FICCI

13th Annual Capital Market Conference

#CAPAM2016

"A Vibrant Capital Market – an Enabler for Investment"

The Experts' Voice

A compendium of articles

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Foreword

India has reinforced its position as the fastest growing emerging economy driven by improving macro-economic fundamentals, tremendous growth in the digital economy, favorable investment climate and robust regulatory framework. It remains one of the most attractive investment destinations in the world with a strong foundation for long term sustainable growth. This has set the stage for the dawn of Indian capital markets as witnessed by an upsurge in volume and depth of equity and debt instruments and stable foreign inflows. Capital markets are assuming far greater importance in the economy as India's economic growth is expected to reach fresh heights.

This year we are also commemorating 25 years of economic and capital market reforms. Over the years, Indian capital market has not only become more mature, resilient and transparent but has also adopted technology as well as financial innovations during its growth trajectory. Indian capital market is expected to fuel industry's growth appetite and continue to provide returns and protection to investors.

Our flagship Capital Markets Conference (CAPAM), in its 13th edition this year, is focused on 'A Vibrant Capital Market - an Enabler for Investment'. An apt title for a Conference which would focus on the current investment climate, disinvestment initiatives of the Government, freeing up investment from physical assets viz. gold and converting them into financial assets and investment in bonds for infrastructure financing, expansion and growth.

On this occasion, we are pleased to present CAPAM 2016 Knowledge Paper, 'The Experts' Voice' a compendium of articles contributed by members of FICCI Capital Markets Committee focusing on the various segments of investment activity. The articles also capture the recent reforms in the domain, their impact, challenges and put forth possible solutions to ease out such challenges.

We would like to take this opportunity to thank the Regulators, senior bureaucrats and highly esteemed government officials for their participation in CAPAM 2016 and also for their support to the initiatives of FICCI Capital Markets Committee through the year.

We also express our appreciation for the members of the FICCI Capital Markets Committee who have contributed their valuable time and inputs over the years to strengthen FICCI's policy advocacy. A special thanks to all the members who have contributed to this compendium.

We do hope you will find this publication insightful.



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Technology in Capital Markets: "CAPTECH"

Sunil Sanghai

Chairman, FICCI Capital Markets Committee and Vice Chairman, Head of Investment Banking, HSBC India

A journey from the present market capitalization of USD 1.5 trillion to an estimated USD 4 trillion by 2025 would make the Indian capital market the fastest growing market in the world. It implies that we will be adding USD 2.5 trillion in such a short period of time to a market which has taken many decades to reach USD 1.5 trillion.

The Progress so far

Undoubtedly, our capital market has developed significantly in the last 25 years. The 'open outcry' system for trading has been replaced with the modern open electronic order book market, paving the way for nationwide connectivity which has led to the emergence of an integrated national market. Institutions such as SEBI and NSDL have been set up and all market participants are now registered and regulated. Till 1996, share transfers in the market required physical movement of shares, but with introduction of dematerialized shares, problems arising from physical certificates have been solved. Trading cycle in 1990s used to vary from 14 days for specified securities to 30 days for others with carry over facilities under badla system. This has reduced to T+2 settlement period. Newer instruments such as derivatives have been introduced. The mutual fund industry has been opened to the private sector. The Indian stock market has been opened for foreign portfolio investment since 1993 and today constitutes 20% of total market capitalization[1]. Fundamental institutional changes have brought about drastic reduction in transaction costs and considerable improvements in market efficiency, safety and transparency.



While we have come a long way in terms of size and efficiency in terms of capital raised from market, number of listed stocks, market capitalization, investor population, trading volumes, turnover in stock exchanges and technological sophistication, ***the next phase of accelerated growth will mean that we will also need to keep pace with the new technological innovations.***

Technologies that Could Change The Face of Capital Markets

Thus far, digitalization's impact on financial services has been on non-knowledge-intensive services that can be standardized. This includes areas such as payments solutions, online trading and automated financial services. However, there are many emerging technologies which could play a significant role in disrupting capital markets:

Blockchain technology

The blockchain concept, best known for being the technology underpinning Bitcoin, has generated a lot of interest within capital markets. It is a distributed database which can record financial transactions or

[1] As of June 2016, Source - Prime Database

any digital interaction in a secure, transparent, traceable, and an efficient way. Hence, it is suitable not only for providing a universal virtual currency but also for digital smart contracts, accounting and auditing of financial transactions of any nature.

Blockchain (or distributed ledgers) offers a new approach to data management and sharing that is being proposed as a solution to many of the inefficiencies afflicting the industry. It offers a new architecture, where all capital market participants work from common datasets, in near real time, and where supporting operations are either streamlined or made redundant. A new market infrastructure based on this technology may reduce operational costs or lessen the operational or systemic risk.

Technology experts in Fintech start-ups, incumbent market infrastructure providers and banks are working on the technology and its potential uses. This technology has the potential to move the markets from today's system to a new technological paradigm. This technology may even pose a threat to the traditional capital market models by way of disruptive innovations outside of the core capital markets ecosystem. ***There is a need for collaborative efforts to explore the potential of this technology and shifting the existing value chain to blockchains.***

Big Data and Artificial Intelligence

In the past few years, artificial intelligence has been used for self-driven cars, remote sensing, medical diagnosis, etc. In capital markets, these are being used for analysis of voice patterns at brokerages, investment banks, etc. Such softwares can also perform complex searches on the recordings and identify new patterns of trading or system abuse. AI solutions can also lower the cost of many processes throughout the trade lifecycle, and also tackle the revenue side of the equation: research, sales and trading.

Further, big data can be leveraged to process increasingly large unstructured data in a timely



manner. It would help financial institutions gain insights into operations, risks, customers and market opportunities, and can help them position themselves for ongoing success. The solutions that will combine big data analysis, correlation, and causal-based technologies on data, text, image, and voice will be more powerful in the future.

Robo-Advisory

The concept of "robo-advice"-the use of automation and digital techniques to build and manage portfolios of exchange-traded funds (ETFs) and other instruments for investors-has gained significant attention in the recent times. This is a low cost, highly scalable tool which involves usage of algorithms to understand financial goals and risk profile of clients to come up with personalized investment portfolio. While robo advisory is at a minuscule level at present, it presents investors with an interesting value proposition - a meaningful price reduction for some services - and its rate of growth is both rapid and accelerating. It is projected to grow by CAGR of 68 per cent over the next five years and manage USD 5 trillion worth of assets by 2025.[2] ***Overall, robo-advice capabilities will effect profound and permanent changes in the way advice is delivered.***

[2] Source: Robo-Advisors AUM Could Grow To USD 5 trillion In 10 Years: Citi, ValueWalkwebsite

Biometrics

As the consumer acceptance of biometric authentication increases, recognition through biometrics (digital signature, facial, finger prints, voice, iris etc.) has the potential of becoming the most commonly used technology for customer interactions. It would help reduce the risk of fraudulent transactions and ensure secure transacting platforms.

Where we are Headed - Mega Trends in India

The below mega-trends are expected to dramatically impact the future of Indian capital market industry:

Increasing per capital income and growing work force: Favorable macro-economic indicators and attractive demographics are expected to drive per capita income to c.US$ 3,000 in the next 5 years from c. US$1,600 currently[3] . Given the burgeoning educated and English speaking population, India's workforce is expected to be the world's largest in 15 years[4].

Financial inclusion: Bank account penetration in India is c.53% with around 175m bank account holders added between 2011 and 2014[5]. With government's initiatives such as JAM trinity, more people are going to be covered by financial services.

Rapid growth in electronic payment channels: India is one of the most cash-intensive economies in the world. However, this trend is changing slowly. 15 billion transactions[6] were conducted through payment channels other than cash in FY16 and cards accounted for majority of the volume. Prepaid instruments (incl. m-wallets) have seen a rapid increase in usage over the last few years with 122% CAGR in volume and 68% CAGR in value since FY12.

Technology revolution: With rising smartphone penetration and internet access, India is rapidly evolving into a digital behemoth. India has over 1 billion mobile subscriptions and over 240 million smartphone users and this base is projected to increase to over 520 million by 2020[7]. Increasing 3G and 4G penetration in the remotest parts of India will ensure technology adoption by the masses.



Demanding customer expectations: Customers have shown an unprecedented rate of adoption to fintech offerings. The advent of e-commerce and payments wallets has exposed customers to a superior end-to-end experience. They expect a seamless and responsive multichannel experience from financial service providers as well. Customers are consequently accelerating this drive to digitalization.

Favorable regulatory environment: The Government, RBI and SEBI have been constantly keeping pace with the rapidly changing technology and customer expectations. Some of the key initiatives include introduction of Unified Payments Interface (UPI), financial inclusion - Jan Dhan Yojana, use of Aadhar for KYC etc.

Cost optimization benefits: Companies adopting technological tools in capital markets are able to optimize business processes and interactions with the clients. Digitizing information-intensive processes can help in cutting costs and improving turnaround times.

[3] Source: EIU
[4] Source: Aberdeen report, India: The Giant Awakens
[5] Source: World Bank
[6] Source: RBI
[7] Source: BCG Digital Payments 2020

Are We Geared Up For Future Growth?

With such high volumes of capital markets activity expected in the coming years, several initiatives will need to be undertaken. ***The right mix of innovative mind-set, technical skills, capital investments, government policies and regulatory framework could be the driving force to establish technology as a key enabler for financial services in India.***

Innovative mindset: The capital markets participants need to develop a clear strategy that enhances customer experience, optimizes processes and costs, manages rising data volumes, connects data to the business and fulfils the growing number of regulatory requirements. This may require an innovative mindset and a willingness to do things differently.

Evolving regulatory framework: While SEBI, RBI and other capital market regulators have kept up to speed with the changing landscape of capital markets, there will a requirement for regulators to proactively encourage and regulate disrupting technologies.

Differentiated model for financial services: In order to cater to different customer segments, there will be a need for customised financial services for private



banking, broking or any advisory related financial services.

Usage of data analytics: Data management and analytics platforms are crucial as they bring out customer insights, quicker and better decision-making and strong performance tracking.

The financial services firms that are prepared for the onslaught of emerging business models and are proactively embracing technology will be the ones to survive this wave of disruption. Some institutions have already started focusing on such initiatives. Others will follow soon, as there is no choice if one wants to succeed.

The Arrival of a Complete Funding Cycle - Financing Avenues for Indian Start-ups

***Anup Bagchi**, Co-Chairman, FICCI Capital Markets Committee and MD & CEO, ICICI Securities Limited*

The Start-up Ecosystem in India

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 over 3,100 start-ups. The year 2015 saw an increased activity with the addition of over 5,000 start-ups, according to the Economic Survey 2015-16. 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". 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.

Angel Funding

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 with 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.

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 record. In fact most times, the founders wouldn't even have formed a corporate entity. 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 modest return which is expected to cover up the capital for the entire portfolio. The remaining are 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 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.

Investment commitments by angel groups in the country were up by 62% 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 decreased to Rs 1 Cr in FY16 from Rs 1.3 Cr in FY15 and the median pre-money valuation grew to Rs 9.9 Cr in FY16 from Rs 9.0 Cr in the previous fiscal. IT and the online services were the hottest sectors attracting over 48% of the angel money and NCR overtook Bangalore in witnessing the highest level of angel investments in the year.

Venture Capital Funding

Once a company has established that it has a viable product or service, it needs capital for 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. There are 180 registered Venture Capital Funds in India according to SEBI. The final close size of the largest ever India-focused VC fund, Sequoia Capital India IV was close to US$ 920Mn. 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 14 companies in H1 2016.

