infrastructuresector scenario for REITs and InvITs

The real estate and the infrastructure sectors are deeply linked to the economic performance and hence likely to be major beneficiaries in the expected strong Indian economic growth. The major drivers supporting the real estate and the infrastructure sector include urbanization, strong expected growth in the manufacturing and service sector and a vibrant young population.

According to the Twelfth Five Year Plan, India requires an investment of around INR65 lakh crores in the infrastructure sector during 2012-2017. Similarly, in the context of real estate sector, India has plenty of real estate assets ready to be packaged into REITs. The total value of office real estate pan-India stood at USD 34 billion as of end-2013 which is likely to grow to over USD 50 billion. Additionally, as at the end of 2013, India has office space of 376 million square feet across its seven biggest cities[1] .

These statistics indicate a strong potential investment opportunity and a fertile ground for the REITs and InvITs to flourish in India.

Regulatory and Tax initiatives

Regulatory framework

The Securities and Exchange Board of India ('SEBI') released draft guidelines for REITs in October 2013 and a concept paper on InvITs in December 2013 for public comments. Later, SEBI released a separate regulatory framework under the draft SEBI (Infrastructure Investment Trusts) Regulations, 2014 for public comments. Based on the public comments received, SEBI, in its meeting dated August 10, 2014 approved the final guidelines for REITs and InvITs in India.

[1] India's Stock of Commercial Real Estate" JLL Research Report, 2014

While the final REIT and InvITguidelines are still awaited, the SEBI press release highlights many positive changes carried out by SEBI to the draft REIT guidelines and the draft InvIT guidelines.

Some of the key changes to the REIT framework include allowing REITs to have multiple sponsors, permitting REITs to raise money through private placements, reducing the asset size requirementof REITs to Rs. 500 crores, reducing the threshold for investment in completed and rent generating properties to 80%, etc. Similarly some of the key changes to the InvIT framework include removal of the requirement of minimum two assets in case of publicly offered InvITs and the requirement of necessary bundling of assets for privately offered InvIT, permitting related party transactions with prior unitholders approval, sponsor holding in InvIT not to be mandatory where concession agreement requires minimum sponsor shareholding in the SPV, etc.

Tax framework

As widely expected by the industry, the Budget 2014 made the announcement of tax proposals for REITs and InvITs (collectively referred to as 'Business Trusts') in India. As a positive step, the Government announced a tax pass-through regime for Business Trusts (effective from October 1, 2014) with the various streams of income being subject to a single level of tax.



Some of the key tax issues that still need to be resolved include exempting the SPVs held by Business Trusts from dividend distribution tax, providing clarity on tax deductibility of interest payments by SPVs to Business Trust, reducing the holding period for Business Trust units to qualify as long term capital assets to 12 months, etc.

Amendments required in other regulations

With the approval of final REIT regulations and the InvIT regulations by SEBI and clarity in the tax provisions, the following other regulations require change for thriving of REITs / InvITs in India:

a) Appropriate amendments in foreign exchange control regulations / foreign direct investment policy which inter-alia include:

- Necessary amendments to be made in the Foreign Portfolio Investors and Non-resident Indian investment framework permitting them to invest in units of REIT / InvIT without any cap or restriction on the units that can be acquired.
- Transfer of units of REIT / InvIT and repatriation from REIT / InvIT to foreign investors to be permitted under automatic route.
- With respect to downstream investments by REIT / InvIT, clarifying that foreign owned conditions would not apply to REIT / InvITs.
- Allowing foreign Sponsors to acquire units of REITs / InvITs under automatic route. In such a case, swap of shares by non-resident Sponsor with the units of REIT / InvIT should be permitted under automatic route.

- External commercial borrowing regulations to be modified to permit REITs / InvITs to avail foreign currency loans / bonds from non-residents.

b) IRDA's Investment regulations to be tweaked to allow insurance companies to invest in REITs / InvITs, thereby enabling REITs / InvITs to have a wider investor base.

c) One time waiver of stamp duty on transfer of assets to REITs / InvITs or SPVs owned by REITs / InvITs.

d) Amendments in PPP Policies to facilitate movement of shares of Project SPVs / infrastructure projects to the InvIT without adversely impacting PPP Agreement/terms.

