FICCI

CAPAM 2015

'Recent Innovations in Capital Markets'



The Experts' Voice

A compendium of articles

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Foreword

India's capital markets have witnessed a strong growth momentum in the last year driven by the country's improving macroeconomic fundamentals, greater integration with the world economy and business-friendly environment. Over the last 18 months, the government alongwith the regulators has introduced several reforms and initiatives to improve the overall investment climate and give impetus to economic growth. Capital markets act as the economic barometer of the country and robust, easily accessible and well regulated capital markets go a long way in improving the ease of doing business in India.

Our flagship Capital Markets Conference (CAPAM), in its 12th edition this year, aims to assemble investors, practitioners, policy makers and other stake holders of the Indian capital markets eco-system and provide them a platform to share their views, experiences and research results on every aspect of Indian capital markets.

This year's Conference publication titled 'The Experts' Voice' is a compendium of papers prepared by members of FICCI's Capital Markets Committee. The compendium is truly a reflection of the recent innovations which are changing the Indian capital markets. The articles herein analyze the impact of the recently enacted and proposed regulations and delve into possible solutions to some of the challenges that may also arise. The articles cover the gamut of capital markets including equity markets, asset management, bond markets, InvITs, gold monetization scheme and recent regulatory changes in the sector. Some of the articles provide insights into innovative capital markets solutions such as financing urbanization through municipal bonds and clean energy through green bonds.

FICCI's Capital Markets Committee has endeavored to engage closely with the policymakers in the financial sector and suggest ways to revitalize India's capital markets. The Committee comprises of very senior members from the industry who have helped us with their valuable time and inputs over the years. We are truly thankful to them.

We would also like to take this opportunity to thank the regulators, senior bureaucrats and highly esteemed government officials for their participation in the conference. Lastly, we would also like to thank all the Committee members and their teams, without their 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.



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Recent Engagements of FICCI's Capital Market Committee 2014 & 2015

Ease of doing business: Contribution from capital markets

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

Ease of doing business and improving India's rank to top 30 in World Bank's rankings in the next 5 years has been a key focus area for the BJP led government. India currently ranks a dismal 142 among 189 countries on the ease of doing business in the latest World Bank's 'Doing Business' report, behind its BRIC counterparts and most other South Asian countries. With the exception of two parameters viz. protecting minority investors (Rank 7) and getting credit (Rank 36), India does not feature in the top 100 in any of the other 8 parameters.

Over the last 18 months, the government alongwith SEBI[1] and RBI[2] has introduced several reforms and initiatives to improve the overall investment climate and give impetus to economic growth. These steps have pivoted around removing bottlenecks, reducing processes and decreasing delays and costs, resulting in speedy and efficient administrative processes. Capital markets act as the economic barometer of the country and robust, easily accessible and well regulated capital markets go a long way in improving the ease of doing business in India.

There has been a renewed focus from SEBI on strengthening the market infrastructure, making capital markets more transparent and more accessible to all – from large institutional investors to new age start-ups. Some of the key initiatives by SEBI include:

- **Relaxation of listing guidelines for start-ups**: Alternative institutional trading platform, easier lock in requirements, removal of promoter concept and diluted disclosure requirements (only broad objects of the issue required), no cap on amount raised for general corporate purposes will help further strengthen the start-up ecosystem in India. At the same time, SEBI is protecting the retail investors by keeping the minimum investment size for such IPOs to INR10 lakhs



- **Crowd funding norms for start-ups**: SEBI is in the process of finalizing crowd funding norms for start-ups aimed to encourage young entrepreneurs and small companies to raise capital
- **Introduction of new instruments such as REITs[3] and InvITs[4]**: SEBI came out with regulations for REITs and InVITs with an objective to help real estate and infrastructure developers to raise funds using operational assets
- **Streamlined corporate governance regulations**: Regulations on corporate governance and similar matters have been made consistent with the corporate law which removes unnecessary compliance burden on listed companies
- **Strengthening Insider trading regulations**: New insider trading regulations have been announced

[1] Securities Exchange Board of India
[2] Reserve Bank of India
[3] Real Estate Investment Trust
[4] Infrastructure Investment Trust



with an objective to align Indian regime with international practices. Definition of insider has been widened to include persons connected on the basis of being in any contractual, fiduciary or employment relationship with access to unpublished price sensitive information (UPSI). Definition of UPSI has been strengthened by providing a test to identify price sensitive information, aligning it with listing agreement and providing platform of disclosure

- **Introduction of Foreign Portfolio Investment (FPI) regime**: SEBI rationalized the various foreign portfolio investment routes such as FII[5], QFI[6] and FII sub accounts under one category – FPI. Simplified the registration process authorizing designated depository participant to grant registration to FPIs. In the same regulation, SEBI also allowed granting permanent registration to FPIs unless suspended or cancelled by SEBI. These regulations have made it easier for foreign entities to enter and operate in Indian capital markets.
- **Use of exchange based platform for delisting, open offers and buybacks**: This is a significant step as it makes the process easier and at par with taxation on secondary trading.
- **Relaxation of delisting regulations**: Reduction in delisting timeline from 135 days to 91 days is a big positive for the corporates. Ability to undertake a direct delisting whilst acquiring control is also a step in the right direction as it provides a choice to acquirers to structure their business as per their needs

The government and the RBI recognize the need for a well-developed corporate bond market. There have been several reforms to encourage corporates to issue bonds and encourage increased participation from foreign investors in the corporate bond market. Some of the key initiatives include:

- Increasing the limit of foreign investments in corporate bond market
- Allowing corporates to raise rupee denominated debt overseas (Masala bonds)
- RBI has also proposed fund raising via ECB[7] route by allowing corporates to borrow from foreign regulated financial entities, pension funds, insurance funds and SWFs[8]

The government has also taken several steps for the development of capital markets such as mandating EPFO[9] to invest 5%-15% of their total corpus in equities. EPFO has entered the equities market through ETFs[10] and would be investing 5% of its incremental deposits in the equities market this year. The new government is keen to regain the confidence of foreign investors and encourage increased participation from them in the capital markets. Some of the key initiatives include:

- Increasing the FDI[11] limit in insurance, railway infrastructure and defense is a step in the right direction
- Removal of separate caps for FPI[12] and FDI and moving to a composite cap is another shot in the

[5] Foreign Institutional Investors
[6] Qualified Foreign Investors
[7] External Commercial Borrowings
[8] Sovereign Wealth Funds
[9] Employees Provident Fund Organization
[10] Exchange Traded Funds
[11] Foreign Direct Investment
[12] Foreign Portfolio Investment

arm for foreign investments. The composite cap provides greater flexibility to foreign investors to structure their investment and saves the investee company from complying with several regulations

- Allowing foreign investment in Alternative Investment Funds will help in fund raising for start-ups, small and medium enterprises and early stage venture
- The recent announcement of MAT[13] not being applicable to FIIs retrospectively brings the much awaited clarity around taxation reform
- The government also plans to modify Permanent Establishment norms to ensure there is no adverse tax implication for offshore funds with a fund manager in India
- These reforms have resulted in stable foreign investment flows in India despite global volatility – India has received more than US$80 bn of foreign investments since the new government has come to power
- India is on a similar growth trajectory as China and the continued improvement in business environment through ease of doing business will ensure massive foreign investment in Indian capital markets in the coming years.

India is home to two of the largest equity bourses in the world – NSE and BSE are world class trading platform with combined execution capabilities of 0.5m trades per second and response time of 200 milliseconds. The stock exchanges are planning to further improve the speed by 10,000 times in the next 3 years. This will strengthen the market infrastructure and provide investors an experience in line with the top global exchanges.

The Way Forward

While the new government has shown commitment towards capital markets reforms and has managed to win the confidence of foreign investors, there are a few development areas which need to be addressed in the coming years:

- **Development of bond market**: While there have been recent initiatives to provide higher flexibility to investors and corporates, initiatives are required to simplify bond issuance procedures, strengthen market infrastructure and enhance transparency and disclosures.
- **Penetration of Mutual Funds**: India has significant growth potential as its AUM[14] penetration (AUM as % GDP) is just 7%, compared to 83% in USA and 41% in EU. Steps need to be taken for increasing awareness of mutual funds products through investor education campaigns to ensure that penetration of mutual funds increases
- **Development of new capital markets products**: The government alongwith other regulatory bodies should incentivize the use of new and innovative products such as gold-backed schemes & deposits, REITs and InVITs. Since these products replicate the returns from physical assets, they are likely to get a lot of interest from retail investors and will help in channelizing household savings to capital markets

Conclusion

The capital markets have evolved considerably over the last few years and there is a strong foundation to support future growth. As the inter-linkages between capital markets increase around the world, India should continue on the path of capital markets reforms and ease of doing business to become a globally competitive capital market.



[13] Minimum Alternate Tax
[14] Assets Under Management

From Idea To Maturity - The Financing Continuum

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

Entrepreneurship is the next big thing in India. More graduates and young professionals are opting for entrepreneurship or working with a start-up than ever before. According to the Economic Survey 2014-15, India emerged as the fourth largest start-up ecosystem housing 3,100 of them and adding 800 annually. It is estimated that by 2020 there would be more than 11,500 start-ups, employing over 2.5 lakh people. The top six locations accounting for 90 per cent of start-up activity in India are Bangalore (28%), Delhi-NCR (24%), Mumbai (15%), Hyderabad (8%), Pune (6%) and Chennai (6%).

While there are several factors that contributed to create an ecosystem of innovation and entrepreneurship, perhaps the most important one is the relative ease of accessing capital for the "good idea". India has seen an increasing influx of money in the technology and related space with venture capital investors having funneled US$2.46 billion in 197 deals in the first 6 months of calendar 2015, a record high.



On the ground, there is an evolving and connected landscape of Angels, Venture Capitalists and Private Equity funds helping companies by financing and mentoring them through their infancy to a stable growth state. While wealth creation is the common ethos across these categories of investors they do have distinct investing styles and objectives vary somewhat as they invest at various stages in the life cycle of a firm.

Backing the idea

The financial investment relay begins with the angel investors who are typically individuals who provide capital for a business startup at the idea or the discovery stage. This set mostly consists of High Net-worth Individuals (HNIs) who have built and exited businesses, created wealth for themselves and have a desire to use their experience and wealth to assist in the creation of the next big thing. India Angel Network, the country's foremost angel investor group boasts of over 350 angel investors. Investments by five prominent angel groups in the country were up by 80% year on year in the last fiscal according to the India Angel Report. The report further pointed out that the median size of an angel investment grew from Rs.52 lakh in FY14 to Rs.1.3 crore in FY15 and the median pre-money valuation grew to Rs.9 crore in FY15 from Rs.6.7 crore in the previous fiscal. IT and the online services were the hottest sectors attracting over 39% of the angel money and Bangalore overtook Mumbai in witnessing the highest level of angel investments in the year.

For a seed or an angel investor, it is more like a calculated bet. The investment opportunity is not a running business with a performance track record. In fact most times, the founders don't even have a corporate entity formed. They bet on the uniqueness of the idea, the founding team and the potential to scale. The quantum of money invested is generally limited to establishing proof of concept to pave the way for a more formal 'Series A' round with an institutional venture capital fund. Angel investing is in the highest-risk category - the thumb rule used by the angel investors is to invest in a large, diversified portfolio which in aggregate will provide an IRR of well over 25%. Most angels look at a return on investment in the range of 3x to 5x in 5 years. In a typical Angel investor's portfolio of 10 startups, almost half wither without providing any return and additional three to four provide a modest return which is expected to cover up the capital for the entire portfolio. The remaining is expected to grow big and bring all the return on the investment. A study by Luis Villalobos, a pioneer in Angel investing, brings out that 84% of the total return on the portfolio came from only 14% of the investments. Because of such poor odds of success, angels only invest in companies which can scale rapidly and have low capital intensity.

The Angel's method of valuing companies is much more of an art than a science. It is more about risk adjusted return than evaluating a business plan and ascribing a value to it. Valuations are generally arrived at by over the table negotiations and are driven by a combination of the factors mentioned earlier (uniqueness and quality of the founding team) and an estimate of the potential dilution (from subsequent rounds of fund raising) to take the company to a mature stage where the angel can hope for an exit.



The early years

Once a company has established that it has a viable product or service, it needs capital to scale up from pilot stage. Questions around the venture's business model and sustainability still remain and this is where the venture capitalist comes in. Today we have an abundance of such investors. Indian venture capital fund-raising, deals and exits all hit record levels in 2014 and latest statistics show that 2015 is well on track to exceed last year's quantum. There are 103 India-based venture capital fund managers reports Preqin. The final close size of the largest ever India-focused VC fund, Sequoia Capital India IV was close to US$700 million. Out of all the investments made by PE & VC funds in India, more than 70% were in the early or the growth phase in 2015 (year to date) as compared to 50% in 2011. Many first generation entrepreneurs like Narayan Murthy and Aziz Premji have started their own venture fund to aid and assist the new age tech-entrepreneurs. Ratan Tata, after stepping down from his position at TATA, is using his personal wealth and has invested in over 11 companies in the year 2014.

Although there is some track record by the time VCs look at investing in a company, it is insufficient data to evaluate using traditional valuation methods. Therefore, VCs also generally value companies in broadly similar ways as angel investors. The valuation of a funded entity in the exit year is calculated by estimating the revenues and margins in the exit year. Then a backward calculation is used to arrive at the VC investor's entry valuation by applying the anticipated return on investment at the time of harvest, adjusted for the business' riskiness.

Maturity and scale-up

Some years into a company's existence and once the building blocks have been put in place in terms of an organization structure, systems and processes, etc and the business itself has achieved sustainability, companies look to raise larger amounts of capital beyond the means of VC investors. This is where the PE investors come in with growth capital to back the promoter and management team to rapidly expand the business across the country and potentially across geographies. Quite often, the PE investor provides an exit for the angel and VC investors who by this time have been invested in the company for 3 to 5 years. India is a promising destination for private equity funds across the globe. Data from Venture Intelligence, a research service focused on private transactions in India, suggests that the year to date PE investment tally in 2015 has already crossed US$13 billion across 500+ deals and is all set to cross the historical high of US$14.6 billion in 2007. IT&ITES was the hottest sector and investors pumped in over US$5 billion (39% of the total) followed by Banking & Financial Services (12%) and the Energy (10%) sectors.

PE funds use the more traditional methods of valuing companies - valuations based on the discounted cash flow method or multiples of revenue/EBITDA/ profits are commonly used. Of course, the PE investor also does a "sanity" check on his entry valuation to see if at the time of exit, the valuations, the company could potentially obtain, support the anticipated returns of the investor.

The terms of investment

Investors across categories use the same principles in creating a contractual framework inter-se the promoters, the company and themselves. This "shareholders agreement" covers the commercial arrangement as well as the rights of investors who are not involved in day to day management. The



shareholders' agreement may be rudimentary at the angel stage covering only the basic principles but progressively becomes more complicated as the business matures and more investors participate in the shareholding. Typically, agreements include aspects covering:

- **Valuation** - The agreement contains details of the money invested, initial ownership and valuation. Performance milestones are sometimes included in the financing terms that if met, lead to additional shares for investors or entrepreneurs. This is a frequently used method to close the gap between valuation expectations of the investors and the entrepreneur.
- **Pre-emption and Information rights** - The rights of the investor to maintain its ownership by taking part in any future share offering done by the company. The right of the investor to have access to information regarding the performance of the business and representation of the investor on the Board of the company.
- **Protective provisions** - Provisions requiring the company to obtain approval of the investors before taking certain actions, such as changing shareholder rights, capital and revenue expenditure above certain levels, the auditors or the nature of the business, corporate action, etc.



- **Exit** - Investors want to see a path from their investment in the company leading to an exit. Exit time horizons and methods of exit are set out along with the course to be taken if exit within a certain time frame is not achieved.

The one big difference between angel/VC investors and PE investors is in relation to liquidation preference. While PE investors for the most part get liquidation preference in the case of actual liquidation of the company, angel and VC investors stretch the definition to include any liquidity event such as a sale of the company, etc. The distinction being that if the proceeds are not sufficient, the investors first recover their investment and the balance if any, will be shared between the investors and promoters as per a pre agreed formula.

From a situation where capital was only available to mature companies, the stage has dramatically shifted to a point where capital is now available from the idea stage onwards. And the capital is available in a structured and organized manner which addresses the needs of the entrepreneur and the investor.

Municipal Bond: An Effective Remedy to Fund Urban Infrastructure

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The main purpose of this paper is to emphasize the need to develop municipal bond market in the present scenario of the rapid urbanisation, inadequacy of the much needed infrastructure facilities and constraints on funding such infrastructure facilities in urban areas/cities. Smart cities would be engines of growth as they would adequately compete for investments not only nationally but also internationally. Hence, it is imperative that cities must provide quality, world class infrastructure and services at affordable costs to their citizens. The term urban infrastructure means "the underlying mechanical or technological networks for providing goods and services, such as transportation systems (including mass transit), water and sewage systems, and communication systems (including telecommunications)".