Although there is some track record by the time VCs look at investing in a company, it is still very little to use traditional valuation methods. Therefore, VCs also generally look to valuing 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 ROI at the time of harvest, adjusted for the business' riskiness.



After a record influx of money in 2015, H1 2016 saw a slump in the number of deals as well as the ticket size. Venture Capital funding in India was US$ 1 Bn across 180 deals in the first 6 months of the calendar year 2016, according to VCCEdge, a research platform focused on private transactions in India. Across the investments made by PE & VC funds in India in H1 2016, ~28% were in the early or the growth phase.

Private Equity Funding

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.

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.

Data from VCCEdge suggests that in the first half of 2016, PE investments, excluding Private Investment in Public Equity & Pre-IPO, crossed US$ 2.5 Bn across 60

deals. IT & ITES, including Online Services, was the top sector with a share of 38% followed by Banking & Financials Services (16%).

Contractual Framework for Investments

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 being put in, 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 & 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.



Governance Regulations: Rules Versus Discretion

***Amit Tandon**, Founder, Managing Director, Institutional Investor Advisory Services of India Limited*

The International Corporate Governance Network's (ICGN) annual event is one of the few must attend events for Corporate Governance buffs. The theme this year was "Promoting long-term thinking and behavior for sustainable capital markets," so ESG, Sustainability and Integrated reporting, Non-GAAP disclosures, engagement in Asia, Stewardship codes etc. all were on the agenda. But like in all such events, a few topics dominated the conversation. In this event there were three topics which engaged the attendees: i. one share one vote ii. Integrated reporting iii. gender diversity on boards.

A few days before the conference, Peter Clapmann and Richard Koppes, both of whom had served on the board of ICGN wrote an op-ed for the Wall Street Journal urging investors to rethink one share one vote. In this piece (http://www.wsj.com/articles/time-to-rethink-one-share-one-vote-1466722733), they argue that today's corporate landscape is very different from the 80's. Today, 90% of the directors are elected by majority vote, shareholders increasingly propose directors on the board, and only 3% have poison pills in place. They go on to argue that "we see aggressive pushes for stock buybacks and calls to spin off or break up businesses and cut costs, including spending on research and development. Activists increasingly demand board representation to implement their agenda, often meaning that short-term investors take and quickly relinquish boards' seats. Boards frequently settle with activists out of fear of losing a proxy battle—or worse, winning a pyrrhic victory." They then argue for change, including tenure voting i.e shareholders with long holding periods have greater voting rights.



Given the immediacy of announcement by Facebook introducing a third class of shares (http://www.business-standard.com/article/opinion/amit-tandon-prepare-to-unfriend-promoters-116050901325_1.html), to say nothing of the fact that the conference was being held in San Francisco a city that favors innovative thinking across all domains - including governance structures - this was clearly a hot button issue. But investors, including long term investors, overwhelmingly weighed in for one share one vote. While companies, lawyers and academics will continue to press for change, do not expect this to change anytime soon.

Integrated reporting is new to Indian investors. Only one company seems to have adopted it: Tata Steel has published its FY16 annual report based on the framework adopted by the International Integrated Reporting Council. While the financial data are in line with the Companies Act 2013, and other regulations, the non-financial data is based on the principles laid down by IIRC, the UN Global Compact and SEBI. Clearly communicating the company's strategy and policies with regard to the manufacturing process, its use of renewables and non-renewables, the interaction between the company and the communities it operates in and the organizational use and management of its knowledge base is welcome. Investors will take more from this, once it become more widespread and cross-company data can be analyzed.

Another issue that cropped up in session after session was the absence of women directors on (American) boards. Delivering her key note address – through

video - Mary Jo White, the Chairman of the Securities and Exchange Commission (SEC), remarked that "In 2009, women held only 15.2% of board seats at Fortune 500 companies and that number has only risen to 19.9% in the past six years; 73% of new directorships in 2015 at S&P 500 companies went to men. At this rate, the US Government Accountability Office has estimated that it could take more than 40 years for women's representation on boards to be on par with men's. The low level of board diversity in the United States is unacceptable."

In the absence of any authority to mandate board diversity has, the SEC has focused on disclosures. The SEC ruled – way back in 2009 - that companies need to disclose if they have a policy on diversity – including how they define it. It then required the nominating committee to comment on its effectiveness.

What has been the impact of this rule? Mary Jo White says "Companies' disclosures on board diversity in reporting under our current requirements have generally been vague and have changed little since the rule was adopted. Very few companies have disclosed a formal diversity policy and, as a result, there is very little disclosure on how companies are assessing the effectiveness of their policies. Companies' definitions of diversity differ greatly, bringing in life and work experience, living abroad, relevant expertise and sometimes race, gender, ethnicity, and sexual orientation. But these more specific disclosures are rare." Clearly the SEC is not satisfied.

Gender diversity clearly is an area where Indian boards have rapidly moved ahead. The Companies Act 2013 legislated that all listed companies and companies above a threshold needed to have a women director on their boards. And Indian firms with some nudging and cajoling have embraced this change.

Figures from the PRIME database showed 1,268 out of



1,457 relevant firms listed on the National Stock Exchange of India had appointed women by 1 April 2016. It would have been ideal if all of them were also independent (even though there is no such regulatory requirement); yet, contrary to the popular misconception, a study my firm carried out last December found that only one-fifth of the women directors belong to promoter families.

Using disclosures as an enforcement tool is a signal – a strong one no doubt, but it is not a diktat. Companies that are forward-looking will hear the message and comply. But both in India and elsewhere it is clear companies prefer to wait for regulations to compel change. Given such corporate behavior, regulators need to do a balancing act here as well: mandate the basic requirements of good governance (for example, enforcing diversity), yet remain directional about others. They also have the difficult task of balancing the demands of different stakeholders – including both long-term and short-term investors who have differing goals – while ensuring they do not burden companies with additional disclosures that quickly become meaningless.

A modified version of this article appeared in Business Standard on 21 July 2016

Developing the Fixed Income Market for foreign Investors

Anuj Rathi, *Head of Securities Services, HSBC India*

Introduction

On 26th August, 2016 Reserve Bank of India (RBI) announced a number of steps that will strengthen the corporate bond market in India. This came on the backdrop of the well accepted understanding that established bond markets create efficient capital raising opportunities for corporates and provide an alternative platform for raising debt finance and reduce dependency on the banking system. Development of Fixed income segment is critical for sustained economic growth.

Recent Initiatives

The Indian Government has considered the views of major stakeholders and has implemented several recommendations to accelerate the development of the debt markets in India.

1. Along with the new Bankruptcy Law which came into effect earlier this year, an important step aimed to resolve bad loans and deepen corporate bond segment; the Upper and Lower Houses passed a bill to amend the existing Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act and the Debt Recovery Tribunal (DRT) Act.
2. The Hon'ble Finance Minister announced several measures in the Union Budget 2016-17, pertinent to foreign investors investing in the bond market:
    a. Setting up a dedicated fund by LIC of India to provide credit enhancement to infrastructure projects which will facilitate investment from long term foreign investors.
    b. Allowing foreign portfolio investors (FPIs) to invest in unlisted debt securities and pass through securities issued by securitization SPVs.



    c. Introduction of an electronic auction platform by SEBI for primary debt offerings.
    d. Development of complete information repository for corporate bonds, covering both primary and secondary market segments by RBI and SEBI.
    e. Expansion of the basket of eligible FDI instruments to include hybrid instruments. Hybrid instruments include optionally convertible or partially convertible debentures, Foreign Currency Convertible Bonds - which are intrinsically debt-instruments.
3. Last year's budget extension of concessional tax rate of 5% (plus surcharge and cess) on interest received by FPIs on government and corporate bonds to June 2017 was well appreciated.
4. Following representations, RBI announced a staggered increase in FPI limits in Government bonds through which FPI limits is being increased to 5% of outstanding stock of central government securities by March 2018. As of 12 Sep 2016, FPIs have utilized ~ 99.5 % limits for central government securities (Long term FPIs have utilized 72.32% of government debt limits earmarked for them). The utilization levels speaks a lot about the interest of foreign investors in Indian Government Securities.

5. As mentioned, in Aug 2016, RBI announced numerous steps (subject to conditions), which will help Foreign Investors investment in fixed income securities, once implemented.
   a) Permission to Banks to issue rupee denominated bonds overseas (Masala Bonds). FPIs can invest overseas directly without registering in India. In addition, capital squeezed lenders get an additional avenue for raising funds.
   b) Permission to entities exposed to exchange rate risk, whether resident or non-resident, to undertake hedge transactions with simplified procedures, upto a limit of USD 30 million at any given time.
   c) Permission to brokers to participate in the corporate bond repo market. In a repo trade, the owner of the security agrees to repurchase at a specified price, thus improving liquidity in such scrips and boost turnover in the secondary market.
   d) Enabling trading of FPIs on NDS-OM through primary members.
   e) Allowing FPIs to transact in corporate bonds directly without involving brokers.
   f) Market making in Government securities (G-Sec) by PDs(thus adding liquidity)
   g) Publishing auction results at stipulated time to provide greater predictability to the timing of declaration of auction results.
6. HSBC India along-with other Solutions working Group members is working with SWIFT India to develop messaging standards for fixed income instruments which should ultimately help improve the straight through processing (STP) for settlement in fixed income securities for clients using SWIFT.

   These measures will definitely help develop market participation, facilitate greater market liquidity and improve communication.

Recommendations

While multiple committees and Regulators have made recommendations to deepen this market, many



of which have been implemented - there is however potential for more. Listed below are few issues and key recommendations made by the industry working group, focused on helping foreign investors trading and settlement in fixed income securities.

1. Removal of Auction Mechanism process:

Presently FPIs have to go through the auction process in specific situations.

CCIL under the direction of RBI, is already working on evaluating phasing out auction mechanism with certain industry participants. We should look to implement the changes. In addition, FPI to FPI (inter FPI) trades in Government and Corporate Bonds within same category can be evaluated to be permitted when limits (scrip wise or aggregate) are exhausted akin to Inter-FPI segment in Equity capital market of the exchanges. It will provide flexibility for FPIs to trade where there is a FPI counterparty willing to sell India Debt and release reinvestment limit.

2. KYC of Debt counterparties:

FPIs need to on-board counterparties with whom they deal in corporate bonds. Though KYC information of such counterparties is available in the KRA portal, it is not accessible to FPIs.

Since FPIs are granted registration by SEBI under the FPI regulations, access to the KRA portal may be extended to FPIs for the limited purpose of accessing KYC information for onboarding debt counterparties.

3. Aligning Reporting & Settlement cycle for investment in Government Securities

Confirmation cycle of sale and buy trades in Government Securities is not aligned for FPIs. FPIs sale trades are required to be confirmed on T date whereas purchase trades can be confirmed by T+1 date with settlement date as T+2 for both purchase and sale trades. This differential treatment does not help FPI investors, as operations and trading desks may be located in different times. Market participants have also advised that they face difficulty in getting quotes for T+2 settlement thereby reducing FPIs' counterparty options. Recommend that both reporting and settlement on T+1 for both purchase and sale transactions in Government Securities by FPIs.

4. Relaxation in minimum residual maturity

FPI investments are required to be made in government bonds / Corporate Bonds with a minimum residual maturity of three years whereas there is no lock-in period for sale transactions. Request that regulators should review relaxation of the residual maturity criteria.

To conclude, India has implemented several measures for the development of the fixed income market and has announced further steps. Timely implementation of the proposed measures and continued stakeholder engagement will further improve the depth and efficiency for investment in fixed income securities by foreign investors.