Way Forward

REITs and InvITs are likely to infuse additional transparency and liquidity in the Indian real estate and infrastructure market. With Indian players showing an increased keenness to list Indian real asset and infrastructure assets offshore, especially in Singapore exchange, SEBI's move is likely to attract such markets onshore and increase depth of Indian real estate and infrastructure capital markets. From a private equity perspective, REITs and InvITs will also



create exit opportunities for developers and financial investors allowing them to move completed assets to REIT / InvITs and provide much needed liquidity in the market.

Additionally, the introduction of REITs and InvITs will provide a new source of funds to Indian developers hitherto struggling to reduce debt, with interest rates among the highest in Asia, while giving investors the access to benefit from regular income and appreciation from the country's property market and infrastructure assets. Moreover, it will reduce the developers' dependence on banks encouraging them to own and manage assets with a long term view.

Indian REITs and InvITs – are welcome footsteps but need clarity to provide a stimulus to the sentiment in the sector

D.C. Jain, *MD & CEO, IDBI Capital*

Why REITs and InvITs in India?

The Indian Infrastructure and real estate (being capital-intensive sectors) have growing need for additional sources of funds and the success story of global REITs is compelling enough to encourage the implementation of a similar regime in India with requisite adjustments, keeping in perspective the unique dynamics of its economy.

Real estate and Infrastructure projects are in urgent requirement of funds, especially in the form of long-term institutional capital. REITs and InvITs will offer replacement capital and exit opportunities for project developers and financial investors, allowing them to unlock capital employed in completed assets by injecting such assets into REITs and InvITs. The overall physical property market and infrastructure projects will be positively impacted by improved liquidity, lower cost of capital, improved transparency[1], professional asset management and positioning.

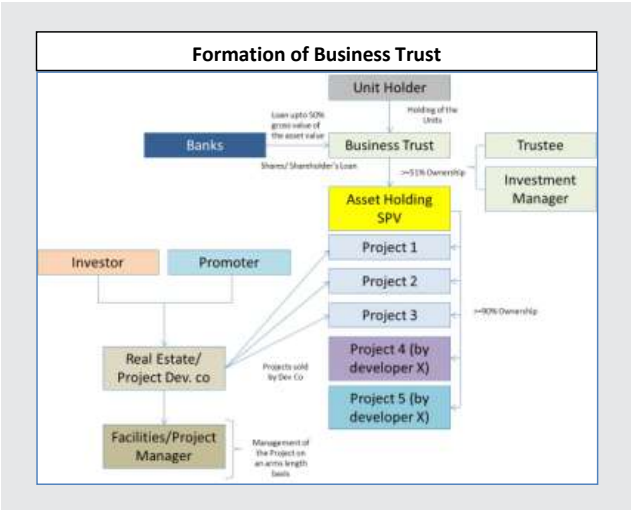
It is a natural hedge against inflation, provides portfolio diversification, experiences low volatility and hence, generates positive long-term returns. Therefore, the common investors have the opportunity to share in the gains of this asset class.

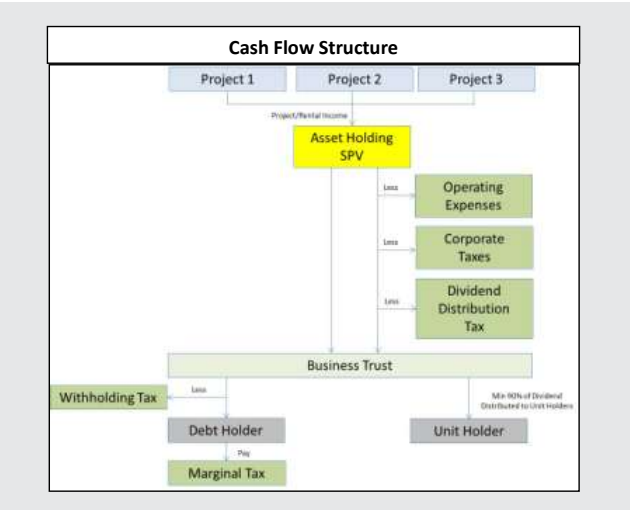
Globally, REITs are pooled investment entities that predominantly invest in completed, revenue-generating real estate assets and distribute a major portion of the earnings amongst their investors. About 30 countries, including most of the developed nations, now have laws governing REITs. REITs globally have recorded a 13% CAGR in market capitalisation from US$300bn (in 2003) to more than US$ 1trn (in 2013). REITs market have evolved for a decade of operations to mature in terms of market depth (the number of REITs) and capturing investor appetite (market capitalisation as a percentage of the global REIT market). Singapore has the most tax efficient form of REITs across Asia, without leakage through the value chain (from a yield-bearing asset to the unit holder).