A basic requirement for efficient and effective Urban Local Bodies (ULB) is the matching principle - where expenditure needs to match revenue handles and hence revenue capacities match political accountability. It has also to do with the 3Fs (Finance, Functions and Functionaries) to be devolved adequately so as to empower ULBs. Urban infrastructure service delivery remains a big challenge due to very high investment requirement, weak financial capacities of ULBs, low cost recovery for service provisioning, and a nascent private capital infusion framework, which has thus far yielded mixed results. It is well accepted that ULBs need to borrow to



effect infrastructure improvements. However, capital markets will trust municipal infrastructure financing only after being convinced of viability through adequate confidence-building measures.

A number of reports have been prepared in the past on the funding requirements for urban infrastructure. The sources of funds for the ULBs include i) internal sources, such as, tax revenues and non-tax revenues in the form of fees, fines, rents and charges, and ii) external sources, including assigned revenues, grants-in-aid and ways and means support. A few of them have had access to institutional funds and to the capital market (municipal bond issuances).

A key mark of ULB is the ability for a local authority to control its own finances. There are three alternatives available to the ULBs/municipal corporations:

1. Raise taxes, or add on new ones
2. Involve the private sector in the production and provision of civic services

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3. Access the capital markets through the issue of appropriate instruments (muni bonds)

The first does not hold sufficient potential to raise the resources that are needed to meet the demands for infrastructure that need to be put in place. In a number of countries, governments are trying to create an environment under which private capital is drawn in to replace or boost public capital in those areas traditionally funded by the government. As regards the third option, the developed and developing countries alike are exploring new ways to finance infrastructure projects using their own capital market.

In the present Indian scenario, budgetary allocations cannot be expected to increase, in fact they may decrease, with the central government hoping to make attempts to reign in the fiscal deficit. Concessional funding from the financial institutions is a thing of the



past, as they have found their own funding sources changing dramatically. Easy access to multilateral and bilateral funding is also not likely to be possible as they are under pressure from the donor countries to bring about greater accountability and market orientation in not only their own operations, but also in the operations of the projects financed by them. Fundamental to the financing framework is the need for ULBs to increase their own sources of revenue. Financing based on borrowing from the capital markets is expected to impose market discipline as only those projects would be undertaken that give a sufficient return on the investment and which lay emphasis on mitigation of risk and strong institutional structures.

The existing and widening resource gap has made it almost imperative that direct access to capital market be accepted as a viable option of fund raising by ULBs. Municipal bonds ("muni bonds") are debt securities issued by state and local governments, or their authorized agencies, to borrow or raise money for public purposes such as building schools, highways, or hospitals. When you purchase a municipal bond, you lend money to the "issuer" (i.e., the government entity that issued the bond), which, in turn, pays a set amount of interest while you hold the bond and returns your principal investment on a specified maturity date.

While the municipal bond market remains at a nascent stage, the Government of India realizes that the debt route could become increasingly important in the future. As part of the JNNURM, GoI has made some efforts to enable ULBs to access the bond market. Credit ratings for municipal corporations and municipal councils of the 65 JNNURM cities are being released regularly. The credit ratings released by the union Ministry of Urban Development for April 2010 suggested that nearly 40% of them were found to be in the investment grade.However, the fact that none of these ULBs have accessed the bond market recently implies that there are major supply- and demand-side constraints limiting its use.

The complex institutional and fiscal framework at the ULB level has not helped in creating an enabling environment for accessing funds in the debt market in India. There are multiple authorities with overlapping jurisdictions, both at the city and state-level; and `urban development' is a `state subject'. This has led to the problem of moral hazard in the municipal debt market, where much of the regulatory responsibility lies with the municipal borrowers (ULBs); the borrower-lender interface lies with states; but, most of



the responsibility affecting lenders lies with the Government of India. In the event of municipal insolvency or bond default, it is quite difficult to visualise who would bail out the ULB. By reducing the dependence of sub-national authorities on increasingly scarce government loans and short-term bank loans, a domestic municipal bond market (as part of a broader and deeper domestic debt market) contributes to making infrastructure development more affordable.

The major participation of banks in the area of urban infrastructure can be helpful in the development of a vibrant secondary market for municipal paper. Despite the need for funds, municipal bonds as a financial vehicle is still not widely used, as has been the experience of developed countries particularly the USA where municipal bonds account for 80% of the bonds market. Part of the reason is the unavailability of any secondary market in this instrument in India.

The larger ULBs needs to be first encouraged to issue municipal bonds so that a yield curve is created for others to follow. Secondly, Pooled financings may allow a handful of weaker municipal bodies to raise money together through a special purpose vehicle. That vehicle would act as the main borrower and, with the right form of credit enhancement, could capture a higher rating than any of the municipalities involved. Some municipal bodies, such as those in Tamil Nadu successfully experimented with pooled financing structures. The 65 ULBs under the JNNURM are rated, thus improving their chances of accessing capital market. Various entities including banks, municipal corporations and rating agencies have suggested that the Ministry of Urban Development needs to remove the 8% interest cap and instead provide subsidies to compensate issuers for the tax on interest payments. This way, better-rated municipal bodies will be tempted to issue more municipal bonds and also achieve finer pricing.

Well-functioning local urban governance, financially autonomous urban governments, overhauling the mechanism of service delivery, upgrading the skills of those who run the institutions which are responsible for service delivery and revenue generation, functional outcomes, including authority for approving and disbursing moneys for approved projects, must match the finances allotted within a framework of transparency, accountability, and community participation; and social accountability must be ensured. The institutional framework for urban governance in India needs a major overhaul if cities are to play a dynamic role in the next phase of India's development. (See HPEC Report, 2011)

The HPEC Report strongly recommends the setting up of an independent Urban Utility Regulator whose responsibility will be to ensure that service standards are met and that user charges cover costs within a framework which is spelt out in a transparent manner. Also recommended a clearly defined fiscal and regulatory framework, adequate capacity at the local level and commercially viable projects are also essential to develop an active market for municipal bonds.

It is thus imperative that an ULB, intending to raise its finance from outside sources in order to fund investment projects, must achieve its earning potential to the maximum by achieving both allocative efficiency between current and capital expenditure and productive efficiency whereby it

delivers the local public goods at minimum cost without compromising quality. Attaining both goals would not only maximize the net revenue earning potential but also boost up "debt capacity" (via credit enhancement) and thus would ease the constraints on financing urban infrastructure projects involving capital expenditure.

Municipal bonds have advantages in terms of the size of borrowing and the maturity period, often 10 to 20 years. Both these features are considered ideal for urban infrastructure financing. Further, if appropriately structured, municipal bonds can be issued at interest costs that are lower than the risk-return profile of individual ULBs. While the initial transaction costs of accessing this market are high—since a ULB needs to invest in meeting the pre-requisites of its first bond issue—as the issue size and frequency increase over time, competencies develop, thereby reducing the transaction costs.

We believe initiative towards issuing municipal bonds would have following few benefits for the concerned municipal corporation (MC):

- Most importantly, borrowing through capital markets imposes market rigor, which requires project development based on commercial principles, that is, project structures that provide for an adequate return on investment, give attention to risk mitigation and allocation and offer secure institutional structures. As a corollary, this instrument is immune to unhealthy political (partisan or otherwise) influence.
- In order to secure best of the rating from the credit rating agency, concerned ULBs will make an effort to have fiscal discipline, improved accounting and uniformity in financial reporting.
- Scrutiny by the market also focuses attention on municipal performance which, in turn, provides incentives for improved management of municipal finances and services.
- Municipal bonds also allow for greater flexibility in the timing of investments, because municipalities are not constrained by annual budget cycles and grant decisions made at other levels of government.
- Longer term resource mobilisation, which is suitable for long term infrastructure projects
- Mapping of interest payments and cash-flows with toll or user charges collected via such infrastructure projects.



- Participation by individual investors, private corporates apart from only public entities.
- The development of muni bond market will not only help larger ULBs but also help raising funds for smaller/weaker ULBs as well.
- More importantly, bridging the gap of funding such a crucial infrastructure facilities required to create "Smart cities".
- Creation of active municipal bond market in the country.
- While the overall process will expedite the process of urbanisation and economic development, it can also make the growth inclusive.
- The money raised from municipal bonds can boost job prospects and quality of life in cities.
- These bonds may also prove a good investment option for investors looking beyond fixed deposits and small saving schemes.



This overview of the innovative method of financing urban infrastructure reveals that, given the resource crunch in the economy, projects have come to depend on capital market borrowing, privatisation, partnership arrangements, and community participation. Raising funds through municipal bond issuances seem to be the only option available for providing infrastructure and basic amenities. Not just the strong ULBs but also the weaker ones can benefit through this route.

We want to emphasize the importance of developing or enabling a vibrant secondary market for muni bonds if these bonds can be expected to emerge as viable financial options for capital market funding of urban infrastructure projects. In the light of the wide-ranging reforms already initiated in the debt segment, coordinated approach and initiative needs to be taken by the municipal corporations, Government of Maharashtra and the relevant/concerned financial authorities.

There is an urgent need to incentivise the municipal bond markets so that investment in these instruments of longer tenure can be made attractive for retail and institutional investors. As we have seen in the above section, the municipal bond is one of the most potent ways of raising resources for smaller ULBs.

Infrastructure Investment Trusts (InvITs)

***R Govindan**, Vice President, Larsen & Toubro Ltd.*

After numerous discussions with various stakeholders, last year SEBI notified guidelines to facilitate fund raising by Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs). This was expected to help drive a fresh round of investments into the real estate and infrastructure sectors by unlocking promoters' capital. It was also supposed to help channelize small savings into these sectors by providing stable, regular incomes for investors.

In Budget 2015-16, the Government provided further impetus to help in the formation of REITs and InvITs (or "Business Trusts"). The proposed measure provided removal of long-term capital gains tax on sale of units of the Business Trust by Sponsors. In the Draft Framework for ECBs, the RBI has also proposed to include REITs and InvITs as eligible borrowers for Rupee-denominated borrowings.

While there have been many enabling actions, we still await the first filing for approval of a REIT or InvIT offering. The reason for the slow progress, despite the latent demand for these products, is the lack of alignment of policies amongst the Ministry of Finance, revenue authorities, and SEBI. In order to operationalize an InvIT under current regulations, Sponsors will be required to significantly change their internal organization structures while maintaining compliance with various regulatory requirements and incurring significant additional costs.

Minimum Ownership in InvIT

Current SEBI guidelines specify that the Sponsor in an InvIT shall hold at least 25% of the post-issue units issued by the InvIT for a period of at least 3 years. Note that at the SPV level most concession agreements require the Sponsor to continue to hold at least 26% stake in the SPV. Thus, in order to provide stable, consistent cash flows to InvIT investors the SPV debt will also have to be replaced through proceeds from the InvIT issuance. The corollary benefit is that the bank funding gets released back into the system to help fund other projects.

This also means that the InvIT issuance needs to fund the enterprise value of the SPV and not just the Sponsors' equity value. In other words, if the initial debt:equity of the SPV was 30:70 and the Sponsor is also required to hold 25% in the InvIT structure, then the release of Sponsors' equity in the process is not significant.

In a positive development, SEBI, in its recent consultation paper inviting public comments for amendments to the InvIT regulations, has proposed reducing the minimum ownership requirement to 10% to meet the objectives of Sponsors. However, this requirement shall still limit the stake monetization by



Sponsors because of expected increase in equity value after operationalization of the project SPV.

Facilitation of Investors to Participate in InvITs

Facilitating various investor classes such as individual investors, Foreign Portfolio Investors (FPI), Mutual Funds (MF), Insurance Companies, Foreign Venture Capital Investors (FVCI) etc. to participate in InvIT is important to spread the investor base and discover a fair price, apart from imparting post issue liquidity.

However, an amendment will be required in the IRDA Regulations to classify InvIT as "Infrastructure" and under "Approved Investments" category for insurance companies to participate fully in InvIT issuances. Similarly, InvIT units should be included in the definition of "securities" in regulations governing Contracts Regulations, Foreign Portfolio Investors and also as an eligible capital instrument under FDI regulations. Expansion of definition of "investee company" and "venture capital undertaking" to include InvIT under for regulations governing Alternative Investment Funds and Foreign Venture Capital Investors is also required.

Carry Forward of Tax Losses

Infrastructure SPVs during the initial few years of operations may have losses. Currently, these tax losses are allowed to be carried forward for set off against future profits generated. Providing continued availability of such tax losses even after transfer of the asset ownership into the InvIT is important since it makes a significant difference in terms of tax pay-out at the SPV level and consequently impacts the cash flows available to investors at InvIT.

A clarification from Ministry of Finance allowing carry forward of tax losses in case of transfer of assets to an InvIT shall be required in order to enable successful transition into an InvIT.

MAT on sale of SPVs to InvIT and Corporate Income Tax and DDT on dividends from the SPV

MAT is still applicable on computed gains at the time of offer for sale which again reduces the ultimate monetization consideration for the Issuer. This leads to additional costs to be borne by the Sponsor at the time of setting up of the InvIT.

Budget 2015-16 had envisaged a pass through status between the SPV and the InvIT. However, the SPV is liable for payment of corporate income tax, dividend distribution tax on dividends to the InvIT as well as withholding tax on the interest expense. This reduces cash flows available for distribution to unitholders, thereby increasing the costs for the InvIT and the Sponsor.

REITs and InvITs can serve as important vehicles for the monetization of Sponsor investments into long-term assets. It also releases bank funding from these projects. This helps drive further investments into new asset creation which is currently the need of the hour in the Indian economy. It is therefore imperative that the major impediments with respect to taxation issues and broadening of the potential investor base be tackled quickly so that issuances from Business Trusts may start happening in earnest.



Capital Markets & Regulatory Changes

***Mr Himanshu Kaji**, Executive Director & Group Chief Operating Officer, Edelweiss Financial Services Ltd.*



The need for continuous reforms in the capital markets emanates from ever changing business environment, for efficient mobilisation of funds for growing businesses, for the orderly development of the capital markets to bring it at par with global best practices, to balance the country's regulatory regime in line with the global needs, to deal with the global uncertainty and most importantly to enhance the growth of economy. Through series of continuous reforms, Government of India, Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI) and other regulatory authorities are continuously engaged in contributing towards the capital markets development by way of introduction of new regulatory regimes, coming out with various consultation / research papers, changing the existing regulation etc. Discussed below are a few imperative changes (some of which are in the pipeline) that are critical for the development of the capital markets.

Key regulatory changes in recent past

- **Foreign Portfolio Investments (FPI) regime / Rationalisation of Investment Routes and Monitoring of FPIs**

SEBI constituted a committee for Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments under the Chairmanship of Shri. K.M. Chandrasekhar. The committee submitted its report in June 2013. One of the key committee recommendation was merging of the then existing FIIs, sub-account, Qualified Financial Investors (QFI) under one investor class namely FPI. In January 2014, SEBI (Foreign Portfolio Investors) Regulations, 2014 ("FPI Regulations") were notified which replace the erstwhile SEBI (Foreign Institutional Investor) Regulations, 1995 ("FII Regulations") and the Qualified Foreign Investors (QFI) framework. The FPI Regulations aims at rationalising and simplifying the portfolio investments regime for foreign investors. The FPI regime will encourage foreign investment in the Indian securities markets given the simplifications brought in by the FPI regulations.

Separately, the Department of Industrial Policy & Promotion ("DIPP") recently allowed composite foreign investment caps by merging the FDI and FPI caps in most of all sectors except for certain select sectors namely defence and banking. The move is likely to benefit companies in various sectors.

- **Listing of Start-ups & SMEs**

SEBI in 2013 first laid down the guidelines for listing of startups and small and medium enterprises ("SMEs") to list their securities on the new Institutional Trading Platform ("SME Platform") of a recognised stock exchange without an Initial Public Offer ("IPO"). Pursuant to the listing on the ITP, SMEs are permitted to do fund raising through private placement or rights issue. Upto 31 December, 2014, total 98 issues have been listed on ITP platform with mobilisation of Rs. 1,032 Crores[1].

Further, SEBI vide its Press Release of June 2015, laid down a simplified framework for capital raising by technology start ups and other companies on Institutional Trading Platform. SEBI press release lays down various conditions including disclosure requirements etc. and is applicable interalia to companies which are intensive in their use of technology, information technology, intellectual property, data analytics, biotechnology, nanotechnology to provide products, services or business platforms with substantial value addition and with at least 25% of the pre-issue capital being held by QIBs (as defined in SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009).

SEBI has played a pivotal role in identifying the need for the legislature at the right time and by constantly evolving the legislature which will act as an enabler for SMEs / start-ups to raise funds. The impact of the above will be seen in the near future given the growing enterprenureship capabilities amongst the Indian youths.

- **Alternate Investment Funds**

SEBI in 2012, notified the SEBI (Alternative Investment Funds) Regulations, 2012, replacing the erstwhile Venture Capital Fund regulation of 1996. AIF is a privately pooled investment vehicle which collects funds from investors in accordance with its defined investment policy for the benefit of its investors. Based on the quarterly / monthly information submitted with SEBI, total commitments of Rs. 33,760 Crores[2] have been raised as on 30 June 2015. The statistics clearly indicates the exponential growth in funds mobilized by AIFs. SEBI has been issuing various clarifications, guidelines, amendments etc. amending the AIF regulations to keep the pace with changing needs of the investors community / fund industry. SEBI has also recently put up a consultation paper on its website with respect to the overseas investment by AIFs and other related aspects for comments on which a circular may be expected soon.