India's forty-three trillion challenge

***Ashu Suyash**, Managing Director and Chief Executive Officer, CRISIL*

India needs ₹ 43 trillion in less than five years from now - or money 8 times India's fiscal deficit - to build out its infrastructure. That would translate into ₹ 8.6 trillion in each of the five fiscals starting the current one.

Indeed, it's difficult to envisage such orders of magnitude. Yet, such is the investment needed, with 70% of it in just three sectors - power, transportation and urban infrastructure.

CRISIL estimates nearly three-fourths of the ₹ 43 trillion investments will have to be funded by debt.

Now it's impossible for banks to cough up such humongous credit. Our calculations show banks could provide about 35% of the overall requirement, while external commercial borrowings (ECBs) could proffer another 12%, or ₹ 5.2 trillion - that, too, because the Reserve Bank of India (RBI) has eased norms for infrastructure companies.

That leaves a large gap of over ₹ 11 trillion, and it's here that the corporate bond market will have to pitch in and play a critical role.

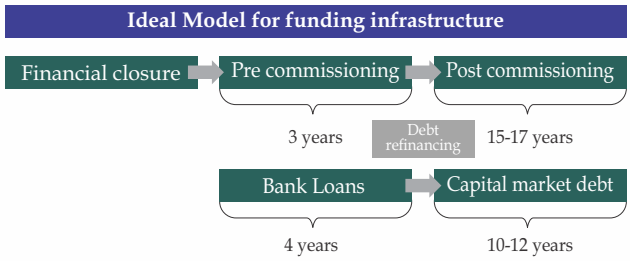
Bank lending model for infrastructure projects can evolve further

Over the past ten years, bank lending to infrastructure has grown at a compound annual growth rate of 26%, faster than the overall credit growth of 18%. Not surprisingly, infrastructure's share of bank credit doubled from 7.5% in 2005 to 15% in 2016.

Such rapid growth means asset-liability mismatches are a clear and present risk, considering infrastructure loans have long tenures of 10-15 years, while bank deposits have a maturity of less than 3 years. If that weren't enough, several banks are also nearing their group exposure limits for lending to large infrastructure companies.

The RBI partly addressed the mismatch issue by allowing banks to raise long-term funds (minimum 7 years) for infrastructure projects with minimum regulatory pre-emption such as cash reserve ratio, statutory liquidity ratio and priority sector lending obligations.

The ideal model for financing infrastructure projects is where banks focus on funding up to the pre-commissioning stage - when risk is the highest - given their strong project appraisal and monitoring skills. And once the projects are commissioned and stable, banks must refinance the debt by issuing bonds to long-term investors. This will free up considerable funds that can be redeployed in new projects. Such a model will allow banks to address their ALMs better, while bond investors will get good quality, long-term assets with stable cash flows.



On the other hand, developers benefit from reduced costs and fixed interest rates, which help offset interest-rate risks inherent to bank loans. However, for this to happen, banks will have to adopt a robust risk-based pricing model for loans which will reflect project profiles well.

Innovative structures and regulatory support can bring investors on board

Most of the investors in bonds are usually risk averse, so credit enhancement mechanisms are essential to bridge the gap between low appetite and higher risk associated with infrastructure projects.

We believe credit enhancement is crucial because it improves the credit rating - and thus saleability - of

bonds. While large investors such as pension funds, provident funds, and insurance companies have pots of money to invest, they can do so only in highly-rated debt. Credit enhancement bridges the gap.

There are three kinds of credit enhancement that can be deployed to facilitate the infrastructure build-out:

1. Partial guarantee

Debt instruments fully guaranteed by third-party guarantors have been popular in the debt market. In India, demand for corporate debt with ratings below high safety ('AA') is limited. Hence, the use of partial guarantee to improve an instrument's rating, and thereby its marketability, is a handy tool for corporates, financial institutions and investors. A case in point is Porbandar Solar Power Ltd, a special purpose vehicle (SPV) of Hindustan Clean Energy Ltd, which refinanced its existing high cost debt through a non-convertible debenture issue backed by a partial guarantee from IIFCL. The partial guarantee combined with a trustee-monitored escrow account and a well-defined payment waterfall structure helped the company get a high safety rating from CRISIL for the instrument. The move by RBI to increase the exposure limit of banks towards partial guarantee from 20% to 50% of the bond issue size is a move in the right direction towards bridging the gap between lower rated infra SPVs and the 'AA' threshold of investors.

2. Securitisation of project cash flows

Here, the project SPV issues bonds by securitising its cash flows and the proceeds are used to refinance existing bank debt. Payments to investors or bondholders are met through future cash flows (such as annuity or toll receivables). Securitisation of cash flows along with structural features such as a trustee-monitored escrow mechanism, well-documented payment priorities (waterfall mechanism), creation of liquidity reserve, etc., elevate the credit quality of the instrument. Similarly, securitisation can help road developers contract additional debt based on the strength of a project's operational cash flows to fund other business investments or invest in other under-construction projects.

3. Infrastructure debt funds

The Ministry of Finance incubated the idea of an infrastructure debt fund (IDF) that can supplement bank finance by taking over a substantial share of outstanding loans. IDFs can be set up as a trust through the mutual fund route and regulated by the Securities and Exchange Board of India (SEBI) or as a company through the non-banking finance company route and regulated by the Reserve Bank of India (IDF-NBFC). Currently, two such entities - L&T Infra Debt Fund Ltd and India Infradebt Ltd, both rated CRISIL AAA/Stable, are operational.

For eligible bonds, there is also a new option in town called green, or climate, bonds.

Money raised through green bonds can be used for capital expenditure or refinancing, but only of projects with stated environmental benefits. For instance, the government has set an ambitious target of 160 GW of solar and wind capacity by 2022, which would entail investments of around `8 trillion. Such investments could qualify for green bonds, thereby attracting investors who invest only in green ventures.

RBI's endeavours to deepen the corporate bond market, and by default infrastructure financing, are encouraging. Its framework on external commercial borrowings announced in November 2015, introduced both new instruments and lenders to help infrastructure projects raise money. The framework allows companies to raise long-term foreign currency-denominated loans with a minimum maturity of 10 years and fewer restrictions on end uses. It also expands the list of overseas lenders to include long-term lenders such as insurance companies, pension funds and sovereign wealth funds.





Further, the Union Budget for this fiscal announced the National Investment and Infrastructure Fund (NIIF) as an alternate investment fund that will have equity participation from strategic anchor partners. Contribution from the government will make NIIF a de facto sovereign fund and is expected to attract overseas, sovereign, multilateral and bilateral investors to co-invest. Based on the initial feedback from investors and sovereign wealth funds, NIIF model has been slightly modified wherein, beside the mother fund, it will also have sector specific sub funds, to begin with for roads and renewable energy, and have investors directly participate in those funds.

We also believe real estate investment trusts and infrastructure investment trusts will raise close to `50,000 crore in the near term, given their current interest. This money can be used to repay debt from banks/ NBFCs/ FIs, or as a consideration to the existing sponsor for dilution of stake or both. This will result in monetisation of sponsor's investment in long-gestation projects, or in release of banks funds for further lending.

Opening gates for domestic pension funds and insurers can play a vital role

The government has taken several initiatives over the last few years to attract foreign investment in Indian corporate bonds. The RBI has indicated that the foreign investment limit in corporate bonds-currently at $51 billion-would be reviewed and revised over the medium term at regular intervals. The government extended the concessional rate of 5% for withholding taxes on debt investments by foreign investors until June 30, 2017. Similarly, the Securities and Exchange Board of India also permitted foreign institutional investors to offer bonds rated AA and above as collateral in the cash and futures & options segments on stock exchanges.

CRISIL believes insurance companies and pension funds, with their large corpuses, can play a significant role in the corporate bond market if investment norms are eased. The Employees' Provident Fund Organisation, for instance, has an investment corpus of over ₹ 8.5 trillion. Although it has been permitted to invest in public sector bonds rated AA with tenure up to 15 years, it is restricted from investing in anything rated lower. Similarly, insurance companies have large corpuses but are restricted from investing in papers rated below AA.

We believe there is a need to liberalise the investment norms for provident funds and insurers, allowing them greater investment flexibility, to channel much-needed funds to the infrastructure sector.

It's time the gates opened wider.

FDI and Investment Climate

***Himanshu Kaji**, Executive Director and Group COO, Edelweiss Group*

Introduction

With 7.6% growth in FY 16, India has become one of the fastest growing economies in the world and there are high expectations that the similar growth will be sustained in near future. To sustain such a growth, India would need better infrastructure, improved business environment, become a manufacturing hub, better and clearer tax laws and most importantly improve the capital flows to meet these needs. While there have been several efforts for mobilization of savings and investments domestically, the Government and regulators (including the Ministry of Finance, Reserve Bank of India (RBI), Securities & Exchange Board of India(SEBI)) have taken several initiatives to bring in more capital flows by way of Foreign Investments into the country. The article discusses various recent initiatives taken by the Government of India for inviting more capital flows in to the country, key challenges and outlook thereof.

Recent Changes

Opening up of various sectors for Foreign Investment:

While the process of liberalization had begun way back in 1991 with a cautious approach in opening up sectors for foreign capital flows to begin with, the government has recently taken many steps to significantly liberalize capital flows in India in many sectors. Government foreseeing the potential for growth and consequent need for capital flows has significantly liberalized foreign direct investment (FDI) norms in several core sectors like construction & development by way of introducing significant liberalization of FDI norms, asset reconstruction company by allowing upto 100% foreign investment, Insurance by permitting 49% foreign investment under the automatic route & beyond 49% under the approval route and similar liberalizations and initiatives in other sectors like e-commerce, defense, banking, civil aviation etc. Over the years, in many sectors the Government has now permitted up to



100% FDI under the automatic route and in few select sectors understanding the sensitivity, allowed near 100% FDI with government approval route beyond 49%.

In order to clear the ambiguities, there have been several clarifications, press notes etc. issued by the Ministry of Finance - Department of Industrial Policy & Promotion ("DIPP"). This further clarifies governments stand on certain contentious issues and eases the process and brings clarity for foreign investor to invest into the country.

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

In January 2014, SEBI (Foreign Portfolio Investors) Regulations, 2014 ("FPI Regulations") were notified which replaced the erstwhile SEBI (Foreign Institutional Investor) Regulations, 1995 ("FII Regulations") and the Qualified Foreign Investors (QFI) framework. The FPI Regulations aims at rationalizing 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 DIPP has allowed composite foreign investment caps by merging the FDI and FPI caps in



most of all sectors except for certain select sectors. The move is likely to benefit companies in various sectors.

Changes impacting the Fund Industry:

Fund industry in past few years has become a key pioneers to supplement the capital needs for various sectors in India. Recently foreign entities have been permitted to invest in Alternative Investment Funds (AIFs) to attract more overseas money into the country; this is a very positive move for the fund industry. Based on the quarterly / monthly information submitted with SEBI, total commitments of Rs. 38,879 Crores have been raised as on 31 March 2016.

Similarly, foreign investment is also permitted in Real Estate Investment Trusts, ('REITs') and Infrastructure Investment Trusts (InvITs), the regulations for which were recently introduced by SEBI in 2014.

FDI flows[1]

Total FDI into India, since April, 2000 including equity inflows, reinvested earnings and other capital stands at US$ 408.68 billion (April, 2000 - December, 2015). During the calendar year 2015, FDI equity inflows of US $ 39.33 billion have been received. This represents increase of 37% over the FDI equity inflows of US $ 28.78 billion received during the corresponding period.