What are REITs and InvITs?

An Investment Trust is an infrastructure/real estate company that owns and manages a pool of infrastructure projects/commercial properties and mortgages and other real estate assets and offers common shares to the public. An InvIt/REIT has two unique features — its primary function is managing income-producing assets and it must distribute most of its profits as dividend while putting a cap on

[1] Reduction in information asymmetry leads to less volatile markets, and aids in price discovery.





gearing (debt-to-asset) ratios, which reduces the risk perception, associated with the asset class.

An Investment Trust is packaged with the benefits of listing, regular and stable source of income for investors, diversification of assets, small initial investment requirement, professionally managed, no project execution risk (as fully completed projects are to be included in the portfolio -80% of net asset value).

Due to the underlying cash flow stability (recurring annual rental income) of the asset and predictability of dividends (compulsory distribution), REITs/ InvITs are commonly viewed as a yield instrument. They typically tend to have a high correlation to bond yields. Thus, in a softening interest rate environment, cap rates will fall (assuming spreads remain same).

In view of the crucial role that REITs/InITs could play as an investment vehicle, Indian government has recently facilitated introduction and formation of REITs (Real Estate Investment Trusts) and InvITs (Infrastructure Investment Trust). These include release of draft guidelines for REITs/InvITs by SEBI in October 2013 (final guidelines yet to be notified) and, subsequently, announcement of tax pass through for REITs/InvITs in the Union Budget F2015 (July'14).

The regulatory guidelines have addressed issues pertaining to the mode of property ownership, investment restrictions and income distribution. The Budget addressed key issues around proposed tax concessions for REITs (restricted to ownership of income-generating assets through an SPV in the form of a company), primarily around a 'pass-through status', which is a crucial first step to provide an enabling environment for REITs.



Key features of Draft Regulations, 2013 and Budget announcements, 2014:

Parameters	Guidelines
Closed-end or Open-end	Closed Ended
Minimum Number of Stockholders	Minimum public float of 25%
Parties to REITs	Trustee, Sponsor and Manager
Number of Sponsors	Maximum of 3 sponsors
Upfront Sponsor Cost	Capital gains tax and stamp duty charges on transfer of interest in an SPV to an Investment to be paid at monetization the investment
Minimum Value of Assets	Rs. 500 crore
Sponsor unit-holding obligations	• Each of the 3 sponsors to hold a minimum of 5% ofunits of REITs • All 3 sponsors to collectively hold over 25% of the units of the REIT for at least 3 years from the date of listing • Beyond 3 years, sponsors collectively required tohold 15% throughout the life of REITs
Restriction on project ticket size for investment	Invest in at least 2 projects. Maximum 60% of value of assets can be invested ina single project
Gearing	Aggregate consolidated borrowings and deferredpayments of the REIT shall never exceed 49% ofthe value of the assets
Investment Restrictions	At least 80% of the value of the assets needsto be in completed and revenue-generatingprojects
Other permissible investment	The remaining 20% of the value of the assetscan be deployed towards multiple avenues including developmental projects (capped at10% of overall AUM); listed/unlisted debt ofcompanies; equity shares of listed companies that derive at least 75% of their revenues from realestate and infrastructure activity; and liquid securities
Mode of property ownership	Direct ownership of assets or through SPVs owning at least 80% of their assets directly in such projects and restricted from investing in other SPVs The Investment Trust shall hold controlling interest and at least50% in the equity share capital of the SPV
Net-worth Requirement	
- Sponsors	Rs. 25 crore
- Investment Managers	Rs. 5 crore
Distribution of Income	At least 90% of the net distributable cash flows of the Investment shall be distributed as dividend to unitholders at least on half-yearly basis
Independent Trustees	An independent trustee registered with SEBI as Debenture Trustee andnot associated with the sponsor is required, and only one trustee per Investment Trust is allowed
Related Party Transaction	Limitations on related party transactions such as area leased to a related partycannot exceed 20% of underlying area of assets
Interest Income	Income in the form of interest received by the Investment from the SPV is accorded pass through treatment; it will be taxed neither at the trust level norat the SPV level. However, a withholding tax of 10%in case of resident unit holder and 5% in case ofnon-resident unit holder will be effected by the trustон the interest income distributed to the unit holder.
Dividend distribution tax	Dividend received by the trust shall be subject todividend distribution tax at the SPV level and exempt at the trust level. Similarly, dividend incomedistributed to the unit holders by the trust also wouldbe tax exempt
Valuation Limitation	Assets should be purchased at not less than90% or more than 110% of their appraised value by professional valuers
Expected Cap rates[2]	Investment Trust units trade at positive spread over bond yields to account for market and individual property risk. It also captures a capital appreciation components