Separately, there were various tax issues given that earlier a pass through status had not been accorded to the AIFs, which by way of amendments vide the Finance Act, 2015, has now been accorded to the Category I & II AIFs. The amendment seeks to do away with various tax issues emerging from the taxation of trust under the Income-tax provisions and therefore has been taken very positively by the fund industry and the investor community.

Further, based on media reports, it also appears that the Union Cabinet has recently cleared a proposal allowing foreign entities to invest in AIFs to attract more overseas money into the country. While the detailed modalities are awaited, this is a very positive move for the fund industry.



[1] *Handbook of Statistics on Indian Securities Market 2014 published on the website of SEBI*

[2] *www.sebi.com*

Clearly, the alternative fund raising mechanism, will supplement the Indian corporate with their funding requirments and take the industry a long way.

- **Real Estate Investment Trusts / Infrastructure Investment Trusts**

In 2014, SEBI notified two key regulations viz. for the Real Estate Investment Trusts, ('REITs') and for Infrastructure Investment Trusts (InvITs). REITs are likely to provide easier access to funds to real estate developers and create a new investment class for the institutional and high net worth individuals. REIT schemes in a nutshell are to be close ended real estate investment schemes that will invest in property with an aim to provide returns to the unit holders. The returns will mainly be in the form of rental income /capital gains from real estate. Similar to REITs, InvITs are likely to provide a structure for financing/ refinancing of infrastructure projects in the country. SEBI in August, 2015, also put up a consultation paper on its website soliciting the comments/views from public on suggestions pertaining to making amendments/providing clarifications on regulations governing InvITs based on its discussions with the industry and in various representations.

Currently, in India, owing to certain tax and regulatory uncertainties, REITs / InvITs could not be operationalised. Once the tax and regulatory aspects are clarified by the respective authorities, in due course of time, this could be a game changer for the real estate and infrastructure sector.



- **Consolidated Account Statement**

Pursuant to the Interim Budget announcement in 2014 to create one record for all financial assets of every individual, SEBI has introduced Consolidated Account Statement ("CAS") for all securities assets by consolidating demat accounts and mutual fund folios. SEBI has also issued operational guidelines with respect to the same. NSDL /CDSL commenced issue of CAS effective from March 2015. CAS is a single account statement consisting of transactions and holdings in investor's demat account(s) held with NSDL and CDSL as well as in units of Mutual Funds held in Statement of Account (SOA) form. The CAS will increase the transparency and effectiveness of reporting to the investors which will help them manage their investments in a seamless manner.

- **Listing Obligations and Disclosure requirements**

SEBI in September 2015, notified the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015. The framework seeks to consolidate the disclosure of information by the companies (including SMEs) which have issued securities (equity, debt (whether convertible or not), debentures, preference shares (whether convertible or not), units of the mutual funds, which are listed on various segments of the exchanges. The regulation is largely driven with an objective to enhance the enforceability of Listing Agreements.

- **e-IPOs**

Vide its press release of June 2015, in order to substantially enhance the points for submission of applications, SEBI provided that Registrar and Share Transfer Agents (RTAs) and Depository Participants (DPs) shall also be allowed to accept application forms (both physical as well as online) and make bids on the

stock exchange platform. This will be over and above the stock brokers and banks where such facilities are presently available.

The aforesaid move will simplify the process to a large extent and also meets the growing need for technological advancement in the securities market as we go along.

- **Insider Trading**

SEBI revamped its nearly two decade old SEBI (Insider trading) Regulations, 1992 with a new framework viz. SEBI (Prohibition of Insider Trading) Regulations, 2015. The new regulations seeks to provide better clarity on various concepts and seeks to provide for a stronger legal and enforcement framework. The new regulations intends to address the inadequacies of earlier regulations as well as attempts to adopt a practical approach, and is an effort to bring the legislature in line with the global best practices on the topic of insider trading.

Changes which are in the pipeline

- **Integration of Commodities & Capital Markets**

Currently 6 national exchanges regulate forward trading in 113 commodities. Besides, there are 11 Commodity specific exchanges recognized for regulating trading in various commodities approved by the Commission under the Forward Contracts (Regulation) Act, 1952. Out of 17 recognized Exchanges, Multi Commodity Exchange (MCX) National Commodity and Derivatives Exchange (NCDEX), National Multi Commodity Exchange (NMCE), ACE Derivatives and Commodity Exchange (ACE), Universal Commodity Exchange Ltd. (UCX) and Indian Commodity Exchange Ltd (ICEX), contributed 99% of the total value of the commodities traded during the year 2013-14.

In order to strengthen regulation of commodity forward markets and reduce wild speculations, the



current Finance Minister Shri Arun Jaitley, in his speech of Union Budget, 2015, proposed to merge the Forward Markets Commission with SEBI. The Finance Ministry recently notified that Forward Contracts Regulation Act (FCRA), 1952 will be repealed and the regulation of commodity derivatives market will shift to the SEBI under the Securities Contracts Regulation Act (SCRA), 1956, with effect from September 28, 2015. SEBI in its Board Meeting recently approved and also amended its regulations to lay down new norms for commodity market to allow the functioning of the commodities derivatives market and its brokers under its ambit. The amended regulations include those relating to stock exchanges and clearing corporations. These norms would also come into force on September 28. It is just a matter of time that one would see the real impact of the merger of unified regulation.

The merger of FMC with SEBI is one of the very significant steps which will create an opportunity for integrated exchanges in near future where equities, debt instruments, commodity derivatives and currencies would trade under one platform. This will create opportunities for the depositories and clearing corporations, who could also cater to the commodity traders going forward. Integration could also offer arbitrage opportunities across segments in an exchange and make margin money fungible for trading across various asset classes like commodities, currencies and equities. These are some of the many

benefits of the FMC merger with SEBI and this is a very positive step of moving towards an integrated platform.

- **International Financial Service Centre (IFSC)**

IFSC is a dedicated hub of financial services participants within a country, which has laws and regulations different from the rest of the country. Usually IFSCs have features such as low tax rates & flexible regulations which makes them attractive for foreign investment. Recently in the Union Budget 2015, finance minister Arun Jaitely made an announcement that first IFSC in India shall be set up in Gujarat International Finance Tec-City (GIFT), near Ahmedabad. GIFT has now been launched by the finance minister in April 2015. Establishment of an IFSC in India is also very critical for the growth of the Indian financial sector and could have a far reaching impact. IFSC would also attract global financial service business. Government, IRDA, SEBI & RBI have also swiftly come up with a regulatory framework for governance of the IFSCs.

- **Indian Financial Code**

The Ministry of Finance, Government of India, constituted the Financial Sector Legislative Reforms Commission (FSLRC/the Commission) in March 2011 with a view to rewriting and cleaning up the financial sector laws to bring them in line with the current requirements. The Commission submitted its report in March 2013. The Commission proposed a financial regulatory architecture featuring seven agencies (retaining some of the existing agencies within the overall framework) with modest set of changes and functionalities:



- RBI;
- SEBI, FMC, IRDA and PFRDA to merge into a new unified agency;
- Securities Appellate Tribunal (SAT) to subsume into the FSAT;
- The existing Deposit Insurance and Credit Guarantee Corporation of India (DICGC) to subsume into the Resolution Corporation;
- A new Financial Redress Agency (FRA) to be created;
- A new Debt Management Office to be created;
- The existing Financial Stability and Development Council (FSDC) to continue to exist with modified functions and a statutory framework.

The Commission also laid down a draft framework, namely, 'Indian Financial Code' proposing to replace the bulk of the existing financial laws. Various steps are being taken in this direction for eg. merger of FMC with SEBI is on its way, Government has created a task force for creation of Financial Redress Agency in June 2015. Draft IFC has been revised in the light of the comments received and hosted on the website of the Ministry of Finance as revised Draft IFC which was open for comments.

- **Report of the Committee on Clearing Corporations**

The Report of the Committee on Clearing Corporations, chaired by Mr. K V Kamath, was placed before the SEBI Board in its meeting held on August 24, 2015. In India, all stock exchanges have their clearing corporation. The committee report which is currently placed for public comments has made several recommendations including vis-a-vis on the interoperability / viability of single Clearing

Corporation, investments by Clearing Corporations, provide the formula for the 'liquid assets' of clearing corporations for the purpose of calculation of its net worth, transfer of profits by depositories etc.

- **Crowd Funding**

SEBI in 2014 had released a consultation paper on crowd funding in order to create funding avenues for start-ups and small companies. Crowd funding essentially means solicitation of funds from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause. Crowd funding mode of fund raising is quite prevalent in countries such as US, China, and the UK. SEBI is attempting to create a regulatory framework for regulation and monitoring the activities in the crowd funding space. Once the regulatory framework is released, this will create an added funding avenue for the start-up and SME industry.

To Conclude:

To sum-up, it is imperative to accept the fact that Capital Markets reforms are critical for India's long term development. A healthy and well developed capital market will create effective capital raising opportunities for enterprenuers from the global and Indian investors. It will also effectively lead to efficient mobilization of savings and financial resources of the economy. For a growing and dynamic economy like India, new reform initiatives like SEBI-FMC merger, AIFs, REITs & InvITs etc will play a significant role in times to come. It would also be very critical to be able to keep up the pace with advent of new technology. Laying down a clear policy frameworks, unambiguous tax and regulatory regime, corporate transparency and adequate disclosures, creation of an error free environment, non-manipulative market conditions, expanding the investor participation base from institutional to retail and all the other critical developmental intiaitives by the Indian government and regulators will take the capital market and the Indian economy a very long way.



Do Green Bonds Have A Future In India?

***Niloufer Lam**, Partner, Cyril Amarchand Mangaldas*

Introduction:

With the dawn of the new Narendra Modi led Government in 2014, India has seen scores of legal, economic and regulatory changes. It has taken several bold steps towards achieving high end targets to effectively compete with the western countries. One such step includes targeting to achieve an installed solar energy capacity of 100,000 MW and a combined renewable energy capacity of 175,000 MW by 2022, which will not only introduce India as one of the most competitive players in the world but will also make it the largest renewable energy producer across nations. In addition to the revised target, India's obligations under the UN Framework Convention on Climate Change (UNFCCC) to take precautionary measures to prevent and mitigate the causes for climate change has lead to announcement of various climate change initiatives such as Jawaharlal Nehru National Solar Mission, National Mission for Enhanced Energy Efficiency, the National Mission for a Green India and the National Clean Energy Fund. The Indian Government has been incessantly focusing on arranging and facilitating capital investment into the renewable energy market to achieve these targets. The total required capital investment is estimated at US$ 200 billion.

However, even with the variety of project financing mechanisms currently available in India, the renewable energy developers and financial institutions have been facing various financing issues



like asset-liability mismatch, high interest rates and banks sectoral limits. To address these issues, India needs innovative financing mechanisms and Green Bonds have therefore been identified as one of the key financial instruments to enable Indian renewable energy project developers to tap scalable, long-term and low-cost debt capital from institutional investors.

What are Green Bonds?

Green Bonds are bonds where the proceeds are exclusively utilised for financing climate change or renewable energy programs. Globally, Green Bonds issued and outstanding have gone from US$1 billion in 2006 to approximately U.S. $60 billion in 2015. Green Bonds can be structured in several ways:

1. Corporate bonds: The corporate entity issuing bonds will allocate the bond proceeds to green projects and the use of proceeds monitored by an independent third party at regular intervals and reported to investors.

2. Asset-backed securities: The corporate entity issuing bonds will collateralize the bonds by one or more stabilised green projects. Cash flows from the projects are used to service debt repayments.

3. Green project bonds: Under this structure investors may or may not have the recourse to issuer of the bonds as the bonds are issued in relation to a specific green project and the investor will have direct exposure to the risk of such projects.

4. Others: Bonds such as supranational bonds issued by the World Bank and the European Investment Bank and Government and municipal bonds issued by Indian Renewable Energy Development Authority and City of Gothenburg, Sweden.

International Green Bond Market

The issuance of Green Bonds has been steadily increasing with over 31 bond issuance undertaken between 2014-2015, which grossed US$ 500 million each, in comparison to seven issues between 2006-2011. The significant growth in this market is attributed to institutional investors including environmental, social and governance issues into the decision process of investing in Green Bonds as the institutional investors are signatories to Principles of Responsible Investments ("PRIs"), an initiative by international network of investors supported by United Nations to put the six principles of PRIs into practice by the signatories of PRIs to incorporate PRIs to develop a sustainable global financial system. On the backdrop of increased investments in the Green Bonds market, global banks such as Citigroup, Bank of America Merrill Lynch, JP Morgan, Credit Agricole CIB along with Green Bonds issuers, investors and International Capital Markets Association launched the "Green Bond Principles" ("GBP"). GBP are voluntary process guidelines intended for broad use by the market that recommend transparency and disclosure, and promote integrity and identify best practice in the development of the Green Bond market. There are four green bond principles (i) use of proceeds should be specifically for the projects which provide sustainable environmental benefits; (ii) issuer of Green Bonds has an internal decision making process to evaluate and structure projects should be a transparent process and have an external assurance mechanism (i.e. third party verification or audit of the process); (iii) use of Green Bonds proceeds should be traceable within the issuing organisation (also with a third party verification undertaken); and (iv) regular periodic reporting of the use of proceeds of Green Bonds. Whilst in India most of the Green Bonds issuance is in the sector of renewable energy, under the GBP, Green Bonds include broad categories such as energy efficiency, sustainable waste management and land use, bio-diversity conservation, clean transportation, sustainable water management and climate change adaptation along with renewable energy. Consequently, it is essentially the use of proceeds of Green Bonds and their impact on climate change, pollution, natural resources depletion and bio-diversity conservation that will determine bond eligibility to be categorised as Green Bonds internationally.



Globally, France leads the issuance of Green Bonds with 21% of global issuance. Initial Green Bonds issuances had participation limited to public sector institutions. However, now, there is a greater

awareness and consensus around socially responsible investing amongst the broader investment community globally. Green Bonds offering by IFC and the World Bank have been purchased by institutional investors such as Blackrock, Goldman Sachs, Ford, Microsoft, Government central banks in addition to pension funds. Participation of large institutional investors reached an all time high when issuance of Green Bonds by issuers such as GDF Suez, EDF and Korea Import Export Bank were oversubscribed. The jump in green bond issuance globally in the past two years is largely attributable to a greater awareness and inclusion of climate change issues by countries in their macro economic policy under the UNFCCC as well as transactions being structured to comply with GBP.

Why do we need a sustainable and deep Indian Green Bond Market

Against the backdrop of the projected capital requirement to develop renewable energy, it is widely understood that the project financing sources such as scheduled commercial banks, NBFCs, multi-lateral and bi-lateral lines of credit to financial institutions, domestic bond issuances are inadequate. Renewable energy companies also face stiff competition from thermal power companies in borrowing from banks as renewable energy comes within the power sector limits applicable to schedule commercial banks plus the long duration required for renewable energy financing (10 year plus loan) creates an asset liability mismatch as banks have short term deposit liabilities. Apart from the domestic credit challenges such as high interest rates, lower loan tenure, fixed interest rate and limited financing options, renewable energy companies in India also face challenges such as high currency hedging costs and poor sovereign ratings and regulatory issues such as restrictions on refinancing and on-lending for the issuance of Green Bonds in international markets through the external commercial borrowing route of the Reserve Bank of India. It is in this context that India needs to diversify



its domestic capital sources and bring in instruments that specifically cater to the needs of the renewable energy sector.

Green Bonds are most effective a capital tool once a project is past is construction phase. Refinancing bank debt through Green Bonds once the renewable project is operational enables a lower cost of debt (increasing return on capital) as the project is revenue generating and cash flow stable. It allows long-term capital to be raised which yields a stable return for investors (with a slight premium to G-SECs) and is a capital instrument which enables investors to have exposure to the renewable energy power market. Banks can reduce their asset liability mismatch by being refinanced from the Green Bond financing thereby freeing up funds for new lending or alternative deployment.

Currently, we have seen five major issuances from Indian entities, YES Bank and Exim Bank for on-lending to renewable sectors and CLP India raised Rs. 600 crores by way of non-convertible debentures for its capex in its wind farm projects. In September 2015, Renew Wind Energy issued Rs. 450 crore bonds with IDFC and Hindustan Power Rs. 380 crore bonds with YES Bank, the first in India under the Regular Credit Enhancement Scheme (the "Scheme") by India Infrastructure Finance Company Limited (IIFCL), a special purpose vehicle of Government of India to

fund long term finance to viable infrastructure projects. IIFCL provided a first loss partial credit guarantee to the bondholders with a backstop guarantee from Asian Development Bank (ADB). This enhanced the credit rating of the bonds to AA+ enabling a wider investor base to invest along with a cheaper cost of capital to the issuers. However, we are yet to see any issuance by Indian renewable energy companies in the international market.

Challenges and Reforms to see this Market Boom

The Green Bond market has the potential to boom by volume and also in terms of product innovation but it is not without challenges and risks some of which are set out below.