The FDI equity during the current financial year 2015-16 (up to December, 2015) surged by 40% to US$ 29.44 billion from US $ 21.04 billion in the year-ago period. During the 19-month tenure of present government, i.e. June, 2014 to December, 2015, FDI equity inflow recorded a growth of 48% from US $ 37.24 billion to US$ 55.06 billion over the preceding period of 19 months (November, 2012 to May, 2014).

It is clearly evident that there is a constant push by the Government and rising trend in the FDI inflows into the country.

Ease of Doing Business & Make in India initiative

Government has been constantly making endeavor to improve the efficiency and ease with which the foreign players make investments in India for eg. opening up of the sectors (discussed above), creating transparency in tax laws, and efficiency in the administrative infrastructure etc. Continuous efforts are made to improve the ease of doing business in India. The World Bank's Doing Business Report, 2016, has ranked India at 130 from a total of 184 countries.

Separately, Make in India program was launched by the Hon'ble Prime Minister in September 2014 as part of a wider set of nation-building initiatives. In order to further the growth momentum, make in India program was devised to transform India into a global design and manufacturing hub. As per the information available on the website of Make in India[2], program is intended to (a) inspire confidence in India's capabilities amongst potential partners abroad, the Indian business community and citizens at large; (b) provide a framework for a vast amount of technical information on 25 industry sectors; and (c) reach out to a vast local and global audience via social media and constantly keep them updated about opportunities, reforms, etc.

Make in India along with the ease of doing business in India initiatives will clearly create confidence and a seamless architecture for making India investments and increasing the foreign capital in the country.

Key Challenges ahead

As India continues to progress, there are a few challenges that the global geopolitical and financial environment poses for the future. While the world is

[1] Annual Report 2015-16 Government of India, Ministry of Commerce and Industry, DIPP
[2] http://www.makeinindia.com/

still recovering from the aftermath of the global financial crisis of 2008-09, in a very short span of time we have witnessed a concern over the global growth resulting from the falling oil prices, slow down in Chinese economy, the exit of Britain from European Union etc. There needs to be a focused improvement including for some of the following areas which may pose some challenges to the FDI climate in near future:

- Simplified tax architecture, to provide certainty, stability and transparency in existing tax regime.
- Effective implementation of Goods & Service Tax (GST) law will be imperative to further confidence amongst investor community
- Keeping inflation under check and control over interest rates;
- Strengthening the Infrastructure (ports, roads, education etc.) and removing bottlenecks for achieving ease of doing business in India;
- Creating stable market conditions;
- Strengthening the Capital Markets and deepening of Bond Markets;
- Reforms in the labor laws;
- Making India as manufacturing hub in long term
- Removing red-tapism

Conclusion

We have come a very long way from more capital restrictive policies pre 1990s to almost near capital free economy in the year 2016. The continuous opening up of various sectors by allowing foreign capital participation has been beneficial to the economy. Currently the SEBI, RBI and the Government of India is doing well on this path to transformation and coming up with the relevant guidelines and regulations well in time. Government and regulators' endeavor should be to create a simplified, clear and transparent tax and regulatory architecture which is free from ambiguities and creates confidence amongst investor community which will further FDI flows into the country. While we have achieved a lot in past few years and are on the right track to achieve the desired results, there is a long way to go on this path of transformation to achieve the desired growth and potential.

Financing India's Infrastructure Spending

***R Govindan**, Vice President – Corporate Finance & Risk Management, Larsen & Toubro Ltd.*

Successive governments in India have focused on economic growth to help in job creation, sustain poverty reduction and maintain socio-political stability. Lack of proper infrastructure is a drag on economic growth as it poses a major hurdle for doing business in India. The current government therefore lays a lot of importance to infrastructure development and has set ambitious targets in critical areas. Some of the major investment areas are as follows:

Roads - INR 16.7 trillion (~11% of GDP) over the next 5-year period FY17-21 on road construction of 50,000 km. The government is targeting construction of 15,000 km of roads (8,000 km by NHAI) and award contracts for construction of 25,000 km of roads in FY17 (15,000 km by NHAI), which will require INR 1,400 billion in funding in the current fiscal.

Renewable Energy - INR 10.6 trillion (~7% of GDP) to be spent over the next 7-year period for achieving clean energy generation capacity to 175GW (100GW of solar) by 2022.

Railways - INR 8.6 trillion (~5.7% of GDP) over the 5-year period FY16-FY20. The focus will be on new DFCs (investment of INR 2,250 billion for 3 new DFCs in next 8 years), station developments, railway electrification and other marquee projects like Mumbai - Ahmedabad bullet train with an estimated cost of INR 980 billion.

Nuclear Power – Plan to augment the generation capacity by threefold over next 8-10 years from the current capacity of 5,780MWe. Upcoming projects, 2x1000MWe at Kudankulam, 6X1650MWe in Maharashtra, 6x1100MWe units in Andhra Pradesh and 6X1000MWe in West Bengal will require investments of INR 6 trillion.

Power Transmission - CEA estimated spending of INR 2.6 trillion during the period FY18-22 for expansion and improvement in India's transmission infrastructure.



Other important projects for ports, inland waterways, Ganga river development and Smart Cities / AMRUT (Atal Mission for Rejuvenation and Urban Transformation) are expected to require investment of INR 4.2 trillion.

In all, the above mentioned projects translate into an overall financing requirement of INR 48.7 trillion. Historically, the majority of the funding for public infrastructure has been dependent on budgetary allocations. Although, recent budgets have continued to have a high allocation towards infrastructure spending, it is not enough for meeting the ambitious government targets. The total capital expenditure outlay for infrastructure in the FY16-17 budget is INR 2.22 trillion, which is less than 5% of the total requirement. Even after factoring in the phased development of these projects the current year budget allocation is not adequate to sustain the infrastructure spending requirement. Thus, the gap needs to be financed either through private capital or from foreign sources.

Private Investment in Infrastructure PPP is Declining

The government introduced Public Private Partnership (PPP) for infrastructure financing in 1997. Funding through the PPP route has grown significantly until a few years back (2014). The 12th

Plan (FY12-17) envisaged ~50% of the total infrastructure funding requirement to come from the private sector (up from ~40% during the 11th Plan). However, PPP funding in the infrastructure sector has declined in the last couple of years given the lack of interest from private infrastructure companies. For example, NHAI projects awarded through build-operate-transfer (BOT) mode declined from an average of 95% (based on length) during the period FY2007-13 to as low as 20% during the period FY2014-16.

Aggressive bidding in the past followed by cost and schedule overrun, regulatory issues (like delay in approval/clearances by authorities, acquisition of land, long drawn out dispute resolution), funding issues (inability or limited ability to raise equity for BOT projects) has negatively impacted the profitability and economic viability of many infrastructure projects done under PPP mode.

Currently, most of the infrastructure companies which focused on BOT in the past are struggling with high leverage and lack the willingness and/or ability to invest in new PPP projects. Hence, most large infrastructure companies are shifting their focus back from the PPP model to EPC as they try to monetize their existing assets, sell stakes in subsidiaries and raise equity to improve liquidity and capital structure.

Banks Under Stress - Credit to Infrastructure Sector is Declining

Asset quality of Indian banks has been getting worse for the last 7 years which saw Gross NPA ratio increasing from 2.5% in FY2009 to around 7.5% in

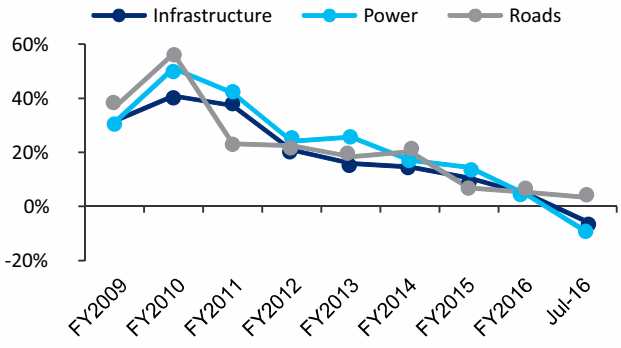


FY2016. There has been a sharp increase in stressed loans in the infrastructure sector in the last few years. As per ICRA, the gross NPA ratio for the infrastructure sector increased sharply to 7.3% in Mar-2016 from 4.1% in Sep-2015, 3.0% in Dec-2014, and 2.3% in March-2014. The transport segment has the highest stressed advances ratio, followed by the power sector.

These factors have led to a decline in credit growth to the infrastructure sector from a peak growth of ~41% in FY2010 to ~4% in FY2016. The bank credit outstanding to infrastructure sector as of July 2016 stands at INR 9.1 trillion, down from ~INR 9.6trillion as of March 2016 i.e. a decline of ~6%. Banks have been reluctant to lend to the infrastructure sector and are also demanding higher equity contribution in infrastructure projects.

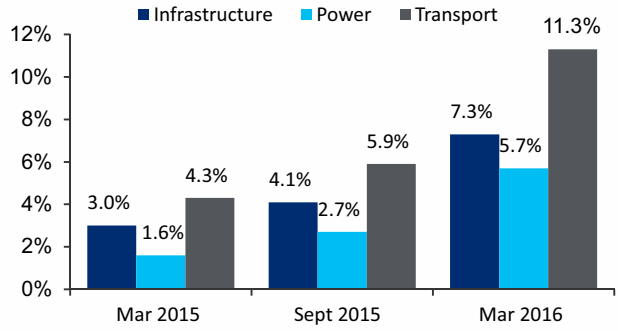
Credit from banks have been the major source of debt to infrastructure projects and constitute around 57% of total credit (banks + NBFCs) to the infrastructure sector. Given the poor capitalization and asset quality, their capacity to continue to provide funds to meet the growing requirement of the infrastructure sector is constrained.

Fig 1. Decline in Infrastructure Credit (Change in %)



Source: RBI

Fig 2. Increase in NPA in Infra structure (GNPA Ratio)



Source: RBI, ICRA

Initiatives taken by the Government

In order to improve the capitalization of PSU banks, the Government has planned to inject INR 700 billion (~USD 10.5 billion) of capital over a period of 4 years from FY16 to FY19, out of which INR 250 billion was injected last year while another INR 229 billion is planned for this fiscal year. However, ratings agency, Fitch, estimates that $90 billion in capital will be needed for Indian banks to meet Basel III banking rules by FY2019. This still does not provide the required growth capital for banks to support the growth of large corporate groups which may aspire to grow at 10-15%.

In addition, the Government has taken many other steps in the right direction. Apart from increasing allocation to the infrastructure sector in this year's budget, key policy decisions were taken to address the problems in this sector and to attract much needed private investments back to the infrastructure sector. Some of the key steps taken are:

- ECB Policy - RBI allowed all companies engaged in the infrastructure sector to raise external commercial borrowings (ECBs) up to US$ 750 mm with a minimum maturity of at least 10 years or at least 5 years subject to a 100% hedging.
- InvIT - The Government has offered tax incentives to InvITs by extending the pass through status to income earned by the InvIT from investment in infrastructure SPVs. It also rationalized the capital gains applicable for sponsors by providing an exemption from long term capital gains on the InvIT units received in lieu of shares of Special Purpose Vehicles (SPV). Tax on distribution of dividends from the SPV to the InvIT has also been exempted. Relaxation of SEBI's promoter lock-in requirement from 25% of the value of the InvIT to 10% is also expected soon.
- Hybrid Annuity Model (HAM) for construction of roads has been promulgated wherein NHAI finances up to 40% of the project cost. In addition, the NHAI supports payment of bank rate + 3% margin on the remaining 60% of the project cost. However, financial closure remains difficult as of now, given bank's reluctance to extend financing given the low equity contribution from the promoter (25-30% of 60%). Although, NHAI has started awarding contracts under HAM mode since Jan 2016, only recently (Sept 2016), the first part of Delhi - Meerut highway achieved financial closure, the first scheme under the HAM model to achieve the financial closure.
- The Government has also taken steps such as a one-time fund infusion into projects that are at least 50% complete, allowed 100% equity divestments two years after construction of PPP highway projects, rationalisation of compensation to concessionaires in case delays not attributable to them, and allowing securitisation of future cash flows.
- Dispute Resolution / Arbitration Measure - Pending claims from Government agencies is one of the major hurdles faced by construction companies with around INR 700 billion tied up in arbitration. According to the new rule approved by Government, 75% of the arbitration award money will be released to the contractor even though the Government agency may have challenged the arbitral award in higher courts. Also, the pending disputes will be shifted to the new, faster arbitration process which has been put in place. This is expected to help construction companies to reduce their leverage / service their debt and complete stranded projects.