[2] This is not part of the Regulations or Announcements

Current roadblocks / bottlenecks for evolution of REITs/InvITs in India

Tax on acquisition of SPV: Applicable taxes on transfer of assets to SPVs- (i) stamp duty on transfer of land in the region 6 - 8%; and (ii) capital gains tax on the transfer. Promoters would not be able to transfer the real estate asset of the SPV at nominal value as the ready reckoner value will be deemed to be the sale price received

Suggestions:

- No capital gains tax on trading of Investment Trust units on the stock exchange where security transaction tax is paid and its long term (i.e., 12 months) or restricting the tax on capital gains from original cost to value at which shares of the SPV are exchanged for units of the Investment Trust
- Stamp duty exemption on purchase and sale of properties by Investment Trust or its underlying SPVs
- Additionally, since REITs are required to be mandatorily listed on the stock exchange, the same lowered rate of capital gains tax (between 0% and 15%) should be afforded to sale and purchase of units of a REIT (on payment of STT) in a stock exchange

Foreign investments: Amendment of SEBI FII / QFI regulations to allow portfolio investments in units of a REIT and the exchange control regulations to facilitate FII / QFIs to subscribe to units of a REIT. Capital account transaction rules will also need to be amended to exclude REITs from the definition of 'real estate business', as even foreign portfolio investment is not permitted in real estate business. FDI and FII should be allowed under the automatic route

Cap rates and Yield Limitation: Most sponsors with potential REIT offerings command a strong brand equity and thus better cost of borrowing versus others (12-12.5%, post-tax 8-8.5%). Ideally, a sponsor would look at monetizing value, which is better than its existing funding options. If fund raising takes place at lower cap rates, it becomes unfavourable for the investor.

Supply Dynamics: The quantum of Grade-A assets (investible stock of income-generating assets across office and retail space) available for injection into I-REITs is limited in the Indian context. Experts suggest that the investible universe is restricted to about 30% of the Grade-A office space (amounting to ~100msf) and about 20% of India's total retail space (amounting to ~10msf)

Amendment in PPP policy: to facilitate movement of shares of SPV/infrastructure projects to the InvIT without adversely impacting PPP agreement/terms, and continuing the benefits/concessions to the infrastructure projects post transfer to the InvITs

Tax on distribution of income from Investment Trust: DDT is applicable at one-level, which is unlike foreign markets where it is typically tax-exempt

Investment Restrictions: Investing in Limited Liability Partnerships ("LLPs"): REITs can only invest in SPVs, which are defined to mean only



body corporate as defined under the Companies Act, 2013. That definition defines a body corporate to include companies incorporated in India and outside India. LLPs are classified as body corporate under the Limited Liability Partnership Act, 2008, and therefore should qualify as an SPV under the draft REIT Regulations.

Parity in Tax Treatment: Income in the form of interest received by the Investment from the SPV is accorded pass through treatment; it will be taxed neither at the trust level nor at the SPV level. However, a withholding tax of 10%in case of resident unit holder and 5% in case of non-resident unit holder will be affected by the truston the interest income distributed to the unit holder.Tax proposals are skewed in favour of non-resident investors.

Valuation Limitation: Assets should be purchased at not less than90% or more than 110% of their appraised value by professional valuers. This situation can reduce the bargaining power when there are distressed assets available in the market. It reduces flexibility.

Independent Trustees: An independent trustee registered with SEBI as Debenture Trustee and not associated with the sponsor is required, and only one trustee per Investment Trust is allowed. This will be a challenge to find sufficient number of trustees who meet the requirement.

Related party transaction: Currently, there is a limitation on related party transactions such as area leased to a related party cannot exceed 20% of underlying area of assets. This could potentially impact sale-and leaseback based REIT structures.



Summary

With its massive commercial real estate, and fast growing cities needing more investments in commercial properties, India has a potential for REITs that has constantly been attracting attention both domestic and international investors.