1. The debate as to whether the projects for which Green Bonds are being issued are green enough has to be put to rest. What makes a bond "green" is the end use of its proceeds. Lack of clarity on what nature of end uses will be considered as green i.e. for renewable energy has led to several issuers facing reputational risks and potential accusations for misusing of funds. It should be noted that there is no specific legal or regulatory framework for the issuance of Green Bonds under Indian law. This means the lack of standardised criteria which would probably be beneficial for the market to have transparency on. In the absence of a robust tracking process and third party assessment, it is not clear how tightly proceeds are managed and used only for the intended renewable energy projects. There is no clear way to measure performance. Suggestions to deal with this include appointing a nominee on the board of the relevant companies, raising the money to monitor the use of proceeds, appointing a third party auditor (upfront) who will provide a quarterly assessment and report to investors, specify the nature and extent of the reporting. Some of these aspects will be key to, in particular, international long term investors. Whilst it is true that this may increase costs of issuance, it is critical to developing a credible and sustainable market, which is in its infancy in India but with limitless potential.



2. The categorisation of a bond as 'green bond' principally depends on the end use of the proceeds. While the international GBP broadly set out the criteria to ascertain the nature of the bonds, the Indian framework has yet to put together specific regulations to aid this classification. Relaxing the investment restrictions on insurance companies, pension funds, mutual funds, banks, NBFCs or FPIs (for instance eliminating the rating requirements and permitting the investor to determine this according to the credit risk or having a percentage allocation by rating) and bringing about clarity in the eligibility criteria for investors would go a long way in enabling investors to easily invest in Green Bonds and building a sound green bond market in India.

3. Credit rating is key for investors. Since the Indian bond market does not have many investors in below AAA/AA rating projects, projects rated below these levels may not get sufficient traction - therefore third party credit enhancement by international climate change or donor agencies (such as Green Climate Fund), multilaterals, other third parties or structural enhancements (e.g.

tranches bond issues with first loss or second loss pieces) may be beneficial. Obtaining this from international entities will meet the structure objective to pierce the sovereign ceiling and achieve a BBB international rating. We have recently seen this with domestic credit enhancement from IIFCL under the Scheme as described above.

4. The longest tenure of Green Bonds has been 10 years. Given the nature of these projects financing at the 15/20/25 year is required (including to effectively amortise the bond principal).

5. Revenue payment risk associated with the inability of electricity distribution companies to pay for the purchased green power results in higher interest rates, eventually making the Green Bonds almost as expensive as any other financing instruments. This in effect defeats the very purpose of introducing Green Bonds. The Ministry of New and Renewable Energy has initiated various schemes such as feed in tariffs/guaranteed pricing, generation based incentive schemes to shelter the renewable energy producers from such risks. It is prudent that the Government finds added ways to eliminate this risk entirely.

6. An operational renewable energy company does not face the same risks as conventional power as the raw material inputs are different. In some cases for good projects, banks may not want their loans to be refinanced as depending on market conditions, finding a suitable alternative project to invest in which yields the same or better interest margin can be challenging. Increasing the ability to tap the international capital markets by allowing renewable energy companies to use 100% of the proceeds to refinance Rupee debt or for on-lending to SPVs under the automatic route of the external commercial borrowing regulations of the Reserve Bank of India would also permit



companies to diversify their funding base. Presently, the Government is also considering dollarization of the power tariffs as a method to eliminate the currency hedge risks associated with foreign debt obtained by renewable energy power producers. In the absence of such hedge risks, tariffs for renewable energy power are expected to substantially reduce making it more a competitive power source and resulting in increased cash flows into the project. This could also result in higher participation of investors into the Green Bond market.

7. Under the present regulatory framework, the Central Electricity Regulatory Commission ("CERC") determine the electricity tariffs at which the power developers are required to sell their power to distribution companies/state electricity boards. While determining such tariffs, several fixed cost components and variable costs like fuel charges, subsidies are factored in to arrive at a tariff price. In the event of inflation, the power producers/developers are unable to increase their tariffs unless CERC comes out with a revised tariff order. As a result, cash flows of a power developer take a significant hit leading to lower return on equity. This is another reason why today investors are reluctant to invest in power sectors. Mechanisms to cushion the producers from such inflation risks such as an annual inflation linked tariff is of growing importance.

Conclusion

To conclude, India has a massive renewable energy target and the Green Bond market is a new born baby by comparison. As a product it has huge potential but needs security of timely payment on the revenue side, structural innovation in the types of bonds and greater investor awareness built on the product which leads to demand for Green Bonds. We look forward to being able to assist in this exciting market as it blooms into a large future.



Increasing Volatility in Chinese Market: How Can India Capital Markets Cope With It?

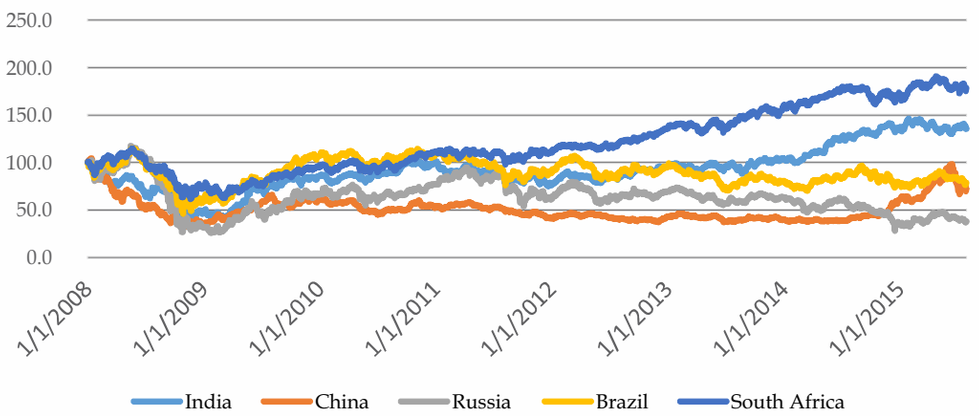
***Naresh Maheshwari**, Chairman, Farsight Group and National President DPAI*

The three months period between June to August, 2015 would be remembered in Capital Market history for wrong reasons where the value of stocks listed on Shanghai Stock Exchange lost by over one third of the value. Major after-shocks occurred globally. It is estimated that global companies who relied mainly in Chinese Market suffered over US $4 trillion because of loss of business. May be it were, alcoholic beverage Remy Cointreau, Luxury Brands Burberry or Yumt Brands? The tsunami even engulfed commodities, base metals, steel, iron ore, etc. Initially, though it was felt that India would be affected minimally yet India could not isolate itself from these shocks. Therefore, the question arises whether the volatility in China is ephemeral or long term. How it is going to affect its peers and more importantly how India can cope with it?

The chart below show a comparison between China and India's Stock Index i.e. Shanghai vs. Sensex, during the post financial crisis period.

Comparing Indian and Chinese stock indices over the period 2008 to 2015, Indian Sensex has steadily grown by more than 70 per cent over the last 7 years. Whereas China's growth has been more or less stagnant in the post financial crisis period. It has only picked up in the last year. Growth has not been uniform for Shanghai Composite. A steep rise since 2014 and a fall in 2015 indicate high volatility in the index.

Chart: Percentage Movement in Indices of BRICS nations during 2008-2015 (with April 1, 2008=100)



Performance of China's benchmark Index Shanghai Composite has been a mixed bag in 2015. Compared with other BRICS nations, the SHCOMP index has given one of the worst performances for last 1 month/3months period. However, the Chinese

Returns of Indices in BRICS countries over different time periods

	Brazil	Russia	China	South Africa	India
1 month	-5.22	-7.18	-6.51	-0.77	-0.30
3 months	-9.18	-16.98	-15.36	-5.40	1.24
6 months	5.20	14.71	16.15	1.28	-7.14
9 months	-8.02	-24.51	60.71	4.51	3.63
1 year	-12.03	-28.79	73.56	-1.23	6.05
Since January	0.48	8.81	17.14	3.67	0.20
2 years	2.10	-36.51	91.73	26.41	40.68
3 Years	-11.15	-40.59	78.00	48.82	63.69
5 Years	-24.96	-44.39	43.09	80.73	53.20
7 Years	-13.43	-56.47	32.94	89.95	99.86
10 Years	92.94	1.37	249.87	240.73	260.99

benchmark index has been doing pretty well for last 10 years. It has outperformed India's sensex in 1 year, 2 years and 3 years returns.

Various theories has come out for such large scale corrections or even re-rating of Chinese economy which created low returns and low capacity utilization on investments made in infrastructural projects. There returns were not adequate to service the large mounting debts. Sharp Corrections in real estate, a buildup of excess capacity, and decelerating export growth were affecting industrial activity. Growth in industrial output slowed from 7.6 percent (year on year) in the Q4 of 2014 to 6.4 percent in Q1 of 2015. Similarly, Growth in credit, decelerated from 19.4 percent (year on year) in the Q3 of 2014 to 14.3 percent in the fourth quarter and 16.8 percent in the Q1 of 2015, driven by moderating growth of credit products linked to China's shadow-banking sector. Even with policy efforts to redirect credit, banks are reluctant to lend to priority sectors. Credit allocation to priority sectors, including micro and small enterprises and households, has not seen huge change over recent years. Among the 36.1 percent of households that borrowed any money in 2014, only 9.6 percent had access to formal loans from a financial institution, while 26.2 percent relied on family, friends, or informal lenders.

Although, the contribution of net exports in the first quarter was positive, largely due to slowing imports, yet data pointed to decelerating export growth



momentum. Export growth for the first quarter moderated to 4.6 percent from 8.6 percent in the previous quarter. China's exports to the European Union (EU) contracted by 19 percent, Japan 24 percent, Russia 50 percent, and the United States 8 percent. Import growth contracted by 17.6 percent in the first quarter of 2015, down from a decline of 1.8 percent in the previous quarter (figure 1.13). Lower oil prices are pushing down nominal import growth. In Q1 of 2015, investment growth decelerated further to 13.5 percent. Some of the factors—overcapacity in key heavy industries, policy tightening in energy-intensive sectors, a slump in real estate sales and construction, and regulatory curbs on shadow banking—have held back private investment.

The Chinese Capital Market suffered not only because of Economic factors but also because structural issues of the Capital Markets like volatility, Margin Trading, Easy Liquidity etc. Just to recap, 30D volatility of Shanghai composite Index (annualized) was 62.2 in July 2015 compared to 10.8 in July 2014. On June 12 2015, China's Shanghai composite reached 7 years high of 5,166 (yielding 152% YOY and 60% YTD returns, surpassing peers by huge margin). During next one month, Shanghai Composite Index dropped more than 30% (highest monthly fall since 2007).On July 27, 2015, Shanghai Composite Index plummeted by 8.5% (making it the biggest daily fall Since Feb 2007) Similarly, Total Outstanding balance of margin transactions (both long and short) combined for both the exchanges (Shanghai & Shenzhen) stands at USD 225 billion at the end of July 2015 compared to USD 73 billion in July 2014. Out of this 225 billion margin outstanding, 224.1 billion was used for long positions where as only 0.5 billion was used for short selling. This shows there was huge build up of long positions in Chinese market. USD 808 billion amount of securities were kept as collateral as against USD 190 billion worth of securities pledged in July 2014.Stock



Market became over-heated as appears from some key ratios. Ratio of securities bought on margin to Total Market Capitalization of china was around 3.4% in July 2015 as compared to 2% in July 2014. Ratio of Value of collateral offered on margin to Total Market Capitalization of china was about 12.1% in July 2015 as compared to 5.3% in July 2014. PE ratio of shanghai composite Index was 18.7 at the end of July 2015 compared to 10.4 at the end of July 2014. Total market cap of China was USD 6.7 trillion at the end of July 2015 compared to $ 3.6 trillion in July 2014. Price earning ratio of Shanghai composite index increased to 25 in June, 2015 from 9.6 in 2014.(almost 7 year high). PE of Shenzhen index reached to 75 (almost 5 times of MSCI).Capitalization increased by over 5 times. Market Capitalization ratio to GDP was increased to 118% reaching almost figure of 10US $ trillion.

The Chinese Economy benefitted due to large scale export based growth based on low cost paradigm. The low income group workers could not share the benefits of buoyancy in the economy and ultimately started going back to their home towns from industries. This reverse migration process affected the local consumption badly and there was no sizable middle income group who could have supported the demand. The problem also got aggravated because of large scale liquidity infusion in capital market. Margin Funding provided to investors coupled with IPO at

heavy discounted prices created a rush for new investors to the market. These new entrants came without proper understanding of market in search of easy money. They also used peer to peer money raised from private sources and acted mainly in tune with market swings which increase the volatility. The upsurge in Stock Market during last one year was hardly commensurate with the growth of economy or industry and became flat at slightest feeling of discomfort.

Whereas, India remained among the most favoured destinations for overseas funds even in July 2015 with equity markets receiving second highest inflows globally despite the rout in Chinese equities and crisis in Greece. However, the problems in Chinese markets will affect India. There will be downside pressure on exports to China from India like Iron Ore or on Chinese FDI in Indian industries. Many Indian Companies have set up manufacturing bases across China. Viability and Profitability of such companies would remain under pressure at least in short term. However, overall Indian economy and Capital Market both are in sound shape not only to withstand this pressure but also to turn this calamity into an opportunity. Post 2008 melt down, Indian Capital Market is growing steadily whereas China Market recorded sharpest increase of over 150% during last one year alone. This skewed jumps in the index forced the investors to book profit. The GDP growth of 1st quarter of current year in China at 7% was the lowest since global crisis in 2008 whereas the 1st quarter Indian GDP was almost highest during this period. Though India do not have capital account convertibility on currency yet the exchange rate of rupee is determined by free market forces which has automatic check and balances for depreciation or revaluation. However, in case of Yuan free market pricing is not available though the Central Bank has changed the range within which Yuan can move. Money in Chinese market came mainly from retail investors who used borrowed money/peer to peer funding/excessive margin funding. The new investment did not come through domestic or foreign institutions who have a long term view of the market. This again created a short term view of the market which created wild swings.

Measures taken by the China to arrest the volatility acted on two pivotals. On one hand, short sales were banned, restriction or halts in trading in select shares were imposed. Large investors were restrained from selling their holdings. On the other hand, large institutional liquidity was introduced in the system to absorb the selling. However, these curbs and measures only created more uncertainties amongst participants which created this volatility. India did not resort to short selling even in 2008 crisis. Moreover, Indian Markets have active sectoral index, futures and option segment which helps in curtailing of volatility by providing a hedging mechanism to the investors.

To conclude, the structural advantage to India thanks to its regulators, policy makers will ensure that India will remain the most attractive market in peer countries.



GMS – it is good but is it good enough?

***Jayant Manglik**, Chair, FICCI Working Group on Commodities and President - Retail Distribution, Religare Securities Ltd.*

The Gold Monetisation Scheme (GMS) has been announced, as promised in the last budget. It is one of three parts of the strategy to address the problem of India being the largest importer of gold worldwide, consistently. This love for bullion has hurt India's Current Account Deficit (CAD) year after year. After crude oil, gold is our biggest import and led to 4.8% CAD in 2012-13. Therefore a long-term gold policy which can achieve the conflicting objectives of quenching our thirst for gold while preventing foreign exchange outflow was a long time coming. Clearly we have to make the huge amount of gold available in India productive and the GMS tries to do exactly that by monetizing the much-quoted, but really a guesstimate number, of 22,000 tons of gold worth about US$ 1 Trillion (about Rs 66 Lac Cr) accumulated by Indian households.

Being a cultural phenomenon, almost every household has gold in the locker. Incredibly, our annual consumption actually rose as the price went up over the last 15 years. Since it was consumption driven by prosperity, the need was two-fold i.e decrease gold imports which was done by imposing import duty of 10% (arguable but perhaps inevitable) and secondly, to monetize the available gold and make it a productive asset.



This aim led to a clear strategy with three key parts: the Gold Monetization Scheme (GMS), the Gold Sovereign Bond Scheme and development of a standard India Gold Coin. Working with speed and clarity, a Draft Gold Monetization Scheme was rolled out for public debate, comments and suggestions. In fact, towards the end of May 2015, FICCI had organized a roundtable on the draft Gold Monetization Scheme. The audience consisted of industry players across the gold value chain and their questions were addressed by Mr. Ajay Tyagi, Additional Secretary, Ministry of Finance and Dr. Saurabh Garg, Jt. Secretary, Investments and Currency. The audience came up with some 24-carat suggestions on the topic, borne out of experience and gave interesting insights on how the GMS ought to progress. All of these were duly noted by the government team present and it was clear that many of them would receive due consideration and possible incorporation into the policy if they pass muster. Few objective points which were thrown up included the availability and implementation of standardized norms for gold purity, availability of accredited domestic refineries, addressing the lack of enough assaying centers and a central marketplace to buy and sell gold. All these plus other factors would decide the success of the GMS.

Accounting for feedback and approved by the cabinet, the details of the schemes have now been announced and will come into effect after notification by the finance ministry. The terms for GMS specify a minimum of 30 gms of gold as gold deposit. This compares well with the 1999 scheme which had 500 gm as the minimum and therefore kept most people out of the scheme. Second, the purity of the deposited gold will be verified by one of the 331 BIS certified assaying and hallmarking centres across the country. Of course, this is a very small number and will prevent mass participation. Third, the minimum melting charge for up to 100 gm of gold will be Rs 500 per lot which can go up to Rs 13,400 for 900 - 1000 gms. Since the idea is retail participation, let us assume an average of 50 gm per person which means gold value of about 1,30,000 on which Rs 500 melting charges comes to about 0.4%. Given that the interest paid out on the deposited gold is expected to be around 1% per annum (given that banks can lease gold from abroad that this rate), the melting charge takes away a good part of the first year's interest income. Also, since jewelry has to be melted, it will either not be offered for the scheme by many or it will mean writing off about 10 to 15% of the gold value. It is also pertinent that the lady of the house may agree to deposit the gold bars but handing over jewelry as deposit sounds like a challenge. The favourable tax treatment is a positive sign for the scheme. As is the fact that redemption will be at the prevailing value at the end of the tenure.