- In order to promote the faster restructuring of stressed assets, including those in the infrastructure sector, the RBI is providing incentives to banks in the form of exemption from CRR/SLR for long term bonds raised to lend to infrastructure sector, flexibility in refinancing norms for infrastructure projects by way of 5/25 structure, SDR and S4A schemes. However, the track record of restructuring of assets under these new schemes is so far not visible.
- The RBI has also relaxed the guidelines for partial credit enhancement wherein the bond issued by a company can be supported up to 50% through credit enhancement from the banking system (subject to a maximum exposure of 20% of each institution). Earlier the limit for aggregate exposure was 20%.

Further steps required

While the Government and institutions like RBI and SEBI have clearly taken a number of steps to resolve the pending issues in the infrastructure sector, a fair amount of work is still required in order to facilitate the financing required for infrastructure investments in India.

- In order to de-risk the banking sector from corporate loan exposures, RBI is considering capping bank's total exposure to a single corporate entity at 20% of its Tier-I capital, and for a group of connected companies at 25% of Tier 1 capital, from the current limit of 40%. Putting such constraints on bank lending to corporates will further constrain the availability of funds for the infrastructure sector, especially in relation to the large projects which are expected to come up for execution. The proposed exposure limits must exclude non-recourse lending to infrastructure companies.
- Certain tax disadvantages still continue to prevail in the current structure of InvITs that can dampen the returns on InvITs. Given that the profit arising on exchange of shares of the SPV in lieu of units of InvITs is notional in nature, the presence of MAT is a deterrent for sponsors. Deferral of the tax liability to the time of the eventual sale of the units is a positive step and is expected to give a boost to InvITs. However the tax exemption to sponsor has been provided only in case of transfer of shares in the SPV in lieu of InvIT units. The direct transfer of assets by the sponsor to the InvIT would continue to be taxed. In addition, there is withholding tax of 10% on domestic investors and 5% on foreign investors on the interest income which is paid by the InvIT to the unitholders.
- Infrastructure debt funds (IDFs), seen as an alternative to bank loans for long-term projects, have remained a little-tapped source since starting up in 2013. IDFs were envisaged to allow banks to refinance their infrastructure books and free them up for lending but that has not really happened. The funds can take over debt provided projects have completed at least one year of satisfactory commercial operation. But banks have been reluctant on relinquishing the few good performing projects when credit growth is slow. In case of projects which are not doing well, there is a difference in valuation expectations between the buyers and sellers. Thus, IDFs needs to be positioned to take over the debt of stalled projects (clearances and litigations). In this regard, a Government-backed IDF may have to be conceptualized in order to make these vehicles more popular among investors.
- Government projects require the contractor to provide performance bank guarantees in order to secure performance of the assets after completion. Given the expected size and tenor of some of the



large future projects, the requirement for performance BGs will go up significantly. Performance guarantees are currently issued by banks, and this requires the banks to set aside capital for these assets. On the other hand, the risk of invocation of performance BGs is generally linked to the performance track record of the contractor, which even other institutions such as NBFCs and insurance companies can also assess. The Government, along with RBI and IRDA should allow NBFCs and insurance companies to issue surety bonds and guarantees, in order to allow banks to release capital blocked for other project financing requirements of corporates.

- Bond investors normally desire at least an AA rating on bonds for considering investments into such instruments. While RBI has relaxed the guidelines on Partial Credit enhancements (PCE) of INR bonds issued by infrastructure companies, sometimes the PCE may be inadequate to attract investor appetite for bonds issued by infrastructure companies. The Government needs to consider providing adequate risk cover for infrastructure projects in case of inadequacy of toll collection below minimum thresholds and/or the takeover of



stalled projects so that the lenders continue to be assured of timely payments. One of the moves in this direction is embedded in the Hybrid Annuity Model of the NHAI. But, in the HAM model the return provided for the promoter is bank rate + 3% only. At this rate, it is not adequate to meet the cost of equity thresholds for most of the promoters. Such models need to ensure reasonable rates of returns for all stakeholders involved in order to make it a success.

Gold Monetisation Scheme: Challenges and Solution

***Samir Shah**, Co Chairman, FICCI Commodities Working Group and MD & CEO, NCDEX Ltd*

INTRODUCTION

The Gold Monetisation Scheme (GMS) was launched on November 5, 2015, with a view to reduce reliance on imports, meet the domestic demand for gold in physical form and bring out the idle gold in the country for productive use. The scheme, one year from its launch, is yet to gain the desired momentum.

For an economy as large and diverse as India with about 22,000 tonnes of domestic gold holding, the current approach of monetisation by notification of a process through CPTCs, refineries and gold account deposit types might not be sufficient. A much more wholesome approach which addresses all relevant aspects is required.

'Monetisation' of any asset class which is held as 'investment' fundamentally intends to put the asset to 'economic use'. In the specific case of gold, monetisation has to target and approach all forms of gold under investment i.e. past investments and future investments. In addition, the economic use should not be limited to gold savings accounts with banks, rather all possible economic uses should be targeted.

The process of monetisation of gold essentially, involves two steps viz. 'conversion' of household gold holding to standardised form of gold and 'utilization' of the gold when it enters the economy for use.

The conversion of household to standardised form of gold is an indispensable prerequisite to the process. This is so because the gold so collected has to be benchmark-able against commonly accepted standards to transparently derive its optimum value.

In simple terms, the gold collected from households must be converted to a form where it becomes freely tradable at transparent benchmark prices. The economic use of gold can encompass any model wherein either 'the gold' or 'the monetary value of the gold' can enter the economic cycle.

NCDEX - CREATING A WORLD CLASS GOLD ECOSYSTEM

India Gold Standards of NCDEX

Turkey is a very relevant and important example when gold monetization is discussed. Among others, one of the main reasons for success of gold monetization in Turkey is the availability of widely accepted standardized certification of gold. Turkey is one of only a dozen countries which have more than one LBMA-accredited gold refiner. Coincidentally (or by intent and design), two of the refineries were listed in December 2011 and the other in May 2010.

Standardization of domestically refined gold and



hence its wide-scale acceptability is a prerequisite to any such large scale initiatives in the sector of gold. Turkey being a small country, one fifth the size of India and having about a seventeenth part of India's population, had three standardized and accredited refineries. By those standards India has to develop at least 50 such refineries. With all its consumption prowess, till date, India only has one LBMA approved refinery which got accredited in 2013. Achieving 50 is a far cry. For aggressive expansion and fitting her size, India needs to have its own world class standard for gold.

NCDEX has already initiated this objective.

India is one of the largest consumers of gold globally to the tune of 1000 tonnes every year. A very large chunk is fulfilled by standard gold bars produced and refined overseas. In comparison, Indian refiners of gold produce a negligible quantity. However, in the recent past because of certain policy initiatives encouraging domestic refining, production of refined gold bars in India has seen a steady increase. Though, Indian production of refined gold bars was on the uptick, yet the acceptability and use of the Indian refined bars was very limited. This happened because of the absence of any standardization and quality accreditation machinery in India. On top of this, the global standards for refining that are available had requirements pertaining to age and turnover of the facility, thereby making the nascent Indian refining sector ineligible.

Hence, the complete industry suffered from this catch-22 situation whereby the overall growth of the industry and the market suffered. To break this logjam NCDEX pioneered the India Gold good delivery standards.

Aligned with the "Make in India" campaign of the government, NCDEX is creating an ecosystem that is at par with international standards for the Indian bullion and jewelry industry.

NCDEX endeavors to bring a world-class experience to gold refined in India with standards that are aligned to the best in the world. NCDEX has followed a rigorous and well defined process for accreditation of



refineries and the India Gold Good Delivery Standards.

Refinery Selection was based on

- Technical Due Diligence
- Financial Due Diligence
- Customer Due Diligence

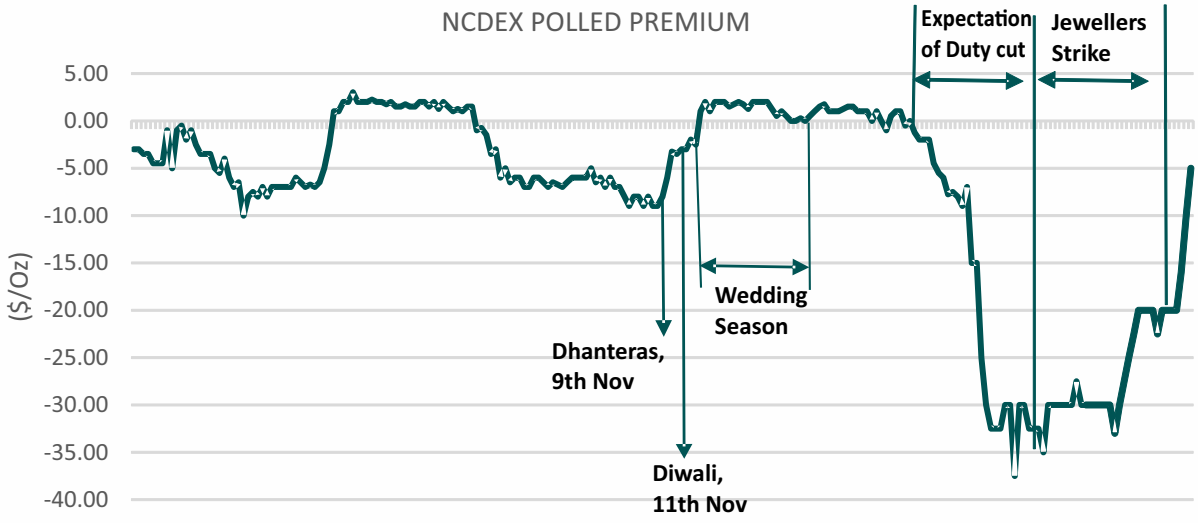
The exchange engaged the services of Alex Stewart (one of the leading independent inspection and metal assayers in the world, acknowledged and accredited by reputable and well known institutions such as LBMA, etc.) to conduct an extensive due diligence of the refiners along with SC Saha, & MP Chitale & Co.

Creating India's own Price Benchmark - NCDEX Gold Premium

NCDEX introduced the premium polling mechanism with the launch of its Gold Deliverable contract on 21st May, 2015, giving an independent gold premium that gave the Indian market an unbiased price benchmark for the first time.

Consumers, jewellers, traders, and gold refiners get a scientific and rigorous assessment of the daily premium for gold prevailing in the physical market to derive the final wholesale price.

NCDEX-polled Gold premium connects the prevailing international price for gold with the wholesale value of gold kilobars in India. This



premium - sometimes a discount - reflects the logistical cost and market fundamentals affecting gold in India.

The daily value of the premium or discount, in US dollars per troy ounce, is based on an independent third party unbiased survey of traders and dealers in various Indian cities for a kilobar of fine gold quality 995, available in Ahmedabad.