As REITs develop, healthcare, infrastructure and other stabilised yield generating assets may also be rolled into REITs. However, the immediate need of the hour is to address the issues relating to tax and foreign investments without which the REIT/InvIT regime may not take off as contemplated.

Also, unlike REITs, InvITs (infrastructure projects) have complex structures and components such as concession agreement, fuel supply agreement, power purchase agreement, land acquisition and environmental clearances, government regulations etc. for a successful project. With these limitations, InvITs would take longer to mature and evolve in dynamics of the Indian scenario.

Real Estate and Infrastructure Financing

Shachindra Nath, *Group CEO, Religare Enterprises Ltd.*

First of all, we would like to congratulate the Indian government for introducing REIT and InvIT enabling regulations, which have been long overdue. REIT norms were first introduced in the United States in 1960 and since then, such regulations have been successfully adopted by more than 20 countries. Despite India being the second fastest growing economy on the global stage, the country has been slow to introduce financial products such as REITS that typically attract substantial institutional capital globally and serve as a mechanism to release capital for developers in capital heavy sectors such as infrastructure and real estate. Typically, 80% of the investors in REITs are institutional investors such as pension funds and insurance companies.

As we are all aware, India requires substantial investment in its infrastructure and real estate sectors in the coming years as the government promotes policies designed to return GDP growth to 8% plus levels. For example, for India to expand its power generation capacity by 44% through March 2017, the country would require an estimated $210 billion in investments. Based on another study, the government's vision of 'Housing for all by 2022' requires an investment of over $2 trillion. The investment required in other sectors like roads, telecom, railways, etc are equally daunting. Given the high fiscal deficit and its limited resources, the government cannot invest the capital required to fund these initiatives. However, the Government can and indeed should facilitate smooth flow of private capital in projects across the spectrum in order to develop world class infrastructure and services required to support the long term GDP growth targets. In this vein, investment vehicles like REIT and InvIT can be attractive products to attract long-term foreign capital, provided some critical issues are addressed.

India is one of the world's most difficult places to conduct business—for both domestic and foreign companies. India ranks 119th on the Heritage Foundation's Index of Economic Freedom and 132nd on the World Bank's Doing Business index. And out of 40 nations assessed by the OECD, India has the 33rd most complex regulatory environment, 37th most restrictive foreign direct investment policies, and most restrictive tariffs on trade. In addition, the regulatory regime is not as transparent as it should be.

When evaluating investment in a new jurisdiction, foreign investors look for:

- Robust and predictable regulatory regime
- Favourable and stable tax and duty structures
- High corporate governance standards and liquidity
- And last but not the least, conducive macro business environment, with stable political regime

Let us address these issues in detail from the new products' perspective

Robust and predictable regulatory regime: In the Finance Bill of 2014, the Government has made REITs and InvITs tax pass-through albeit partially. Interest payments to the holding listed trust have been allowed without withholding tax at the SPV level and the same money will be distributed to investors after deducting withholding tax. If all the economic benefit from the SPV has to be sucked out as interest

payments, then capital structure of the SPV needs to be conducive with more of debt from the listed trust and less of equity. How does this play out in light of impeding GAAR regulations which have thin-capitalization requirements? Why are we creating unnecessary regulatory ambiguity and hesitation in minds of the investors?

We therefore suggest that fully enabling REIT/InvIT regulations should be announced that do not leave doubts in the mind of sellers/sponsors and investors.

Favourable and stable tax and duty structures: For a product to be successful, it needs to be a win-win from both the seller's and the buyer's perspective. Current tax proposals do not allow the seller to go tax free after one year of listing (after paying STT) as it does in the case of companies. Why is the government treating these products differently and putting them at a disadvantageous position from tax a perspective, which is not seller friendly.

Also, transfer of SPV has been allowed with capital gains tax to be levied at the time of sale and not at the time of transfer to the REIT/InvIT, but not the assets. Now the government's presumption is that capital structure of the SPV is conducive for it to pay all its economic benefits as interest to the listed trust. However, not all SPVs will have such an enabling capital structure and may also contain more assets in the same SPV which are not REIT-ready. Hence this is one more issue that needs to be addressed before listing as it may turn out to be a deal breaker from the sponsor's perspective.