Overall, it is a good effort in the right direction but not necessarily one which will lead to instant results. While there is no official target for the first year (or subsequent years), it is necessary to assess the materiality of the effect of the scheme. One figure being bandied about is 20 Tons of gold in the first year. Let us be optimistic and assume 50 Tons which @ Rs 26,000 per 10 gms will cost about US$ 2 Billion. Only! So if the numbers are not large it may not help much. Perhaps it may be fair to assume that most of the gold



will actually come from temple trusts over which the government has some level control. Public participation may not be the highlight of this scheme.

There are learnings too from the Gold Deposit Scheme of 1999 which garnered less than 15 Tons over 16 years. Lack of sufficient assaying facilities was one of them. Two others, i.e. a lower entry grammage and acceptance of jewelry are already addressed in the new scheme. The finding that more than 60% of Indians would be ok with receiving different gold i.e. customer gives in jewelry and receives the gold back in bar form, is one conclusion from a joint WGC - FICCI - BRIEF survey report. This works in favour of GMS. Given the CAD challenge and that this large import item lies unproductive it is a necessary effort. Finally, the requirement of a full KYC from depositors may inhibit participation as most gold has likely been bought in cash or the source is hard to ascertain. Nevertheless, the scheme will also help in making gold part of the larger financial system, currently it is ineffectual and sits idly in safes and lockers. The interest rate too will, of course, be a key driver of this product. But banks will be inhibited by the international leasing rate of gold, which is about 1% per annum. Else there will be a large arbitrage opportunity which will simply bleed banks.



On ground, the success of GMS will lie in the implementation and smooth operations which make it easy and attractive for all to participate. This plan now deserves great execution. Given the sustained affinity we have for gold, the right gold policy can make it a financial asset with benefits for the individual as well as the state.

In sum, between the three segments of the government's gold policy, the GMS would be the most challenging due to logistics and implementation issues. The sovereign gold bond scheme will definitely be successful and will also help in hedging the central bank's gold exposure. The India minted Ashoka-emblem gold coins should be a runaway hit and will essentially made out of gold collected via GMS. The overall effort of the government towards addressing the issue of gold squarely using all means at its disposal is commendable

Currency and Interest Rate Futures & Options on Exchanges

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For ages the exchange universe in India is better known for its equity offerings. However the scenario has changed in the last few years with new products making their debut on NSE's platform. The new entrants to the exchange space are the Currency and Interest Rate products. Both the asset classes are expected to see growth in depth and breadth in the years to come. Already with large number institutions and individuals participating, NSE has emerged as the exchange of choice for the market. A brief introduction to these asset classes are presented here.

Currency Futures and Options have been introduced on exchanges in 2008 and 2010 respectively, but with regulatory changes the product almost witnessed a potential re-launch in 2014 - where there is greater alignment to its OTC counterpart. Exchange Traded Currency Derivatives (ETCD) today provides all resident Indian individuals and all permitted institutions access to the USDINR exchange rate. De-facto market makers (trading members) of the exchange are provided greater limits whereas the end users / clients have been provided limits linked to their underlying exposure to trade payables and receivables. The NSE has seen good growth in trading member and client interest in this asset class. In the OTC market credit availability and pricing to the SME and retail segment is limited and expensive. Exchange traded currency futures and options provide SMEs better pricing and accessibility while simultaneously reducing the credit burden to the banking sector.



Exchange traded currency markets are likely to see some further new developments, the recent credit policy has announced introduction of new currency pairs. Onshore residents / corporates / institutions are expected to get access to EUR-USD, GBP-USD and USD-JPY contracts in the coming few days. This will enable currency desks in India to trade and invest in a range of currency products. Further the regulators have also announced that more sophisticated participants will be provided access to the Currency Derivatives on exchanges. One such category is the primary dealer. It is believed that more will be announced in due course by the regulators. All these steps will take the ETCD market to a different level in terms of volumes, open interest and access for all domestic participants.

Bond Futures were successfully launched on the NSE platform only in January 2014. The product is unique in its design as the NSE Bond Futures (NBF II) are the only "single bond futures" contract traded globally. After having successfully launched a contract in the 9-10 year maturity bucket, regulators permitted widening of the maturity profile and now exchanges have the leeway to introduce futures in three buckets;

4-8 years, 8-11 years and 11-15 years profiles. The product essentially allows users to hedge against rising or falling interest rates or even takes a view on interest rate movements. Participants on the Exchange platform include Banks, Primary Dealers, Mutual Funds, NBFCs, Corporates, Individuals and Exchange Trading Members. NSE has worked extensively with all regulators to get product approval and to allow different segments of participants to be permitted to trade and hedge on Exchanges.

Interest rate risk is inherent to all individuals and entities. From an individual taking a car or home loan to a corporate and institution borrowing or lending interest rate risk exists in their balance sheets. Any exchange of credit involves creation of an interest rate exposure. The NBF II contracts are a good beginning in developing an interest rate futures market in India. We have seen daily average turnover increase from Rs. 500 crores in early 2014 to Rs. 2150 crores in September 2015. Open interest has also seen significant growth. However, compared to global standards we have a long way to go. According to BIS June 2015 statistics, the exchange traded futures account for average daily turnover of USD 5.18 trillion. Of this, the short term interest rate futures contribute 84%; while the long term interest rate futures contracts stand at 14% of the daily average turnover.

India today does not have enough actively traded liquid benchmarks on which credible derivative instruments can be created. The Government of India has already done a very good beginning, but much more can be and needs to be done to create a robust interest rate derivatives market. It can provide investors, hedgers and traders an ability to execute their views more efficiently.

Advantages of trading on Exchanges

- Anonymous order driven: Exchange provides an anonymous order matching platform which runs on a price time priority matching engine. Through this the order with the best price gets executed first.



- Equal Access: Since the exchange offers screen based trading with a robust risk management system; every market participant gets equal access. Given that all market participants big and small mandatorily provide collateral pre-trade, every participant has access to the best price.
- Small lot size: Exchange contracts have a smaller lot size which provides more depth to the market with tight buy sell spread and high liquidity. This also allows the small investor and hedger equal access in terms of pricing.
- Settlement Guarantee: Exchange offers Settlement Guarantee of funds through clearing corporation which take care of counter party risk.
- Risk Management: Exchange platform has robust risk management in place; the clearing corporation monitors real time volatility of assets, collects upfront margin and a daily mark to market ensures that systemic risk is not built up.

To conclude, the exchange platforms which provide standardized products in currency and interest rate products are likely to see growth in the coming years. Both asset classes are likely to see new product launches and newer sets of participants come to these markets. We strongly believe that these assets will be bigger contributors to exchange volumes in the years to come.

Indian Banks and Capital Requirements

***Ananth Narayan**, Regional Head, Financial Markets, South Asia, Standard Chartered Bank*

In the Basel III context, the Indian banking system requires a large amount of scarce capital, before it can fully play its vital role in India's future development. This will not come by easily. As a related issue, there is the spectre of stressed banking assets that needs urgent attention. We likely need innovative solutions to resolve these challenges, to enable banks - particularly public sector banks - to play their pivotal role for our future.



The role of banks in India's growth

Over the next many years, India needs to generate employment opportunities for its young population. This is a social and economic imperative, and critical for India to achieve its potential. This in turn requires strong and sustainable growth, which will need huge investments into infrastructure and manufacturing.

While we seek to grow our domestic capital markets and draw in overseas savings, Indian banks remain, by far, the biggest financiers of the Indian economy. Indian bank commercial loans aggregate to about 50% of India's GDP. Indian banks will continue to have a large role to play in channelling India's 30% domestic savings into productive investments. Within banks, public sector banks still account for 73% of banking credit, and will likely to continue this heavy lifting.

Basel III capital stipulations

Against the backdrop of this banking objective, we have Basel III capital stipulations. Regulators globally devised a simple remedy to the various banking crisis that have surfaced over time - and that is to require banks to increase their capital and liquidity substantially. With banks being tasked to de-risk their businesses, and keep more and more capital on their books, the return on equity (ROE) of banking capital has naturally dropped sharply. From the heady days of 20%+ bank ROE, international banks now struggle with 5-8% ROE, somewhat at par with staid utilities.

Likewise, Indian bank ROE has dropped substantially over the years - and of course, there are several issues besides additional capital that has brought about this change. As per the RBI Financial Stability report, ROE for Scheduled Commercial Banks in India fell from 13.6% in FY11, to 9.4% in FY15 - barely above the risk free rate of return in India. Within the banking universe, private sector banks have far better ROE and therefore command far better price/ book ratios. However, as noted earlier, India needs loads of lending and investments - not just smart banking that minimises risk, and maximises non-lending revenues.

Just how much capital do Indian Banks need?

While low Indian banking ROE makes it difficult to attract market capital, the Indian banking system still requires large dollops of capital, under Basel III stipulations.

First, capital is needed over the next four years, just to meet Basel III requirements under Capital Conservation Buffer (CCB) and Domestic Systemically Important Banks (DSIB) - these alone will mean an additional 2.5%+ of bank Capital to Risk Asset Ratio (CRAR). This by itself amounts to over $20B of capital.

Second, stressed assets in India banks are arguably not adequately provisioned. As on date, 11.1% of India's banking assets are seen as stressed - a combination of gross NPAs and "restructured" assets. Some investors reckon the actual level of stressed assets is far higher than this. Stressed assets, particularly into infrastructure, continues to be the soft underbelly of the Indian economy - and is an area that requires separate & urgent attention. Even the 11.1% declared stressed assets is considered not provisioned for adequately. As a CS report of August 2015 points out, around $20B of capital would be required just to bring up provisions to 70% of gross NPAs and 30% of restructured assets.



Third, fresh capital would be required for funding future lending. The same CS report reckons an additional $20B of bank capital would be required just to fund a nominal 12% of annual commercial credit growth - a bare minimum growth number to foster sustainable growth in the economy.

Of the above, the first two would only drag down the ROE even further, since they do not by themselves result in any increase in revenues.

Shouldn't India be able to attract offshore capital for its banks?

For the larger banks, some capital will indeed be available. However, we must understand the global context for banking capital today.

First, with the prospect of withdrawal of Federal Reserve accommodation, easy money is no longer available. Second, the Global Systemically Important Banks ("GSIBs") are themselves out looking for funding - at relatively steep rates. Under Total Loss Absorption Capital (TLAC) requirements from the Financial Stability Board (FSB), along with Basel III CCB, the funding requirements for the largest banks are going up to 17-24% of Risk Assets by 2019. Even after accounting for the TLAC exemption that Emerging Market based GSIBs have managed, there is still $800B of additional TLAC & CCB related debt to be raised. We are seeing some very well rated Nordic banks raise capital at 6.5-7.0% in USD. These banks are starting with CRAR of 14%+ already, and this additional TLAC related funding, from an investor standpoint, has a fair degree of distance to any actual write off.

The point of all this is that at 6.5-7.0% in USD, international investors appear to have fair better avenues available to deploy their funds, than into Indian banks.

At the same time, 7% in USD is about 13% in equivalent INR. This is way higher than what Indian



Banks can afford on a sustainable basis - unless the Indian banking profitability & ROE goes up sharply. All put together, it does appear that Indian banks and foreign investors will struggle to put together any reasonable capital solution, in the current context.

Some angst, and a rhetorical question...

All this presents a true dilemma for us - we needs loads of capital to be pumped into banks, from a capital starved ecosystem, with the prospect of below par ROE. While we mull this seemingly impossible context, one must ask the rhetorical question - could China have grown the past three decades the way it has, if its banking system had been saddled with these Basel III guidelines? Indeed, could ANY nation have made the transition from developing to developed economy, under these stipulations? Is the Basel III philosophy of de-risking banking truly the right approach to be followed in developing nations at all?

However, we must recognise that these rhetorical questions have little practical utility. Regulators - globally - would consider any questioning of Basel III as blasphemous. We have no choice but to try and find a solution within the seemingly impossible constraints that bind us.

So what is the way out?

There are a few ways in which we could deliver the financial objectives, despite all the constraints enumerated above.

One way is for the Indian government to bear the full burden of bank capital infusion. Instead of the INR 700B that the government has promised over the next 4 years, the government should then be prepared to infuse over four times that amount. The underlying assumption here is that market capital will not be forthcoming at the right price currently, and therefore the government should be prepared to increase - not reduce - its stake in banks. It then has to clean up stressed assets, deliver on investment growth while learning from the lessons of the past, improve banking ROE & price/ book to private sector levels, and then mull divestments. This will obviously entail serious amount of strain on government finances, over the next four years.

The second way is a variation of the above. Rather than physically set aside hard and scarce capital for infusion into banks, the government could offer an additional first loss guarantee for say 3% of CRAR for public sector banks. This will naturally be reckoned as contingent government obligations, but not entail any immediate cash flow as capital into banks. The government has a large role to play in resolving the issues before the banking system, to ensure there is no actual drawdown of capital. By offering this first loss guarantee, the government would be forcefully putting this conviction where its mouth is. With this guarantee, Basel III requirements can be met - and the first loss element would improve the risk-reward for the other equity holders substantially.

A third alternative is to create a bad bank, capitalised by the government, which isolates a big chunk of the current public sector stressed assets. There are plenty of candidates for these assets. 15% of banking assets is into infrastructure sector, and bad loans in this sector

account for 30% of banking NPA. If this is too big a chunk, perhaps sub-sectors within infra - say roads, or power could be looked at. Creating such a bad bank would tick several boxes. First, resolving these stressed assets would anyway require a very different approach from what commercial bankers are used to. It will require tough action against multiple stakeholders, managing the legal ecosystem, overhauling bankruptcy laws, and taking decisive policy action where necessary - all of which requires loads of governmental intervention, something a bad bank capitalised by the government can be designed to provide. Second, by cleansing a chunk of the stressed assets, the remaining good bank ROE will improve substantially, making raising adequate and appropriately priced market capital far more likely.

None of these options are easy or necessarily elegant - there clearly has to be a substantial debate and effort to mull over these, or look for perhaps alternative solutions.

Conclusion

Indian banks face the need to raise substantial amounts of scarce capital, in a context of low ROE and stiff international competition. Unless their capital needs are adequately addressed, banks will not be able to support the next stage of India's economic development. Alongside, there is an imperative to address the issue of stressed banking assets. All this presents difficult challenges, with no easy solutions in sight. The government may have to step up support for the public sector banking system - either in the form of additional capital, or by way of structures such as a first loss guarantee. The creation of a "bad bank" with a directed focus on resolving distressed credit could also be considered. The banking ecosystem also needs several changes alongside - from efficient bankruptcy laws, decisive policy decisions to revive stalled infrastructure assets, empowering management and improving governance.



Collective Investment Schemes: A case for reform

***Sandeep Parekh**, Founder, Finsec Law Advisors*
***Shashank Prabhakar**, Senior Advocate, Finsec Law Advisors*

SEBI has taken various steps in the last one year to provide access for companies to the capital markets. Most recently, SEBI made certain changes to Institutional Trading Platform to help technology and e-commerce start-ups to raise capital and list their shares, without having to follow the rigors of an IPO. Numerous changes were introduced in the SEBI regulatory mechanism in order to help start-ups and early stage companies to raise capital on the new ITP. However, in this piece we wish to focus not on the often glamorous and much publicized world of e-commerce and technology start-ups, but the very unglamorous and often murky world of collective investment schemes and make a case for regulatory reforms. We often forget that collective investment schemes are also part of the capital markets and these investment vehicles raise hundreds if not thousands of crores of capital each year. The source of this capital is not the multi-billion dollar venture capital and private equity funds, but ordinary retail investors. Indeed, while the IPO markets have taken a beating in India, it has been business-as-usual for collective investment schemes.

So what are these collective investment schemes? CIS has been widely defined under the SEBI Act to mean any pooling of funds under any scheme or arrangement where contributions from investors are utilized for the purpose of the said scheme or arrangement, with an expectation from the investors to receive some profit, income, property, etc. Further, the entity pooling the funds from investors will be responsible for the management of the funds and investors do not have day-to-day control over the management and operation of the scheme or arrangement. It has been part of SEBI's mandate to regulate these schemes ever since Section 11AA was introduced to the SEBI Act, 1992 and the SEBI (Collective Investment Scheme) Regulations, 1999 was issued. However, no other initiative of SEBI has been as big a failure as the one regulating collective investment schemes. So much so that in the last 16 years, the only company to have registered itself under the CIS Regulations has been Gujarat's GIFT City which has only been granted a provisional registration certificate by SEBI. However, no funds have been raised by GIFT City from the public, till date. It would be incorrect to assume that because no companies have come forward to register themselves under the CIS Regulations that these companies are not mobilizing funds from the public. Over the last one year, we have seen hundreds of orders issued by SEBI against companies which have been alleged to have raised thousands of crores from ordinary retail investors through these collective investment schemes.