The introduction of the NCDEX Gold Premium is the first step towards shifting price discovery from London to India. As one of top 2 consumers of gold globally, India must make efforts to shift price discovery to India.

Futures Trading of India Good Delivery bars

The final step in creating a 'Made in India Gold' ecosystem to create a trusted marketplace. Combined with the NCDEX India Good Delivery Gold Refineries and the NCDEX Gold Premium, NCDEX will launch futures contracts on Gold based only on India Good Delivery refineries. This will enable true price discovery and risk management of 'Made in India' gold and provide a robust market backbone for the Gold Monetisation Scheme of Government of India.



ENHANCEMENTS IN THE CURRENT COLLECTION INFRASTRUCTURE OF GMS

One of the major sore points has been the authorisation of CPTCs (collection and purity testing centres) to collect deposits of gold on behalf of banks. Most CPTCs are small establishments and do not have robust credentials in terms of constitution, organization structure, networth and accounting practices. Hence they seem to lack the credibility required to handle gold on behalf of banks. Their limited financial capacity and modest offices might not generate enough trust within banks on one hand and depositors on the other.

Additionally, inadequate recourse mechanism in case of any malpractices by CPTCs can expose banks to major risks since banks would bear the ultimate liability of the deposited asset. Also, banks have to enter into detailed arrangements with individual CPTCs which adds on to administrative and other

overheads. In addition, the three different entities / nodes in the current system i.e. CPTCs, refineries and banks (which together form the collection 'system') make the process prone to disputes. While the issue has been moderated to some extent by allowing depositors (RBI's circular dated 21 Jan 2016), at the bank's discretion, to deposit gold directly with refiners, it has further reduced the network and reach of the GMS system considerably. There are only eight refineries licensed to operate currently, with most of them in industrial areas / zones far away from easy public reach.

NCDEX plans to employ its experience and assets to overcome some of the shortcomings in the GMS highlighted earlier. NCDEX endeavours to iron out both the sore points in the current scheme i.e. the multiple nodes as well as lack of credibility of the nodes. NCDEX has its empaneled warehouse service providers (WSPs) who store and manage deliveries of the exchange traded commodities. These WSPs shall take overall 'Single Node' responsibility of the gold collection process. WSPs of NCDEX (unlike the CPTCs and refineries) are regulated entities with credible corporate structures and healthy financials. The WSPs are continually monitored and are subject to checks through various audits and inspections.

The WSPs will set up purity testing centres (PTCs), which shall be the collection points for gold. Existing CPTCs can also enrol as PTCs with the WSPs.

Secondly, involvement of diverse players such as banks, CPTCs, refiners, depositors in the gold monetisation process requires seamless tracking of the flow of gold. A complete back-to-back linkage will be required across all the entities involved in the deposit processing chain. For this purpose each entity in the chain including banks, refiners, CPTCs will be required to develop their own software systems. This will not only be time consuming and expensive but will also lead to duplication of effort and resources. The gold deposit process will have large cost overheads as a result leading to shrinking operating margins for CPTCs, refiners and banks. Lack of a uniform data processing system, on the other hand, across the deposit processing chain will make it difficult to access information quickly when required by regulators and the government.

CONCLUSION

A robust, regulated and transparent marketplace for 'Made in India' Gold opens up multiple possibilities of utilization. Gold deposits offered by banks are just one of the many options. Infact, the government should encourage citizens to start dematerialising their gold holdings. This will be a very critical and important behavioural change for Indians. Once 'Made in India' gold holdings move from a physical to a demat form multiple avenues for deployment will open up and, lo and behold, monetisation of gold holdings would have been achieved!



Disinvestment for a Cause
Long Term Strategic Planning Critical for Aligning Stakeholders Interests

Rakesh Valecha, *Senior Director & Head, Credit & Market Research India Ratings & Research*
Soumyajit Niyogi*, Associate Director – Credit and Market Research, India Ratings & Research*

Segregation on Economic Fundamentals: India Ratings and Research (Ind-Ra) believes that to harmonise government and public interest for disinvestment requires an approach focussed purely on business and economic rationale. This entails a long term strategic plan for public assets and also requires moving away from the short term goals linked to the fiscal arithmetic. For example, not all entities with relatively weak financial and performance indicators may be ideal candidates for disinvestment and similarly, not all profitable and performing entities necessitate the Government to hold a controlling stake.

Competitive Industries Require Limited GoI Participation: In our view, sectors which are competitive and have a reasonable private sector presence with market dynamics determining the success and failure of entities, may not necessarily be ideal for public sector undertakings (PSUs) to operate in. Ind-Ra's study of the financials of most competitive industries, indicate that PSU margins and asset turnover ratios tend to be lower than those in the private sector (Figure 2). The data indicates that while PSUs may remain profitable over their life cycle, the efficiencies can be improved through private sector participation.

Energy Security, Defence and Inclusive Growth Targets Necessitate PSU Presence: India's endeavour to achieve a high rate of growth on a sustainable basis, notwithstanding the recent slowdown in global growth requires self-sufficiency in terms of energy. The availability of energy in relation to adequate quantity and good quality-will be a pre-requisite to sustain targeted levels of economic growth and the desired levels and spread of social development. The energy scenario in India has improved but continues to pose challenges for the future, especially in catering to the unaddressed parts of the market. Hence entities related to oil distribution and rural electrification could remain under the PSU umbrella, till it reaches a critical stage when it can look to attract private sector investments. Also investments in defence related activities, where security issues tend to be paramount may necessitate greater PSU participation and control.

Fiscal Arithmetic: Disinvestment has consistently been viewed as a source of resource mobilisation to bridge the fiscal deficit, both in developing and developed economies. The focus has increased during periods of fiscal stress emanating from anaemic growth, especially post the global financial crisis. The need to rein in the fiscal deficits and increase in government spending as a counter cyclical measure



has brought about a greater focus on disinvestment. Starting from 1991 till 2015, the Government of India (GoI) has raised around INR15 trn by disinvestments with an average yearly contribution of 0.2%-0.5% of GDP to total revenues. The objective of disinvestment was articulated in the 1991 Budget speech- "In order to raise resources, encourage wider public participation and promote greater accountability, up to 20% of government equity in selected public sector undertakings would be offered to mutual funds and investment institutions in the public sector, as also to workers in these firms". As long as the focus remains on achieving the fiscal maths, the realised value of some of these assets may or may not be equal to the potential value.

Class Action Laws Provide a Cushion to Manage Objectives: Class action laws are a tool for minority shareholders. Class action has been empowered in the companies Act 2013 Section 245, in concurrence with the establishment of the National Company Law Tribunal (NCLT). The class action will effectively ensure minority shareholder's interest remains protected. This, in our view, provides a strong option for GoI to ensure compliance with the stated social objectives even post the disinvestment of PSUs.

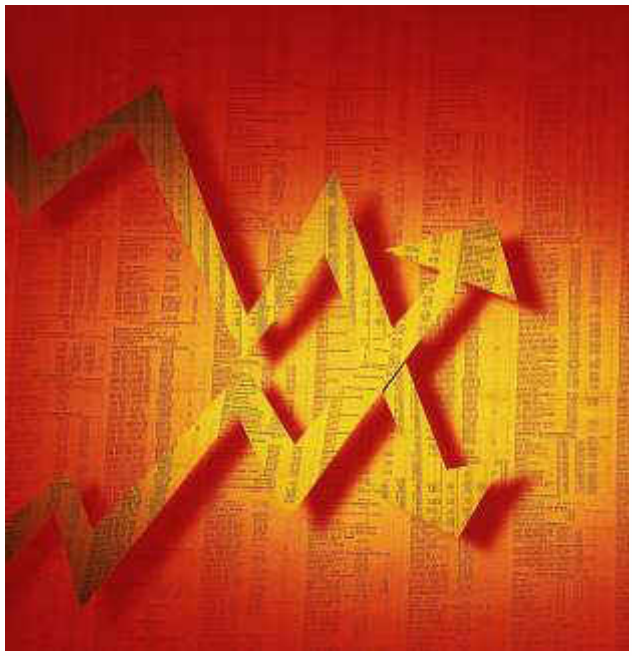


Figure 1

Types of Government Influence

Influence	Effect	Reasoning
Pragmatic	Better government	Prudent privatisation leads to more cost effective public services.
Economic	Less dependence on government	Growing affluence allows more people to provide for their own needs, making them more receptive to privatisation.
Ideological	Less government	Government is too big, too powerful, and too intrusive in people's lives and therefore is a danger to democracy. Free market decision optimises proper resource utilisation.
Commercial	More business opportunities	Government spending is a large part of the economy; and should be restricted. Government should encourage development of private sector with proper ring fence.
Populist	Better society	People should have more choice in public services. They should be empowered to define and address common needs, and to establish a sense of community by relying more on overall long term policy.

Source: Savas 2000 And Ind-Ra Research

The table below provides a framework for identifying which of the industries are amenable to what form of disinvestments. It also provides a comparison of the financial indicators of PSUs with those in the private sector.

Figure 2

Qualitative and Financial Comparison Between Public and Private Entities

		Industry competitiveness	Energy security	Sociological requirements	Capital requirements	Median EBITDA margin (%)		Median FA turnover	
						Public	Private	Public	Private
Public offering of shares	Agri	Moderate	Moderate	Moderate	Moderate	1.59	4.51	3.09	6.60
	Aviation	High	Moderate	Moderate	High	12.37	-3.66	0.58	3.09
	Oil & Gas	High	High	High	Moderate	3.52	10.02	1.72	2.84
	Power	Moderate	Moderate	High	High	0.00	14.78	-	0.89
	Ship Building	High	Low	Low	High	0.37	-6.48	5.19	0.36
Strategic sale	Automobile & Ancillaries	High	Low	Low	Low	-2.17	8.60	11.62	4.23
	Capital Goods	High	Low	Low	Low	1.51	8.55	6.67	5.44
	Chemicals	High	Low	Low	Low	0.00	9.22	1.59	4.01
	Construction Materials	High	Low	Low	Low	-14.99	11.48	1.78	1.25
	Consumer Durables	High	Low	Low	Low	-766.95	11.48	0.56	14.77
	Diversified	High	Low	Low	Low	7.42	8.51	4.42	3.14
	Electricals	High	Low	Low	Low	-5.96	8.27	3.87	7.60
	FMCG	High	Low	Low	Low	9.82	7.32	0.74	7.54
	Hospitality	High	Low	Low	Low	2.66	11.23	2.66	2.05
	Iron & Steel	High	Low	Low	Moderate	7.71	5.96	0.78	3.40
	IT	High	Low	Low	Low	-0.34	16.33	17.05	9.12
	Logistics	Moderate	Low	Moderate	Moderate	17.00	8.57	0.44	3.35
	Media & Entertainment	High	Low	Low	Low	2.87	15.42	5.14	2.84
	Mining	Moderate	High	Low	Low	19.76	34.68	3.44	2.44
	Non - Ferrous Metals	High	Low	Low	Low	25.29	8.59	1.28	7.14
	Paper	High	Low	Low	Low	-62.88	12.56	2.56	1.24
	Photographic Product	High	Low	Low	Low				
	Realty	High	Low	Low	Low	-0.61	15.45	74.99	4.07
	Telecom	High	Moderate	Moderate	High	-5.23	13.49	0.41	1.72
	Textile	High	Low	Low	Low	-6.05	9.84	3.24	3.08
Leases or management contracts	Mining	Moderate	High	Moderate	Moderate	19.76	34.68	3.44	2.44