Another example is that indirect tax is levied on rents paid by hospitals and education institutions, while both these sectors do not charge service tax to their customers. Hence, it is an extra burden on hospitals and education institutions that want to unlock the value of their real estate by listing them as REITs, which enables them to grow faster as asset-light models. I am sure we all agree that our country



needs more of both hospitals and educational institutions as government cannot fill the demand requirements.

In our view, REITs and InvIT structures should be made completely tax pass-through structures with no corporate tax, DDT, service tax on rents paid by health and education sectors and withholding tax for these to be very successful products for both the sellers and investors.

High corporate governance standards and liquidity: Organizations that enjoy greater investor confidence practice high level of corporate governance. The current REIT/InvIT regulations envisage lock-in requirements for sponsor(s) to perpetuity.

If the sponsor's obligations are to perpetuity, then independent asset managers cannot form REIT/InvIT by either putting together high quality assets from different sellers or by growing listed vehicles with other's assets. These listed vehicles will become captive to every sponsor, which will be marred with interested party transactions that may not be actually at an arm's length. Plus, it puts onus on the seller to keep infusing more capital for it to maintain its percentage shareholding. Other geographies where listed REITs/Trusts thrive, have no such requirement for the sponsor to hold its units

to perpetuity. Unless independent professionals manage REITs/InvITs, we are afraid we will keep beating the drum on corporate governance standards and our probability of matching up to the global levels, which foreign investors expect, will be a distant pipedream.

Since the onus will be on sponsors to keep their percentage shareholding above 25% for first three years and to no less than 15% in perpetuity, growth of the REIT with non-sponsor's asset will be a challenge. It will purely depend on the ability of the sponsor to infuse more assets/capital. This will constrain the listed trust from adding more high-quality assets from the market and there by impeding its growth and liquidity.

We suggest that sponsor's obligation be tied to its units and not percentage shareholding and the sponsor be free to sell all its units after certain lock-in period of time, say one to two years as by then, performance of the asset would have been demonstrated and then it becomes the responsibility of the asset manager to extract maximum economic benefit for its investors.

Conducive macro business environment, with stable political regime: The new government with absolute majority in the lower house of the parliament mitigates the political risk that our country had been exposed to for the last decade. That said, the new government does need to demonstrate that it is capable of providing a stable regime such that India once again becomes a favourable destination for foreign investors.

Infrastructure and real estate sectors have a long gestation development cycle with approvals that tend to be lethargic - from land acquisition to environmental clearances.



A well managed REIT/InvIT will allow investors to invest directly in a portfolio of assets that are well diligenced, benefit from the necessary approvals and provide an attractive yield.

Streamlining of holistic business environment by addressing extant labour laws, regulatory requirements, land holding restrictions and lack of transparency in approval processes, is important for our economy to thrive and grow and to gain foreign investors' confidence.

India's decision to embrace robust economic and trade liberalization reforms in the early 1990s led to the economy growing 40 percent faster per year in the ensuing two decades than it had in the two decades prior to the 1990s. The country requires a similar approach going forward in order to achieve its growth targets going forward.

Conclusion

Although the introduction of REIT/InvIT regulations are steps in the right direction and long overdue, the government still needs to address certain critical issues from both the perspective of sellers and investors for these products to be successful and attract long-term stable foreign capital.

Recent Engagements of FICCI's Capital Markets Committee 2013 & 2014



Interactive Session with Rajeev Kumar Agarwal, Whole-Time Member, SEBI - February 18, 2013



Meeting with Anand Sinha, Deputy Governor, RBI - February 18, 2013



Interactive Session on Goods & Services Tax with Sushil Kumar Modi, Deputy Chief Minister and Chairman, Empowered Committee of State Finance Ministers – April 22, 2013



Meeting with Akhilesh Ranjan, Joint Secretary, Department of Revenue & P K Mishra, Joint Secretary (Investments), DEA, Ministry of Finance – March 18, 2014



FICCI Capital Markets Committee meets K P Krishnan, Additional Secretary, DEA, Ministry of Finance and Ramesh Abhishek, Chairman, Forward Markets Commission – March 18, 2014



Interactive Session of FICCI's Capital Markets Committee with Arun Shourie – April 25, 2014

FICCI – Industry's Voice for Policy Change

Recent work on policy & regulatory issues undertaken by Capital Markets Committee

The FICCI's Capital Markets Committee, over the last couple of years, has engaged closely with the policymakers in the financial sector and suggested ways to revitalize India's capital markets.Members of the Committee regularly interact anddeliberate on key issues impacting the sector and explore ways to further broaden and deepen Indian capital markets.