Collective investment schemes have been mushroomed all across the country and these companies carry on a wide variety of business operations. There are companies which pool money for the purpose of carrying on some real estate business, schemes that raise money for plantation and agricultural activities, schemes that raise money for the purpose of buying and rearing cattle and there have also been companies which have pooled money for the purpose of investing in art. Most recently, companies that offer timeshare and holiday packages have also come under SEBI's scanner.

It is indeed surprising to see that while the IPO markets in India dried up for a good 2-3 year period, collective investment schemes have been successful in raising capital from a large number of investors. One of the most worrying aspects for SEBI has been that the retail investors have stayed away from the organized equity capital markets over the last few years. What is even more surprising is that these collective investment schemes mostly mobilize funds from retail investors and they have been happy to raise funds and carry on their business operations without bothering to register themselves with SEBI under the CIS Regulations. The lack of registration does not seem to have affected their ability raise funds from the public at all. Most collective investment schemes offer very attractive returns on investments and investors are lured into investing in them. It seems that these companies are happy to carry on their business in a regulatory (and sometimes enforcement) vacuum and the public is happy to invest in such ventures too. Even a cursory glance at the CIS orders passed by SEBI seems to suggest that companies flourish in smaller tier 2, tier 3 cities and rural and semi-urban areas. However, it is indeed unfortunate that not much data is available on how the funds raised by collective investment schemes compare with funds raised by other regulated investment vehicles in India. It would indeed be worthwhile for SEBI and / or the government to conduct this study just to get a sense of how much money is being funneled into this unorganized sector.

What is clear as daylight, however, is that the collective investment scheme regulatory regime has been a dismal failure. SEBI has failed to lure these companies to register themselves and function within the regulatory parameters. The existing collective investment scheme regime does not facilitate a smooth migration of unregulated schemes to a more regulated environment where they can carry on their business under the watchful eyes of SEBI. The existing CIS regime insists on closing down these schemes, wind up the business and refund all the monies raised from the public along with the returns promised on such funds raised. SEBI does not seem to be concerned about how investors will get their monies (along with the promised returns on them) if the collective investment scheme is directed to wind up and not allowed to carry on its business, often within a short period of 3 months. This has resulted in another problem for SEBI. The regulator has not been successful in getting these companies to refund the monies raised to the investors. Ultimately, it is the small investor who has suffered - the very same investor whose interests SEBI is obligated to protect under the SEBI Act.

How does one solve this conundrum? SEBI, on its part, has been taking various initiatives to educate investors and members of the public to be cautious and not invest in schemes that appear to offer unusual and very attractive returns on investments. SEBI has been putting its considerable Investment Protection Fund to good use by educating investors. That is indeed laudable and all efforts must be made to increase investor education and awareness. It is also equally important, in our opinion, for the capital markets regulator to look within and try and come up with serious reforms to the existing CIS regulatory mechanism to facilitate the existing unregulated investment vehicles to migrate to a regulated space. Efforts must be made by SEBI to involve all stakeholders in a bid to reform the existing regulatory mechanism. In our opinion, a top down approach which does not consider the ground reality, like the previous initiatives, is very likely to lead to a failure. Finally, this understanding will also segregate honest efforts of collecting money and bring them in a regulated environment and enforce strict action against ponzi schemes and the likes which simply need to be shut down. The former will further the cause of financial inclusion and the latter will stamp out fraud.



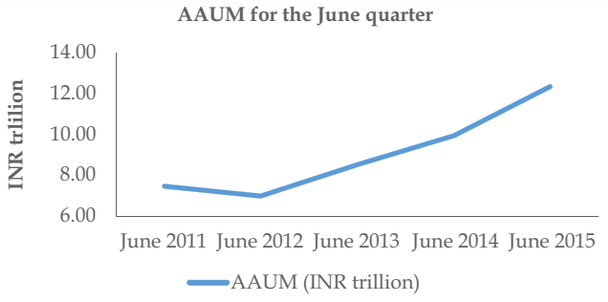
Asset Management Industry – Pivotal to the Indian Capital Markets

***Kapil Seth**, Managing Director & Head, HSBC Securities Services*

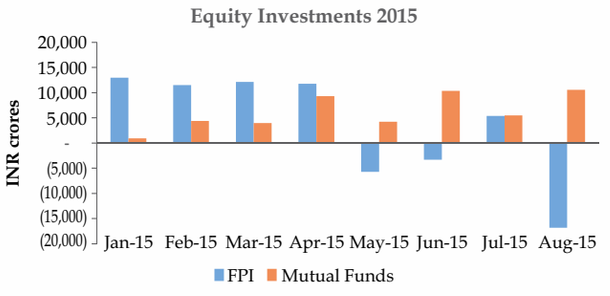
Positive Growth Trajectory

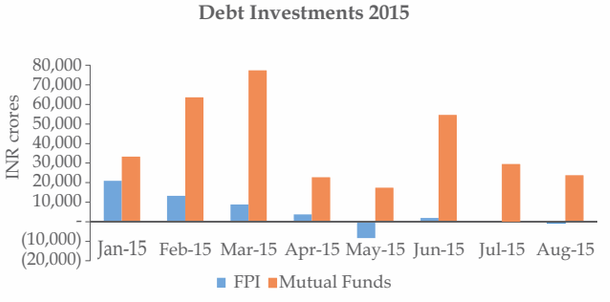
The landscape of the Indian capital market is continuously evolving, accredited to the economic developments and regulatory changes being undertaken. In the backdrop of such a dynamic landscape, the Indian asset management industry has nurtured itself as an important market participant to add depth and stimulate our capital markets. Since the 1990's when the Mutual Fund (MF) space opened up to the private sector, the industry has come a long way and played a pivotal role in channelizing domestic savings in capital markets. Today the industry is among the fastest growing in the world. Total assets under management (AUM) of the MF industry clocked a Compound Annual Growth Rate (CAGR) of 12 per cent over 2008-2014 as compared to the global average CAGR of 7 per cent. (Source – ICI FactBook 2015)

2014 has been a transformational year for the MF industry in India. India's decisive election mandate built enormous euphoria around the India growth story, triggering a new wave of optimism among the investors. Aided by equity markets reaching to new highs, the MF industry registered a spectacular growth of 24% in AUM. The total average AUM for the quarter ended June 2015 was INR 12.34 tn as against the total AUM of INR 9.93 tn for the quarter ended Jun 2014, MF investments in equity and debt securities have been holding steady even in the face of intense volatility that has been witnessed in inflows of foreign investors. In August 2015, MFs with net purchases of INR 105.06 bn, helped cushion the impact of record selling in Indian equity markets by foreign portfolio investors (FPI) who were net sellers to the extent of INR 168.77 bn.



(Source - AMFI)





(Source – SEBI, NSDL)

Given the current scenario of global market volatility and uncertainty, ongoing growth of the local asset management industry assumes more importance to provide a platform of routing local savings in Indian capital markets.

Maximizing share of the savings wallet

Notwithstanding the spectacular growth in the last decade, MF penetration in India has a significant scope to grow. The AuM in 2014 as a percentage of GDP was about 7 per cent in India as compared to global average of 40%. Even Brazil, considered as a peer economy, is significantly ahead with the AuM to GDP ratio of 42 per cent (Source – ICI FactBook 2015, World Bank GDP).

In an economy with one of the highest rate of household savings globally (approx. 30% as per the World Bank report), the MF industry is still to make sufficient inroads to maximize its share of the available wallet. In a basket of investment options, mutual funds in India continue to remain as 'push' products compared to the traditional 'pull' products such as FDs, gold or real estate.

It is necessary to inspire trust amongst investors to view MFs as a long term tool to meet their financial goals. Increasing the share of wallet for MFs will depend on increasing consumer awareness at a grass root level. Financial literacy remains as one of the most fundamental factor impeding the growth of MF products, especially in the non-top 15 (T15) cities. And whilst the Securities and Exchange Board of India (SEBI) and industry stakeholders have launched several initiatives to tap the underpenetrated investor base, particularly in the regions beyond the top 15 cities, perhaps it is necessary for the industry to introspect on whether there is a need to re-look at the way mutual funds are perceived by the common man in India.



Active vs Passive investments

In the asset management industry, there have traditionally been two types of investment strategies: passive and active. The passive approach, primarily through ETFs and index funds, includes investment in indices that track specific benchmarks i.e. the SENSEX and the NIFTY and other benchmarks like the CNX 100 etc. By contrast, the active approach entrusts investment to a professional portfolio/fund manager. A fund manager determines investing in which companies would give better returns and when it would be appropriate to buy or sell the shares of chosen companies.

If one looks at the global trend, it indicates a strong thrust towards passive investments. A recent analysis by Morningstar, aggregating data on mutual funds and exchange-traded funds (ETFs), suggests passive investing is now the default choice for investors in the US, attracting close to 68% of the past 12 months of investor inflows. Assets invested in the global exchange-traded fund industry (including exchange-traded products) passed the $3 trillion milestone during May 2015. [Source – ETFGI report 2015]

In stark contrast, the situation in India is tilted strongly towards active investments. As per the August end data on mutual fund investments published by AMFI, ETFs comprise of only 2% of the total mutual fund AUM in India. This fact is also underscored by the number of ETFs traded in India.

The NYSE, for instance, has 1,470 ETFs listed on it while the NSE has fewer than 50 ETFs listed on it.

The biggest plus points for passive investing are the low cost and high transparency. As the mandate is to mimic the benchmark, there is no need for heavy research expenses. Costs are also reduced as churning is low. For a common investor in India with little knowledge and appetite to research and track the market, ETFs/index funds are therefore an ideal way of creating an exposure to the market in a manner that is free from risk in a relative sense. Marketing such passive investment products in a more investor friendly manner will likely benefit the industry to gain a better share of the savings wallet.



The Government's decision to allow Employees' Provident Fund Organisation (EPFO) invest 5 percent of its Rs 1 trillion investible fund in exchange traded equity funds is a step in the right direction and should provide the industry a sense of optimism to launch and market passive products in a big way.

Conclusion

The Indian asset management industry is currently witnessing a positive trend. Rightfully tapping the large potential offered by the Indian market, one of the fastest growing economies (estimated growth rate in excess of 7.5% by multiple global agencies), can propel the asset management industry in to an era of high growth. To achieve the right growth, the mutual funds will need to attract newer flows and expand its investor base. One approach could be to re-emphasize on the aspect of passive investments by repositioning elements of sustainable returns, costs, risks and benefits. From an overall market perspective, it is important for the mutual fund industry to ensure that it capitalizes on the momentum created in the last 18 months to mobilize a healthy share of savings instrumental for invigorating our capital market and keeping it insulated from external dependency.

How We Missed Creating An Additional Trillion Dollar Economy?

***Nilesh Shah**, Managing Director, Kotak Mahindra Asset Management Co. Ltd.*

In the last decade Indians imported Gold, Silver and Gems aggregating $ 515 billion. After adjusting Gems and Jewelry exports of $ 319 billion with nominal profit margin Indians exported savings in foreign currency of $ 227 billion. Outward flows exceeded combined debt and equity FII Inflows of $ 190 billion or net FDI inflows of $ 174 billion in the same period. In a criminal wastage of capital India remitted more money abroad than what it received in FDI or in FII flows in the last decade. If we had retained and wisely invested $ 227 billion within Indian economy, it would have created an additional trillion dollars plus economy with more Jobs, better Growth, stronger currency and more prosperity. It would have kept some of the blue chip Indian Companies under the majority ownership of Indians.

Indians imported Gold despite being the largest owner of Gold in the world. More than half of the Gold was bought after Gold Prices corrected from highs of Mid-2011. Gold is notionally liquid. Banks only sell gold. They can't buy Gold. Jewelers won't have liquidity to buy even a fraction of current gold holdings. Not only Gold carries a 10 % import duty, but also premium ranging from 5%-30 % for smaller denominations creating an instant loss for the buyer. Making charges on Jewelry are expensive. Quality of Gold remains an issue despite hallmarking. Gold prices have fallen more than 40 % since Mid-2011 in $ terms and 18 % in Rupee terms since Mid 2013. It is strange that despite low return, illiquidity, quality issue and upfront losses Indians kept on buying Gold in the last decade. What is driving this strange behavior?



Following factors are potentially responsible for such behavior.

-There are more Jewelers than Financial Product Distributors. An appropriate network of distributing financial products with comparable incentives and similar regulatory mechanism does not exist to help Indians move from Gold to financial assets. Prosperity of average Jeweler vs a vs a mutual fund agent explains why more gold is sold than equity mutual funds. Gold trade has no regulatory oversight like KYC norms. One can sell small Gold coins at 30 % premium unlike financial products. We need to bring Gold Investment at par with Financial Products from a Regulatory Oversight point of view in the form of KYC, Demat Holding, manufacturer's margin and distributor incentives.

- Despite huge efforts from Regulators to spread Financial Education, average investor has been a slow learner. Retail ownership of Gold and Gems is higher than the retail ownership of bank deposits, mutual funds, insurance or direct equity. PF money has been invested in debt which has barely given real return. Organized sector employees haven't tasted benefit of investing in volatile but richly rewarding equities through regular and long term investment which PF offers naturally. No wonder number of mutual fund investors is less than PF Members. It is important to spread financial education in common men's language rather than in technical jargon. It is also important to make financial education part of school and college curriculum. Gold can be taxed to raise funds for spreading financial education especially in non-metro areas in regional languages.

- Lot of demand comes from Parallel economy for Investment in Gold and Gems. Most of Gold and Gems is imported through limited number of entities. It is possible to track major buyers of Gold and Gems from Distribution channel. Swift and heavy punishment for misinformation will ensure cooperation. Most of the jewelers have surveillance cameras. One can track cash purchases from recordings to correct acts of past tax avoidance and create a strong deterrence for future. Fear of law which is sadly missing among parallel economy needs to be enforced.

-The rules and procedures for entry into financial markets end up deterring retail investors. Buying Gold is infinitely simpler than buying a financial product. No wonder more SIP runs with Jewelers for buying Gold than Equities in Mutual Funds. Even today it is not uncommon to see in a place like Mumbai, migrant laborers standing outside the bank branches rather than inside to remit money. If this is the scenario in Mumbai, one can imagine what must be happening in non-metro branches. Even today



there is no common KYC across financial products. Having done KYC with a bank is not good enough for a Mutual Fund Investment. KYC done in Mutual Fund is not good enough for opening a Broking account or a Demat account. KYC done in the same bank is not good enough for opening another account in the same bank. There is no portability of KYC in banking like in mutual funds. We need to simplify purchase of financial products or make gold and gems purchase as complicated.

Government's initiative to unlock the gold is a welcome step in this regard. The scheme does away with the necessity of spending for locker for safe keeping since government takes over the security responsibility; and infact pays an interest for it.

There is only a marginal suggestion towards its improvement. In the present scheme of things, the government accepts gold in any form, but it melts it and converts it into bullion as a form of depositable asset. Since most of the indian gold is in jewelry form, the value addition by way of jewelry creation is lost. Moreover, there is a sentimental value associated with many of these jewelry products, since they have been

inherited as heirloom, as gift at important occasions etc. The melting of such jewelry into unrecognizable form acts as a deterrence towards monetizing the locked gold asset. Government needs to arrive at a mechanism where such value added gold products, and jewelry is placed intact while ensuring that monetization is only for the obtained gold value. This will increase the size and scope of the scheme and increase the chances of its success.

Financial Education, Deterrence from tax authorities, easing entry into financial markets and appropriate distribution network will make domestic capital available for rapid economic growth.

Other than that, the issue of financial illiteracy needs to be tackled with more seriousness given the cost it has for the nation. Basics of investment, investment industry, difference between investment and insurance and personal finance management must be inducted as part of the higher schooling and college curriculum. This will generate not only a disciplined investor over the long term but will also create a more informed human resource base within the nation.

Currently the level of mis-information is such that I come across finance MBA's from reputed colleges investing in NFOs because, "It has a starting NAV of Rs 10" or brilliant doctors that invest in fixed income investments because, "Mutual Funds generate NAV numbers randomly". I even came across a mid level corporate banker who quipped to his relationship manager," so what if the nifty is down, why should the equity fund decline". I can't bring myself to imagine the extent of misinformation which the average man on street might be operating in.

This illiteracy has a cost in form of misallocation of capital which becomes evident in symptoms such as investment in dead assets like gold, or investment in negative (real) interest bearing debt instruments or in opaque and uncertain asset like real estate. This in turn leads to sub optimal wealth creation, capital decay, revenue leakage for the government and general misery. For that reason, financial literacy must be seen as a nation endeavor rather than a limited initiative. Such companies/AMCs that have shown tangible improvement in reach, education and service of even remote investors must infact be remunerated for such undertaking.

The rising expanse of digital technology will lead to integration of marginal and remote areas into the mainstream. The launch of payment banks, increased licensing for small banks, and the discussions of 'regular banking license on tap' is predicated on this very assumption that India will integrate offline and online as a singular market. Government's efforts towards GST and Digital India seem to indicate that very vision. Such an offline and online integration will ensure that India's savings rate and capital formation rises up significantly. This will also move India towards cashless economy and bring transactions even in remote India, into the mainstream.