Source: Ind-Ra's Analysis, Ace Equity

Framework for Divestment

Ind-Ra believes that the following framework could provide useful inputs in deciding which sectors are more amenable to disinvestment and what could potentially be the forms of disinvestment used:

Industry Competitiveness:

- ✓ An existing industry with reasonable number of companies does not necessitate Government presence as another entity
- ✓ Government support is necessary during the early phase of developing a capital intensive sector, but not mandatory once it achieves a high growth momentum or reaches the maturity stage

Energy Security:

- ✓ Critical resources which require seamless operation under normal as well as adverse conditions (war, natural calamity, adverse economic condition etc).
- ✓ Ensuring non-disruptive supply

Social Requirements:

- ✓ Basic requirements like railway, transportation, medical facility (vaccination, basic lifesaving drugs)
- ✓ Harmonisation of services across the section of people

Capital Requirements

- ✓ Highly capital intensive (thermal power, distribution of power in the initial stages)

- ✓ Heavy defence equipment

Depending on the category in the identified framework, one of the following dis-investment processes could be followed:

- ✓ **Public Offering of Shares**

Under this method, the government sells to the general public all, or a large block, of the shares it holds, in a wholly or partly owned PSU. This is basically a secondary distribution of shares; when a government decides to sell only a portion of its holdings, the result is joint state/private ownership of the enterprise. The main advantage of public offering is that they permit widespread shareholding; in generally this is politically more palatable

- ✓ **Strategic Disinvestment**

Under this method, the government sells all or part of its shareholding in a wholly or partly owned PSU to a pre-identified single acquirer or group of acquirers. The transaction can take various forms, such as a direct acquisition by another corporate entity or a private placement targeting a specific group, for example institutional investors. The privatisation can be full or partial, with the latter resulting in mixed ownership enterprises. A private sale of shares may also be carried out before or sometimes simultaneously with, a public offering. Disadvantage of any private sale is that it may give rise to criticism relating to the selection of the acquiring party, particularly in case a large number of transactions are concluded, giving rise to the inadequate spread of wealth in the country.

- ✓ **Strategic Disinvestment in Critical Assets:**

The common argument against strategic disinvestment is impingement of security aspects and compromise of social aspects. Another argument against privatisation is that it would create private monopolies or improper competition, but actually monopolies arise out of protection. The perception is that public monopoly will not engender super profit ignoring socio economic aspects. But at the same time public monopoly can also produce inferior value propositions by offering mediocre products/services as compared to the price levels.



By enlarging the base of popular participation in the disinvestment process, the government can also ensure that a significant segment of the population will benefit from the disinvestment. Even for those who stay outside the privatisation process, they will reap the benefit of enhanced productivity of the economy consequent to the transfer of production assets to superior management and better government focus on the essential functions of governance.

- ✓ **Sale of Government or Enterprises Assets**

Under the previous two methods of privatisation, the private sector purchases shares in a PSU that was a going concern. Here the transaction consists basically of the sale of assets, rather than shares in a going concern. The government may sell the assets directly; the PSU may dispose of major of the assets. Generally, while the purpose may be to sell off separate assets representing distinct activities, the sale of separate assets may be a means of selling the enterprise as a whole. Thus, the assets may be sold individually or be sold together as a new corporate entity.

In some cases, assets are not technically sold, but are contributed by the government to a new company formed with the private sector. In addition, it offers additional flexibility in that it may be more feasible to sell individual assets rather than the whole PSU, or it may permit the sale of a state-owned enterprise that might be borne in mind; however, often this approach can result in residual liabilities for the government.

- ✓ **Leases or Management Contracts**

Management contracts are a relevant means of partial or provisional transfer of operational ownership to managements with the superior

ability to manage businesses. This method encompasses enhancement of productivity without losing any ownership control. Moreover, under a management contract the government may still need to inject funds. Both leases and management contracts are arrangements whereby private sector management, technology and/or skills are provided under a contract to a PSU for an agreed period and compensation. While there is normally no transfer of ownership and therefore no divestiture of state assets, these arrangements can be used to 'privatise' management and operations and thereby possibly increase the efficiency and effective use of state assets.

Meaning of Disinvestment

The term disinvestment is generally coined by the Government selling stake in public sector entities. This, in other sense, is the transfer of government ownership in public sector entities, which is also known as privatisation in case of the Government selling majority stake. In complete divestiture, publicly owned assets may be completely transferred by the sale to private individuals or firms, after which the government bears no further responsibility for the operation of the assets. Alternatively, in partial divestiture the state retains partial ownership of the divested assets by means of public stock flotation. The assets may also be removed from the direct control of the government by management contracting, which places the operations in the hands of an outside management group, while leaving ownership in the government's hands; its major purpose (as is the case with leasing or franchising) is to restore an ailing firm to profitability (Cowan, 1990).

The term 'privatisation' connotes a bounded sphere of activity; in general privatisation is a process that entails the transfer of ownership from the public to the private sector for the entity and its resources. The means of privatisation can range from replacing public ownership with private ownership, to the introduction of private management techniques into the public sector. The changes in ownership could be partial or full, which also determines control mechanisms.

The thrust for privatisation is to allocate resources more prudently, by way of running commercial intention rather than the government's approach to facilitation (Vickers & Yarrow 1985). The common belief is that privatisation brings about a reduction in costs and prices, improvement in services, increases efficiency and efficient resource allocation, and enhances competition.



The ratings above were solicited by, or on behalf of, the issuer, and therefore, India Ratings and Research has been compensated for the provision of the ratings.

Annual Information Memorandum - An Unfinished Agenda in the Indian Capital Markets

Sayantan Dutta, *Partner, Shardul Amarchand Mangaldas & Co*

The Indian economy is one of the fastest growing emerging economies of the world. It has experienced phenomenal growth in the last ten years and the Indian capital markets have been at the heart of this transformation. In these ten years, the Indian capital markets have witnessed a number of significant changes in the capital markets regulatory regime including the Companies Act, 1956 being replaced by a new Companies Act, 2013, the SEBI (Disclosure and Investor Protection) Guidelines, 1999 being replaced by the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 **("SEBI ICDR Regulations").** Even the accounting standards under which the financial statements are reported in the prospectuses are also going through a massive change - Indian GAAP paving the way for the new Ind-AS. The ASBA (Application Supported by Blocked Amount) process has also made the entire fund-raising process more efficient which has led to a significant reduction in the listing timelines. There has also been a continuous drive towards rationalisation of the disclosure norms by SEBI.

However, one important change that was first proposed by SEBI through amendments in the SEBI ICDR Regulations in October 2012 and subsequently through a Discussion Paper in February 2014, but yet to be implemented is annual updation of offer documents or issuance of Annual Information Memorandum by the listed companies.



What has been proposed by SEBI until now?

SEBI, pursuant to its notification dated October 12, 2012 through the SEBI (Issue of Capital and Disclosure Requirements) (Fourth Amendment) Regulations, 2012, included a provision for annual updation of offer document in the SEBI ICDR Regulations.

> ***"Annual Updation of Offer Document***
>
> ***51A.*** *The disclosures made in the red herring prospectus while making an initial public offer, shall be updated on an annual basis by the issuer and shall be made publicly accessible in the manner specified by the Board."*
>
> Additionally, pursuant to this amendment, SEBI had also inserted a proviso after clause (b) in Sub-Regulation (2) of Regulation 57 of the SEBI ICDR Regulations, namely -
>
> *"Provided that in case of further public offer or a rights issue, the offer document shall be deemed to be in compliance with the provisions of this regulation, if suitable references are made to the updated disclosures in the offer document referred to in regulation 51A of these regulations."*

Pursuant to these amendments, the updated offer document is required to be made publicly accessible in the manner to be specified by SEBI. Further, SEBI has allowed disclosures to be made in offer documents for further public offers or rights issues, by way of reference to disclosures included in the updated offer documents. Subsequently, SEBI had issued a discussion paper on 'Annual Information Memorandum' in February 2014 in which SEBI proposed a format for the Annual Information Memorandum while acknowledging the benefits of the annual updation of the offer documents. However, there has not been any further notification from SEBI on this and the annual updation of offer



document is still an unrealised dream in the Indian capital markets.

Why do we need annual updation of offer documents?

Filing of annual reports by companies is a common practice in many jurisdictions. In the United States of America, all listed companies are required to file an annual report either in the Form 10-K (for US companies) or in Form 20-F (for foreign private issuers), which are comprehensive summary of the company's performance, with the United States Securities and Exchange Commission, the securities market regulator of the United States. Similarly in the United Kingdom, an issuer which is incorporated and listed in the UK, must file and publish an annual report at the end of a financial year which should include annual audited accounts, a directors' remuneration report, a directors' report which includes a corporate governance statement, a business review and statements on a list of mandatory information including details of share capital and various other items.

Annual updation of offer documents provides a higher level of awareness about a listed company among the investors. Such annual disclosure will bring more transparency in the secondary market and will provide significantly improved and comprehensive information about listed companies to shareholders and investors. Additionally, inclusion of information through reference to updated offer documents, as envisaged by SEBI through these amendments and the discussion paper, will make further capital offerings by listed companies more efficient and less time-consuming. Since the proposal is to file such Annual Information Memorandum only electronically, SEBI has pointed out that this will lead to a substantial cost saving for the companies as some of the information (which will be included in the Annual Information Memorandum), will not be required to be repeated in the Annual Report resulting in decrease in the size of the Annual Reports.

The roadmap ahead for Annual Information Memorandum - What should be done next?

Given the size of the Indian capital markets and the increased fund raising activities experienced in recent past, implementation of the annual updation of the offer document or issuance of the Annual Information Memorandum is an immediate necessity. The discussion paper on Annual Information Memorandum did provide for a proposed roadmap - it was to be applicable to top 200 listed companies from April 1, 2014 and for all other listed companies from April 1, 2015 - which was never notified by SEBI.

While it is absolutely necessary to implement the updation of offer documents, we have to be careful about a few operational issues in order to ensure that the quality of the Annual Information Memorandum is not diluted and the standard of investor protection is not affected through this process.

Incorporation of information by reference:

Pursuant to the proviso to clause (b) in Sub-Regulation (2) of Regulation 57 of the SEBI ICDR Regulations, in case of further public offer or a rights issue, the relevant offer document shall be deemed to be in compliance with the provisions of Regulation 57 of the SEBI ICDR Regulations, if suitable references are made to the disclosures in the Annual Information Memorandum. While this proviso refers to further public offer and rights issue, it omits to mention that such disclosures in the Annual Information Memorandum may be used by reference in the placement documents for qualified institutions placement **("QIP")** under Chapter VIII of the SEBI ICDR Regulations or for institutional placement programme **("IPP")** under Chapter VIII-A of the SEBI ICDR Regulations. Incorporation of information by reference should be extended to QIPs and IPPs as these too are SEBI regulated offerings and the disclosure requirements in such capital offerings are

driven by the SEBI ICDR Regulations. This will ensure that listed companies provide more detailed information in their Annual Information Memorandum, since they are far more likely to raise further capital by means of a QIP than through a public offer or rights issue, once listed on the Indian stock exchanges.

Liability and certification:

The federal securities laws of the United States provides for the incorporation by reference of information contained in Form 10-K or Form 20-F. As these are included by reference in a prospectus, they carry anti-fraud liability. Similarly, incorporation of information by reference to an Annual Information Memorandum in India should carry similar liability as that of the prospectus under the Companies Act, 2013. Accordingly, it is imperative that the Annual Information Memorandum be signed by all the directors and the chief financial officer of the company and they should be liable for any material omission or any material misstatement made in the Annual Information Memorandum, reference to which has been made in an offer document for a further capital offering.