Some of the key representations, submissions and feedback given by this Committee to RBI, SEBI, Ministry of Finance and Ministry of Labour in recent years are given below.

2014

- SEBI Consultation Paper on Infrastructure Investment Trusts
- SEBI Consultation Paper on Corporate Governance Norms
- SEBI Discussion Paper on Review of Clause 41 of Equity Listing Agreement
- SEBI Discussion Paper on Employee Benefit Schemes
- Draft SEBI Listing Obligations and Disclosure Requirements
- Draft SEBI Delisting GuidelinesProposal on relaxationof guidelines for External Commercial Borrowings
- Credit enhancement of corporate bonds by banks
- nitial Public Offerings for Qualified Institutional Buyers only
- Green Shoe Mechanism for price stabilization post public offerings
- Confidential filing of IPOs
- Pricing Guidelines for FDI instruments with Optionality Clauses
- Views on Report of the Financial Sector Legislative Reforms Commission
- Overseas listing by Indian companies
- Non-deliverable forward contracts

2013

- SEBI Discussion Paper on Proposed modifications to the existing framework for buy back through open market purchase
- SEBI Discussion Paper on Revision of Clause 41 of Equity Listing Agreement
- SEBI Discussion Paper on Co-location / Proximity hosting facility offered by the stock exchanges
- SEBI Discussion Paper on SEBI Prevention of Insider Trading (PIT) Regulations, 1992
- SEBI Circular on Amendments to SEBI (Employee Stock Purchase Scheme) Guidelines, 1999 and Equity Listing Agreement
- SEBI Circular on Scheme of Arrangement under the Companies Act, 1956 – Revised requirements for the Stock Exchanges and Listed Companies
- Modification of the existing delisting regulations, in particular the pricing mechanism
- Review of FDI sectoral caps – Inputs to the Committee set up by Ministry of Finance to review FDI sectoral caps and FII/ QFI definition
- Proposed modifications to Credit Valuation Adjustment (CVA) as part of Basel III guidelines
- Inputs to Ministry of Forum chaired by Dr ParthasarathiShomeon tax related issues or tax related disputes

2012

- Complying with Minimum Public Shareholding by Indian companies
- Issue concerning U.S. SEC' proceedings on Indian brokers
- Real Estate Investment Trusts (REITs)
- Challenges for FII investment in debt
- Credit Default Swaps (CDS)
- White Paper on Infrastructure financing
- Pricing of preferential placements to institutional investors
- Relaxation of Provident Fund investment norms to include private sector bonds
- Collateralized Borrowing and Lending Mechanism (CBLO) in corporate bonds

2011

- RBI's draft guidelines on licensing of new banks in the private sector
- RBI Working Group (chaired by Mrs. Usha Thorat) set up to examine issues related to the NBFC sector
- Impact of repeated interest rate hikes by RBI
- Development of the Corporate Bond Market
- Lowering the cost of intermediation
- Rationalization of Stamp Duty
- Primary market Post-IPO Settlement Process
- Rationalizing Securities Transaction Tax
- Stock Lending and Borrowing Mechanism
- Recommendations on Dr.Bimal Jalan Committee Report on Ownership and Governance of Market Infrastructure Institutions

FICCI's Capital Markets Committee

List of Members - 2014

1. **Mr. Sunil Sanghai,** MD & Head of Banking-India, HSBC and Chair, FICCI's Capital Markets Committee
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3. **Mr. Raj Balakrishnan,** MD and Co-Head of Investment Banking (India), Bank of America Merill Lynch
4. **Mr. A. Balasubramanian,** CEO, Birla Sun Life Asset Management Company
5. **Mr. Bharat Banka,** MD & CEO, Aditya Birla Capital Advisors
6. **Mr. Tarun Bhatia,** Director-Capital Markets, CRISIL
7. **Mr. Sandip Biswas,** Group Executive Vice President Finance, Tata Steel and Chair, Corporate Finance Subgroup of FICCI's Capital Markets Committee
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18. **Mr. Rakesh Jha,** Deputy CFO, ICICI Bank
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Contd...

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45. **Mr Nilesh Shah,** Managing Director & CEO, Axis Capital
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64. **Mr. Ravi Varanasi,** Senior V.P. & Head-Business Development, National Stock Exchange and Co-Chair, Secondary Market Subgroup of FICCI's Capital Markets Committee
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