For the investment industry point of view, these changers are harbinger of very many changes. The integration of the nearly 20-30% of the Indian population and the mobilization of their savings into the mainstream financial channel provides not only an opportunity but also a challenge to communicate to them our proposition and our value.



New wave for Private Equity – what is holding it back?

***Anjani Sharma**, Partner, KPMG India Pvt. Ltd.*

With the current government working towards improving the country's business environment, the future outlook for India seems strongly positive.

Private Equity (PE) has grown to become a critical source of capital in the Indian economy. As per a Mckinsey Report[1], PE firms are responsible for 36 per cent of the equity raised by companies in the past 10 years and contribute even more when times are tough- 47 per cent in 2008 and 46 per cent, on an average, from 2011 to 2013. Further, Mckinsey's research suggests that PE-backed companies in India increased revenue and earnings faster than public companies across nearly all sectors and vintages, and these companies are, on balance, better governed, more compliant with respect to regulatory and fiduciary obligations, more likely to pursue mergers and acquisitions, and better at seizing export opportunities. Hence, there is a strong belief that PE will play a significant role in India's growth trajectory.

One of the boosts that the PE sector needs for a new wave of growth and returns is support from regulators to lift the confidence of foreign and domestic investors. While baby steps have been taken in this direction, a major overhaul is required for the PE industry to reach its full potential.

On the tax side, Budget 2015 did provide the much sought after tax pass through status to Category 1 and 2 Alternative Investment Funds (AIFs). However, the drafting of the related provisions have opened up



several interpretation issues. A separate scheme of taxation has been introduced for AIFs earning business income. AIFs, by their very nature and the regulatory framework can only engage in investing activities. And hence, the question of carrying on business does not arise. By providing a separate scheme of taxation for AIFs earning business income, there is a window that is now available to the tax officials to seek to recover tax from AIFs and this could then trigger needless protracted litigation. Secondly, while one understands the rationale behind the 10 per cent tax withholding that has been imposed on Category 1 and 2 AIFs, there is clarification that is required on multiple counts - is tax withholding

[1] *Mckinsey Article (February 2015) - Private equity in India: Once overestimated, now underserved*



required in respect of income that is exempt as per the domestic law; is tax withholding required in case of income that is exempt under the treaty provisions; on what does tax withholding apply - on gross income or on net taxable income or on distributed income. These are issues that need to be addressed so that investors have visibility on their likely net of tax returns from investing in AIF.

On the offshore side, the introduction of safe harbour provisions for location of fund managers in India is a move in the right direction and is aimed towards making India a financial hub on the lines of Singapore and London. However, the conditions that have been set out to qualify under safe harbour are so far from practical realities when it comes to PE houses, that this provision seems like an eyewash. For the safe harbour provisions to have true relevance and thus workable in the Indian context, the stipulated conditions such as: a minimum of 25 investors, limit on participation interest of a single investor at a maximum of 10 per cent and of 10 or less investors at 50 per cent, need to be streamlined.

Linking the residency criteria to the concept of place of effective management is in line with international tax practices and hence is more contemporary and thereby welcome. Detailed objective guidelines are much needed so that this concept can be applied in an objective manner, without the tax authorities using this as a tool to cause harassment to taxpayers, in genuine cases.

Coming on to the indirect transfer provisions, they are here to stay. While the objective is fair, the drafting of the provisions could lead to tax being applied in unintended situations in a fund context. For instance, in an India-focussed fund, up streaming of returns to the limited partners could create a tax event for the limited partners. While dividend income has been specifically exempt, up streaming of returns could happen in several different ways, other than dividends, which in the absence of specific exemption, may be sought to be taxed in India. This is a serious dampener for the PE industry. Also, transfer of shares of offshore-listed companies should be exempt from the indirect-transfer provisions, since it could be a challenge for the offshore investors in listed companies, having frequent churning, to discharge their tax obligations in India coupled with compliances around this.

Extending the holding period to 36 months for unlisted shares is a harsh measure and it would be desirable to treat listed and unlisted shares at par, as far as the holding period is concerned.

Pressure to exit is expected to rise, with pre-2008-vintage un-exited deals. Strategic and secondary sales are seen as common exit routes. A major bottleneck in these exits is litigation on account of withholding tax obligation. In secondary exits, buyers seek protection with respect to tax withholding. While the market practice is to provide indemnity or to seek insurance, this poses a serious challenge in case of funds towards the end of their fund life. The fear of potential litigation around tax withholding has become a serious obstacle in deal activity in India. Clarity and

certainty around this could help spur deal activity in India and avoid time and resources being deployed after an otherwise unproductive activity of negotiating tax-withholding risk.

On the regulatory side, the PE industry needs a mechanism for India-based funds to raise monies from overseas, under the automatic route, without having to approach the Foreign Investment and Promotion Board (FIPB). That could provide India-based fund managers with a platform to access offshore and domestic monies without having to put in place structures that do not reflect the commercial reality.

With multiple pricing norms being at play - Companies Act, 2013 requiring issue of shares to be at a minimum of fair value, issue of shares at less than fair value triggering tax for the recipient of shares, issue of shares to offshore PE investor at more than fair value triggering tax for the issuing company and exchange control-pricing norms; it becomes a challenge to meet the commercial objectives in deals, especially where multiple parties - resident and non-resident are involved; and the transaction involves a combination of secondary purchase and primary issuance. Streamlining the myriad pricing norms is required so that deal activity is not hindered on this account. At the least, the taxation of Indian companies on account of the issue of shares at a premium to fair value could be relaxed for Category 1 and 2 AIFs and Foreign Venture Capital Investor (FVCI) entities. At present, an exemption in this respect is available to Venture Capital Funds (VCFs) under the domestic tax laws.

With non-performing corporate loans rising fast in the financials of Indian banks and more corporate-debt-restructuring cases landing in the books of banks, there is a strong case for more distressed-debt funds. Many companies have problems in their capital structure, and PE players have the skills for efficient restructuring. However, both mezzanine and



distressed-debt funds need regulatory support. For this to take off, regulators would have to develop an appreciation of mezzanine debt. SARFAESI protection to NBFCs was announced by the Finance Minister in his last Budget, but the notification to give effect to this is still awaited. Also, some form of SARFAESI protection to offshore debt investors could further deepen the debt-market segment.

The new Companies Act, 2013 ('New Act') poses several challenges to private equity investments. Some of those are highlighted below.

Rightly focussing on management, the New Act puts a higher onus on directors appointed by PE funds. Additional liabilities have been imposed on directors appointed by PE funds. The PE directors could potentially be liable for prosecution for any default by the company's management. It is interesting to note that a director will not be penalised for misconduct of the company if he has raised objections against the activity on record. Whilst this is a welcome step towards effective corporate governance, it would perhaps be more appropriate to have PE directors treated on par with other independent directors, as typically they are not involved in day-to-day management.

As per the New Act, a company with any listed security will be treated as a listed entity. So an unlisted portfolio company of a PE investor, which may have listed its Non-Convertible Debentures (NCDs), can be

suddenly burdened with an entire gamut of obligations applicable for a listed company. This acts as a deterrent to the NCD route at times.

Further, investment is not permitted through more than two layers of investment companies. Private equity investors prefer to invest in holding companies, to realise higher returns from the entire group through a single investment rather than multiple investments in subsidiaries. Thus, this restriction may deter PE investments, especially in the infrastructure sector and hence carve outs should be made for genuine multi-layered corporate structures.

From an exit perspective, the New Act allows an Indian company to merge with a foreign company, thereby facilitating cross-border M&A. Guidelines in this respect are awaited. One hopes that guidelines are drafted to make this a feasible option from a practical perspective.

The PE sector would get a boost if the above concerns are timely addressed in some form.

As per the Bain PE Report 2015, General Partners (GPs) in India expect a further increase in deal activity, propelled by macroeconomic conditions, positive investor sentiment and an improved exit environment. However, India needs to continue to improve the ease of doing business in the country, a large part of which involves a regulatory environment that is more conducive to business growth to attract investment.

The PE industry is well positioned for a new era of growth and returns if inter alia regulators recognise that investors can deliver more than money across the capital structure and hence move actively and nimbly to address the above. Given that growth in China is slowing down and is grappling with its set of issues at present, India is well poised to ride the next wave. Having a supportive regulatory and taxation framework in place could therefore provide the PE industry with an ideal ecosystem to thrive.

The views and opinions expressed herein are those of the authors and do not necessarily represent the views and opinions of KPMG in India.



Masala Bonds Will Find Appetite, But The Market Will Take Time to Develop

Atul R Joshi, *Managing Director & CEO, India Ratings and Research*

Section 1 - Introduction

The Reserve Bank of India's (RBI) efforts to operationalise the issuance of Indian rupee denominated off-shore bonds by Indian corporates are commendable and consistent with the global trend to reduce currency mismatches for its resident entities. These bonds, popularly called the Masala bonds, would potentially provide corporates an alternate avenue to raise debt funding from international investors in addition to the existing channels of external commercial borrowings (ECBs), plain vanilla bonds and foreign currency convertible bonds.

Foreign portfolio investors (FPIs) have also evinced a fair amount of interest to invest in government securities (G-secs) and corporate bonds within the allowable limits set up by RBI. The move to internationalise rupee bond issuances can be seen as a step towards full currency convertibility. It could also lower the cost of capital, over a period of time, which remains one of the the highest in Asia. To date, International Finance Corporation (IFC) has sold INR106bn (or USD1.7 billion) Indian bonds to international investors. The bonds ranging in tenor from three to 10 years are likely to create an international AAA yield curve for offshore rupee markets.

There are clear quantifiable benefits of allowing an offshore rupee market. **From an issuers' perspective,** borrowing in local currency overseas does not carry the currency mismatch risk or refinance risk which is present in foreign currency denominated debt. Currency mismatches result in the ballooning of interest and debt obligations in a scenario of depreciating rupee. Indian corporates have become increasingly dollarised in the past seven to eight years and currency risk is one of the key concerns for corporate India's performance. Thus, any reduction would aid corporates better manage balance sheet risks in an increasingly volatile global environment. Hedging currency risks carry significant costs which may make foreign currency offerings lesser attractive especially at the lower end of the credit curve. In comparison to issuing in local currency bond domestically, a similar overseas offering provides deeper markets, a diverse liquidity pool and a new class of investors who may not necessarily be present onshore.

From an investor's perspective, attractiveness of yields and a stable/appreciating currency define the attractiveness of any offering. Indian debt offerings could be attractive for a multitude of reasons which are both strategic and tactical in nature. In this context, Indian growth story becomes particularly relevant in



view of the slowing Chinese economy. The rupee has performed better than other emerging markets, given sound macroeconomic management and inflation targets set by RBI. India presents among the highest yields within Asia as well.

For an investor, a rupee offering overseas also addresses the concerns on disclosures for corporates in India. It will also take care of the legal jurisdiction issue in case of arbitration as any such matters would be settled in the foreign jurisdiction compared to Indian laws which invariably lead to protracted delays. Furthermore, settlement systems will be more robust such as the euro-clear settlement mechanism. However, it is important to note that FPIs are allowed to invest onshore in rupee-denominated corporate bonds; however, the usage of the limit has been to the extent of 77% with investments being restricted to quasi-government entities or banks which are rated at a higher level. The inability of FPIs to move down the credit curve reflects the challenges of information asymmetry in the Indian credit markets between loan issuers and bond investors and bankruptcy laws which provided limitations to enforcement and recovery of security.

However to begin with, the momentum in offshore rupee bonds will be slow, and issuers accessing the market would be mostly public sector undertakings (PSUs) and AAA corporates/banks testing the waters. Initially, firms may have to offer a pricing premium to attract investors though ideally the benchmarks should be close to the domestic market. This is because in addition to the traditional interest cost, investors may look at some component of the cost of hedging. Some issues relating to withholding and capital gains tax issues still need to be clarified before this market kicks off. However, if this market is to benefit issuers down the credit curve, a sound macro fundamental environment needs to be maintained besides incorporating structural changes relating to information asymmetry and strengthening of the bankruptcy laws.



Overseas issuances typically note the development of a complementary credit default swap market which though theoretically is an insurance product on credits. However, in case of any adverse macroeconomic development such products have been seen as having an adverse impact locally as well. In the overseas markets, many hedge funds and investment companies could resort to pure speculation ad write CDS contracts without owning the underlying security. These CDS contracts create a way to "short" sell the bond market, or to profit on the fall in the value of bonds.

Section 2 - International experience

While making a decision on which currency to borrow in firms look at interest costs, foreign exchange differences, debt issue transaction costs besides other strategic considerations. All else considered equal, issuers would typically raise debt in a currency which will have a low interest rate. When capital is freely mobile, no arbitrage should exist between the expected interest rate costs in different currencies. However, price differences have been observed empirically for protracted periods of time. This largely explains why borrowers may prefer one currency over the other while borrowing.

Traditionally, many corporates that issue debt in international markets have done so in the five "major" currencies - the US dollar, the Japanese yen, euro, British pound, and the Swiss franc. According to a study by Federal Reserve Bank of San Francisco done



in 2014, 97% of global bond issuances were done in these major currencies but borrowers domiciled in these currency areas did not exhibit any home bias. This trend of borrowing in different currencies has existed for long and exposes the issuer to a currency mismatch risk, which leads to ballooning of interest and debt obligations in the scenario of a depreciating home currency. This also exposes the firm in question to a refinance risk.

Paradox of Original Sin

Nevertheless, firms may still choose to issue debt in global currencies as observed empirically, either because investors may demand higher interest rates for dealing in home currencies or because debt in home currencies could fail to generate demand.

In many cases it is the push factor rather than the pull factor which motivates foreign currency issuances. Firms and governments which are unable to issue debt in their home currencies in international markets on concerns of macroeconomic and hence settle for borrowing in foreign currency debt only increase the probability of instability. This is due to the phenomenon of the "Original Sin", first propounded by Eichengreen and Hausmann in 1999.

However, over the past few decades, several economic developments such as inflation stabilisation (often achieved through an explicit inflation target) have helped mitigate the problem of original sin to some extent and certain emerging market borrowers have gained credibility on lower exchange rate volatility. Technology advances have also helped.

Offshore vs. Onshore Domestic Currency Issuances

In emerging markets, onshore domestic bond markets are seldom well developed due to lack of proper infrastructure, poor legal environment, illiquidity, challenges of information asymmetry between loan issuers and bond investors and bankruptcy laws which provided limitations to enforcement and recovery of security.

In certain developed markets, offshore markets provide a substitute for and draw liquidity away from the domestic market such as in Hong Kong and New Zealand. However, in most emerging market cases these offshore markets may complement the domestic market development in such cases by helping, diversifying the overall local currency market, establishing a minor currency asset class, in addition to resolving currency and maturity mismatches.

Local Currency Overseas Offerings Gained Momentum During 2007-2009 Crisis

In the recent years, appreciating currencies and higher yields have drawn billions of dollars into emerging market bonds issued in local currencies overseas. Debt issuance in home currencies increased markedly during the 2007-2009 global financial crisis when the relative cost of issuing in home cost of using USD for issuing debt.

But not all Emerging Market countries have been able to successfully issue local currency bonds overseas

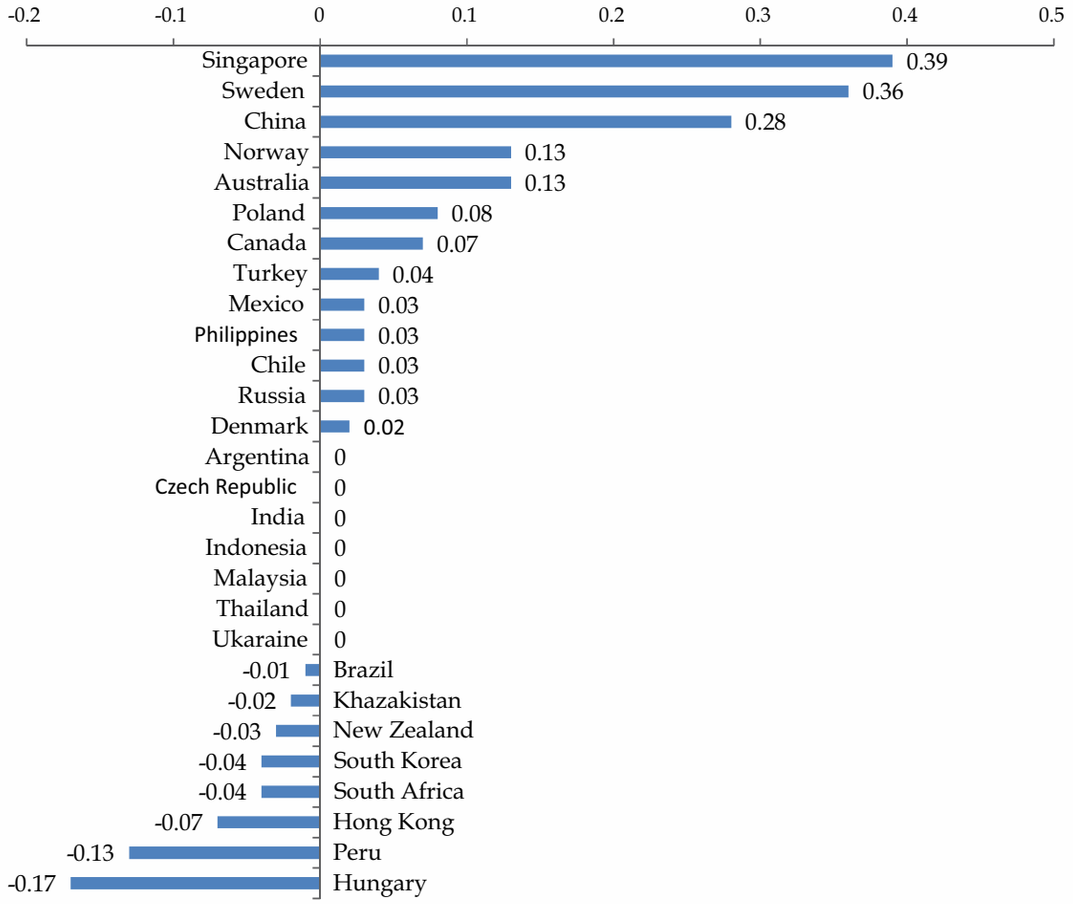
In the recent past, there has been a decline in the premium associated with issuing in local currency and many debt issuers became seasoned issuers in this market. Corporates from Singapore, Sweden, China and Norway saw a significant rise in the proportion of such issuances according to a study by Federal

Reserve Bank of San Francisco. However, countries such as Singapore, Sweden and Norway are the ones with a sound macroeconomic policy framework.

China, motivated by the aim to internationalise its country, a relatively stable renminbi (RMB), a growing offshore RMB center in Hong Kong and a RMB deposit base overseas has been successful in its promoting local currency issuance. Other emerging market countries such as Peru saw decline in the percentage of home currency issuances due to economic stability issues. It has also been noted that a mere adoption of an inflation target alone may not provide a conducive environment for local currency issuances overseas. The issuer countries' inflation and monetary policy stability provide the necessary and sufficient conditions.

Further, in 2015, local-currency emerging market debt has posted negative total returns. Heavy losses from a widespread weakening of emerging market currencies have notionally more than wiped out the interest income earned on many bonds. Bond prices have also declined on concerns of slowing economic growth and falling commodity prices.

Change in ratio of bonds issued in home currency, from before to after the 2007-08 crisis



Source: FRBSF Economic letter 2014-24

Section 3 - Dim-sum bonds - China

The Chinese currency, or the renminbi (literally 'the people's currency'; RMB) has risen to become the second most-used trade financing currency in the world. In November 2014, the RMB entered the top five of world payment currencies, behind the Japanese Yen, British pound, Euro and US dollar. These developments are results of the long-awaited steps taken by the Chinese government and domestic regulators in the last few years to liberalize the RMB. Consequently, different offshore RMB currency trading centers have emerged across the globe in financial centers such as Hong Kong, Tokyo, London, and New York.

The "dim sum" bond market generally refers to RMB-denominated bonds issued in Hong Kong and the majority of dim sum bonds are denominated in CNH. Some bonds are also linked to the CNY and paid in U.S. dollars. Between December 2010 and June 2012, the Ministry of Finance issued CNH -denominated China Government Bonds (CGB) in the 3-year, 5-year, 10-year and 15-year buckets which helped evolve the sovereign bond curve which has helped benchmarking dim-sum issuances.

The yields offered on the initial dim-sum bonds was significantly below mainland bond yields, and served as a proxy for CNY appreciation. However as market reforms gathered pace and more repatriation channels opened, the offshore CNH yields gradually converged with onshore. In addition to local Chinese Financial Firms, and corporates Global firms such as



Caterpillar, Mc Donalds etc have also issued dimsum bonds over the last four years and global firms made up 34% of issuance in the last four years.

Certificates of Deposits (CDs) with their shorter maturity have been the most favoured dimsum bonds and more than 50% of all dim sum products were CDs in 2013. It is also interesting to note that most CDs are from financial services, followed by the government, while corporates form a smaller portion.

An overwhelming majority of dim sum bonds (95% in 2007-14) were with fixed-rate coupons and the average coupon was 4.1% for issuances between 2011 and 2014. A majority of the investor base of the nascent dim sum market were buy-and-hold investors, who welcome the fixed-rate bonds (FUNG, KO, YAU, 'The Offshore Renminbi (RMB) Denominated Bonds', 2014).

Bonds denominated in CNH can be settled using Euroclear and Clearstream, as well as in Hong Kong using the domestic settlement system HKMA CMU. Dim sum bonds have often been seen as a way to play Chinese currency appreciation. However, that equation has changed dramatically over the past couple of years. Last year the renminbi suffered its first annual decline against the US dollar since it was de-pegged, on large scale equity outflows as economy slows down. Without the lure of currency gains, investors are now demanding higher yields in order to lend in renminbi, as funding gets cheaper onshore. It is for this reason, two renminbi bonds are being offered on the London Exchange this month one will be a central bank note by the People's Bank of China (PBoC) and the other is an CNH offering by China Construction Bank (CCB).

Section 4 - Why Masala Bonds could become appetizing

Corporates in very high investment grade rating categories would possibly be the ones who may be successful in finally issuing the Masala Bonds.

International Ratings vs. National Ratings: The Indian sovereign is rated at BBB- in international rating scale by Fitch Ratings. This is the lowest level within investment grade. Indian corporates rated AAA in the national scale would typically map to a BBB- rating in international rating scale. This would mean most PSUs and a few private corporates may be at a rating level of BBB- internationally. While some AA+ Indian corporates may also map to BBB- internationally but Indian corporates rated AA and below are most likely to have an international rating level of BB+ or below. Credit ratings of BB+ and below are referred to as sub-investment grade ratings and bonds of such corporates are referred to as high-yield or junk bonds. Since the global investors perceives higher credit risk in corporates which are rated in sub-investment grade on international rating scale, investors would expect much higher returns or yields from bonds issued by such bonds.

Global Investors Treat PSU's favorably: The first off-shore issuance of Masala bond was by International Finance Corporation (IFC) which had maturity after 10 years and a yield of 6.3%. Since then, IFC has seen its rupee-denominated borrowing in international markets in FY15 (year ended June, 30, 2015) surge to the top five in currency terms at USD646mn (4.1% of its international borrowings, nearly comparable to its yen-denominated borrowings and actually higher than its borrowings denominated in the renminbi. This is quite commendable and demonstrates to some extent the insatiate demand for Indian assets as till two years back, India did not figure in the top five in the local currency denominated borrowings of IFC.

It will be somewhat optimistic to believe that this may form some pricing benchmark for issuance of Masala Bonds by even the best of Indian PSUs. IFC being a supranational is internationally rated AAA, while PSUs are rated nine notches below IFC at BBB- rating in International scale. Currently, USD denominated BBB- bonds with maturity in the range of 5 to 10 years exhibit a yield in the range of 3.8% to 4.0%.

However, it must be noted that when SBI issued dollar denominated bond in March 2015, the interest the bond paid was comparable to the yield of BBB rated bonds, implying international markets treated SBI quite favorably. As such, SBI offered a yield of 2.83% which was 144 basis points above the 5 Year US Treasury at that point of time. Empirical observation suggests that best in class non-banking Indian corporates, have issued USD bonds in last 12 months with yield of 200 to 250 basis points, above US-treasury of commensurate maturity that is the yield hovered around 4%.

INR Denominated yield may not be always competitive: While these yields are for USD issuance, the commensurate INR denominated yield should be much higher. The global investor would benchmark the returns in USD. So when they subscribe to a bond denominated in INR, they would ideally hedge for the INR currency risk. Given the current INR forward rates, the cost of hedging would shave off at least 7% to 7.5% from the INR yield. To elucidate, if the global investor expects a 4% USD yield the commensurate INR yield has to be approximately 11% to 11.5%. Of course, if the investor is satisfied with a 3% yield, as has been the case with major Indian banks the INR yield offered can be below 10.5%

However, currently Indian corporates in top rating categories are able to raise debt at yields below 9%.



Thus the only reason these corporates may be interested in issuing masala bond is if they have to borrow substantial amounts for tenure well over 5-10 years or to diversify their sources of funding.

Longer duration bonds preferred in domestic currency

Longer bond duration reduces the likelihood of issuing in foreign currency. Long duration may make it expensive to swap foreign proceeds into domestic currency, as counterparty risk rises along the duration spectrum. Further, as corporate bonds are priced off a government securities curve, the IFC sales of masala bonds may come handy.

To date, IFC has sold Indian Rs.106 billion (or $1.7 billion) bonds to international investors. The bonds range in tenor from three to ten years hopes to create an international triple-A yield curve for the offshore rupee markets.

S***trategic considerations play a role in the decision to issue internationally***. Specifically, large companies are more active in international bond issuance. This is likely to be due to three reasons. First, large companies may want to diversify their investor base across currency regions. Second, large firms may also face constraints in raising funds in their domestic markets. Third, large firms may be better known abroad, easing access and lowering borrowing costs in foreign bond markets.

Indian Authorities have a strong credibility in the international markets: The Reserve Bank of India has a strong reputation amongst investors given its effective management of inflation and inflationary expectations. SOME DOPE ON INFLATION TARGETING

Wider investor audience: To buy corporate bonds, one has to be a registered foreign portfolio investor. But, to buy these masala bonds, registration is not compulsory. This could mean a wider audience for masala bonds.

Section 5 - Impediments to the development of Masala Bonds

There are always risks associated with financial openness and sudden shifts in capital flows. Offshore markets can draw liquidity away from the domestic markets

Most Indian Corporates Unlikely to benefit: Indian corporates rated AA and below would be treated as sub-investment grade credits by international investors. The USD yield for this class of bonds is upwards of 5%. Some existing high-yield USD issuances of Indian corporates trade around 8%. If such corporates want to issue INR denominated off-shore bonds, to attract investors, given the current market conditions the INR yields may be much higher.

Current Scope is Narrow: As seen in the past, the global markets may possibly accept the lowest yields from Indian PSUs followed by a handful of Indian private corporates rated in AAA (domestic scale) category. If the global liquidity deluge continues to squeeze the credit spreads, the window of opportunity will increase. In addition, if global investors for some reason feel that INR will actually appreciate and thus they forego hedging against INR, then one may see very substantial issuance of Masala Bonds.





Speculation in CDS market: Following the increase in foreign investment limit in government bonds in 2013, a sovereign credit default swap (CDS) has developed offshore and is getting traded daily. So far, State Bank of India's (SBI) CDS was taken as the quasi-sovereign. Typically, a sovereign CDS spread develops when a country issues bonds in the overseas markets. India is perhaps among only a handful of countries where a CDS spread has developed in the overseas market even when there is no foreign bond by the government.

A larger problem is the pure speculation in the CDS market. Many hedge funds and investment companies could write CDS contracts without owning the underlying security, and this would just be a "bet" on whether a "credit event" would occur. These CDS contracts create a way to "short" sell the bond market, or to make money on the decline in the value of bonds. Many hedge funds and other investment companies often place "bets" on the price movement of commodities, interest rates, and many other items, and now could have a vehicle to "short" the credit markets.

Tax treatment is not yet clear. A 5% withholding tax on masala bonds would be at par with that on ECBs and domestic corporate bonds. However a more favorable tax treatment might help in building market for masala bonds.

Capital Gains Tax treatment is not clear either in event of currency appreciation leading to an increase in capital gain.

Hedging Currency risk: Investors often include foreign or international bonds in their portfolios for two primary reasons - to take advantage of higher interest rates or yields, and to diversify their holdings. However, the higher return expected from investing in foreign bonds is accompanied by increased risk arising from adverse currency fluctuations. Because of the relatively lower levels of absolute returns from bonds compared with equities, currency volatility can have a significant impact on bond returns. Investors would therefore look for good avenues to hedge the associated currency risk with masala bonds.

Section 6 - Impact

Positive for currency: If Masala bonds are eagerly lapped up by overseas investors, this can help prop up the rupee. The rising demand for Dim-sum bonds in 2011, for instance, promoted the use of the yuan in global trade and investment. With talks of a full rupee convertibility back home, Masala bonds can help the rupee go global.

Opening up new options for retail: A vibrant bond market can open up new avenues for bond investments by retail savers. Dim-sum bonds also provided investment avenues for yuan-holders outside of China.

Help in deepening domestic bond markets: Competition from overseas markets may nudge the government and regulators to hasten the development of our domestic bond markets.

Over-reliance on debt: Good success of Masala bonds could prompt corporates to go for substantial money raising (especially if rates are attractive). This can lead to higher than required corporate indebtedness and could indirectly impact domestic bond market.



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Recent Engagements of FICCI's Capital Market Committee 2014 & 2015



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



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



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



Roundtable on Implementation of Foreign Account Tax Compliance Act ('FATCA') norms in India' - with Shri Akhilesh Ranjan, Joint Secretary (Foreign Tax and Tax Research Division), Ministry of Finance - June 25, 2015



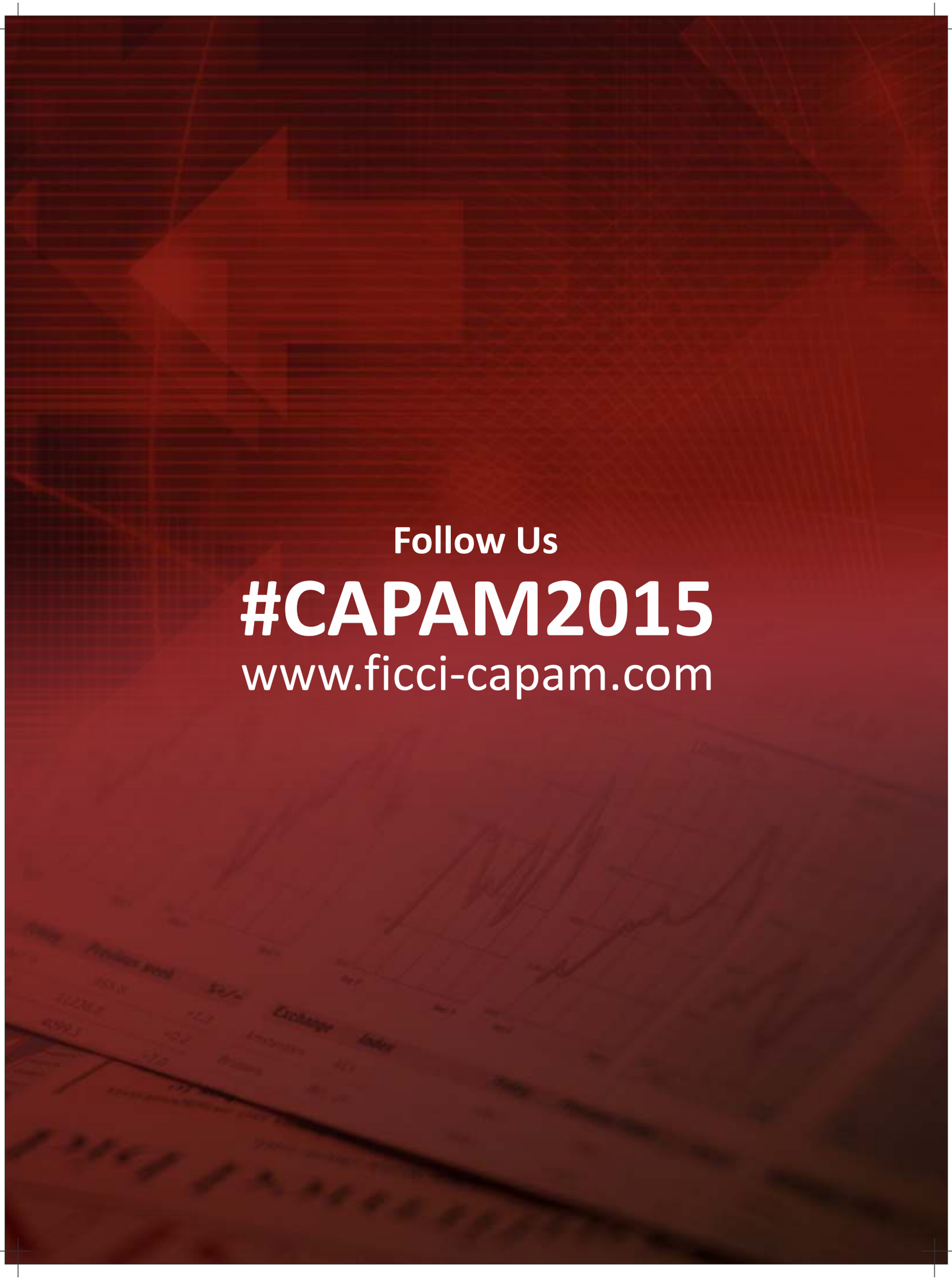
FICCI Capital Markets Committee meets Mr. Ajay Tyagi, Additional Secretary, Ministry of Finance, Dr. Saurabh Garg, Joint Secretary I&C, Ministry of Finance and Mr. Manoj Joshi, Joint Secretary FM, Capital Markets, Ministry of Finance – March 25, 2015



Roundtable Discussion on Draft Gold Monetization Scheme with Mr. Ajay Tyagi, Additional Secretary, Ministry of Finance, Dr. Saurabh Garg, Joint Secretary I&C, Ministry of Finance – May 28, 2015

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