Further, the extent of liability that such Annual Information Memorandum would carry should be specified. Since this Annual Information Memorandum would be prepared by listed companies who already have an existing market for trading of their securities, it should be clarified whether such secondary market investments can be driven by disclosures made in the Annual Information Memorandum. Currently offer documents prepared for public offers carry liability only towards the primary market investors; however, whether such Annual Information Memorandum would carry liability towards secondary market investors should be clarified.



Related amendments in other legislations, regulations and rules:

Currently, there are certain continuous reporting requirements for listed companies under certain other legislations and regulations including the Companies Act, 2013 and the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 **("SEBI LODR Regulations")**. However, given that the listed companies would have to file an Annual Information Memorandum on an annual basis, certain provisions of the Companies Act, 2013 and the SEBI LODR Regulations would have to be modified. For example, (i) the liability of prospectuses under the Companies Act, 2013 should be extended to such Annual Information Memorandum; (ii) there is a need to harmonise the requirement of filing of the annual report with the respective Registrar of Companies under the Companies Act, 2013 and the Annual Information Memorandum with the stock exchanges and SEBI under the SEBI ICDR Regulations and the SEBI LODR Regulations. Considering a substantial part of the contents of these documents are same, suitable amendments to be made to avoid any repetition.

Implementation of the annual updation of the offer documents is not just a need of the hour for the large number of companies listed on the Indian stock exchanges, it also a regulatory necessity for the larger number of capital market investors and their right to quality information about the listed companies on an annual basis.

FDI and Investment Climate In India

***Varsha Purandare**, MD & CEO, SBI Capital Markets Ltd.*

''It is quite obvious that incremental change is not going to take us anywhere. We need to think in terms of a quantum jump"

- **Arun Jaitley** in his Budget Speech (2015)

India has come a long way since Mr Jaitley's speech in the Lok Sabha in February 2015 which marked the first fiscal budget under the Modi government. Macro indicators, which stagnated between 2010 and 2014, look much brighter now giving policy makers a reason to cheer. The economy grew at a robust rate of 7.6% in FY 16 as compared to an average of 6.5% during the preceding 3 years. The Government has met its target of containing the fiscal deficit to 3.9% of the GDP which is much lower than 4.1% and 4.7% registered in FY 15 and FY 14 respectively. CPI Inflation came down to 5% in August 2016 compared to 6.1% in July 2016. The common man heaved a sigh of relief with food- specifically vegetables- accounting for ~95% of the disinflation. Policy initiatives such as passing of the GST bill which replaced 17 indirect tax levies, UDAY for the revival of power distribution companies etc are being complemented by innovative schemes like Make in India, Startup India and Digital India. Improved economic indicators, stabilized exchange rates and controlled inflation seem to indicate an era of a business friendly, growth driven government.

With the slew of policy reforms and government initiatives, India looks poised to grow at a healthy pace over the next 3-5 years. However, the 'quantum jump' which Mr. Jaitley talked about is yet to arrive. Sure, our economic prospects look quite bright when compared to the rest of the world and even China, but no single indicator points at a quantum improvement in terms of performance- with the exception of FDI coming into the country.



At a time when investment flows are declining globally, India has emerged as magnet attracting investments from across the world. FDI from USA particularly, which stood at an unimpressive $806 million in FY 2014, has registered a stellar 500% jump in FY 2016 to reach $4.12 Billion. Total FDI coming into the country has also registered a massive 54% jump from $36 Billion in FY 2014 to $55.4 Billion in FY 2016.

FDI has been a crucial source of non-debt capital, particularly for emerging economies. A healthy investment climate is needed to sustain steady foreign capital inflow. But merely affirming the relationship between a good investment climate and increased FDI inflow is tautological. The accurate question to ask is what are the precise policy measures and government initiatives which have led to the investment climate turning upside down. The World Bank states that a few parameters are critical for an economy to attract global capital: political and economic stability, market size and growth prospects, predictability of

regulatory frameworks, infrastructure connectivity etc. As is evident from the spike in FDI coming into India, the Indian government has performed well on the aforementioned parameters and has managed to enthuse global investors about the vibrant Indian economy.

A Story Retold

The India story had been the darling of global investors before 2012. As things started looking downward post 2012, the India story lost some of its sheen to other emerging markets such as Vietnam, Indonesia, Philippines etc. However, the current government has done an admirable job at improving the state of the economy with a mix of public investments, policy initiatives and even improving our international relationships and trade ties.

In June this year, a series of reformatory steps were taken to liberalize additional sectors in the country for FDI. A number of sectors were opened up for foreign investors including Insurance, Civil Aviation, Pharmaceuticals, Broadcasting, Defence etc. The government has done a commendable job in the infrastructure space as well. In the absence of significant private investment, the government has accelerated efforts to boost government investment in the infrastructure sector. The awarding of national highway projects has risen to 10,000 km in FY 16 from 8,000 km and 3,500 km in FY 15 and FY 14 respectively. In mid-2014, the government announced a push for foreign investment into our railways, as part of its ambitious $128 Billion plan to modernize India's rail infrastructure which will include new tracks, 400 new stations, a $15 Billion bullet train service and a $12.5 Billion dedicated freight corridor. Efforts have also been made to make it easy for entrepreneurs to start, operate and shut down a business in India. The waiving off of paid-in minimum capital for starting a business and passing of the Bankruptcy Code this year for ensuring time-bound settlement of insolvency and



other concrete measures have helped India jump 16 places (the largest gain by any country) to occupy the 39th spot-on the WEF's Global Competitiveness Index in September 2016. The government's focus on international relations and bilateral ties has also been strong. Relationships with US, UK, the Middle East and ASEAN countries have been invigorated since the last two years. The coming years will continue testing the implementation strategies of the Indian establishment, but for now, India has communicated to the global community that its core focus remains on economic development, and the world has taken a note of that.

These steps in unison have contributed to strengthening of the domestic macroeconomic climate and have enhanced India's perception globally. For enabling the tremendous work done at the policy level to trickle down to the grassroots, a robust structural and operational framework needs to be built almost immediately. The policy changes backed by strong intent to implement them have given global investors a good reason to be excited about India. With a ripe demographic dividend encompassing a population of 1.25 Billion, GDP growth rebounding above 7.5%, inflation numbers touching sub 5% levels and the resultant low cost of debt make India's investment climate one of the most favoured in the world.

Cooperating to Operate: Interoperability of Clearing Corporations

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Introduction

A standard market structure includes the stages of trading, clearing and settlement. The recent period, has seen many changes in the trading environment, including new advanced technology services, demutualization, trading systems that are competing on cost and speed of trade execution, faster order confirmation matching, portfolio reconciliation etc., leading to increased competition in services.

The financial crisis of 2007-09 has increased the importance of robust counterparty credit risk management and a range of initiatives to strengthen post-trade operation processes, information sharing and transparency and standardization of documentation and processes. From the market participant perspective, given an increase in trade of smaller sizes there is a need to reduce the cost of clearing and settlement. Currently margins need to be placed with individual clearing corporations even if transactions are offsetting in nature, before the pay in is made. This needs to be done for every trading venue separately, leading to high switching costs. The debate is to choose between a single clearing corporation to have interoperability between multiple clearing corporations. There are various pros- and cons of each approaches which have been discussed for sometime now. The general consensus was a move towards competition based model with multiple clearing corporations having interoperability as against a monopolistic framework of single Clearing Corporation which would lead to concentration of various risks. In what follows, we discuss the benefits of interoperability to the various market intermediaries, the global experience and the takeaway for Indian markets.

Benefits of interoperability for the Investor



Central Counterparty Clearing Houses (CCP) interoperability would mean that the market participants would have the freedom to "deal" with CCP of their choice. The settlement of trades would be on net stock position and that would reduce the upfront settlement fees. The participants would not have to bear switching costs. For example, if a stock matches at multiple exchanges, the participant has to pay margins at those multiple exchanges and also has to pay the net settlement fees at each of the CCPs. This would not be the case if the respective CCPs were connected. With interoperability, the CCPs would be facing an increased competition and should lead to better service levels and lower costs. The margin requirement for the participant would also be reduced. They would have access to deeper order books across the multiple exchanges and would hence have best price execution. There is a level of collateral efficiency that can be achieved by posting a single margin.

Benefits of interoperability for the Regulator

The interconnectedness of the CCPs, leads to a

reduction in overall risk, as the default by large participants is managed centrally, making the overall system immune to risk. It facilitates early detection of market risks enabling appropriate and timely actions for securing market integrity. The netting of risk across trading venues also significantly brings down risk for the participant and the entire market. The need to cooperate with the competitors promotes robust governance standards.

Operational Benefits of interoperability

The benefits of increased competition are observed in terms of an increase in the operational efficiencies of the participant CCPs. Their operational risks are reduced and there is a stronger incentive for CCPs to improve their services. In situations when one CCP supports one product, interoperability leads to expansion in the CCPs current product offerings. The participant has the freedom to choose the trading venue and since the CCPs support all exchanges there are fewer procedures and movement of cash and securities due to pooling. This lowers the risk by reducing multiple settlement to single settlement per stock per day, regardless of the number of venues on which it was traded. The overall operational risks are thus reduced. Overall the back office costs, cost of compliance and the cost of risk is reduced due to operational synergies.

Global Experience on Interoperability



Globally, interoperability has been implemented in some of the economies and is already operational without any major issues. The CCP links are set up as full interoperability, or by cross margining arrangement or mutual offset agreement. The Markets in Financial Instruments Directive (MiFID) II regulation and aims to provide harmonized regulation for investment services across the 31 member states of the European Economic Area will compel major European Exchanges for interoperability by 2017. This is also supported under the OTC clearing rules in the Dodd-Frank Wall Street reform in the US. Internationally consolidating the clearing across markets in the CCP is welcomed as without imposing switching costs on those exchanges, there is an expansion across geographies. As per reports, the increased rivalry between various CCP has proven to be beneficial with *upfront clearing fees falling by 80% from 2010 to 2012. In addition, Euro CC, LCH Clearnet, Six Securities Services; and EMCF have reported a 30-40% reduction in settlement and operational costs* since the debut of interoperability.

Fig (1): Interoperable CCPs in Europe

Exchanges	LCH. Clearnet	LCH. Clearnet SA (France)	SIX X-Clear	EMCF	EuroCCP	Euroclear	Clearstream	NASDAQ OMX Clearing	Oslo Clearing	Italy Casa di Compensazione e Garanzia (CC &G)
LSE	Equity		Equity		Equity					
SWX	Equity		Equity							
BATS CHI-X Europe	All Market Segments		All Market Segments	All Market Segments	All Market Segments					
Turquoise	Equity		Equity	Equity	Equity					
UBS MTF			Equity		Equity					
Euronext	Equity					Equity	Equity			
NASDAQ OMX	Equity		Equity	Equity	Equity	Equity	Equity	Equity		
Deutsche Börse	Equity					Equity	Equity			
Oslo Børs	Equity								Equity	
Oslo Axess	Equity								Equity	
Euronext Paris (France)		Equity								Equity
Borsa Italiana		Equity								Equity

European scenario

Interoperability between the clearing houses at the exchange is defined horizontally across each exchange. In Europe, Markets in Financial Instrument Directive (MiFiD)-II regulations will compel Europe's major exchanges to adopt full interoperability. Most of the CCPs have however resolved to adopt full interoperability. Interoperability between the clearing houses at the exchange is defined horizontally across each exchange. UBS Multilateral Trading Facility (MTF) was the first MTF to offer full interoperability of CCPs. It allows 100 percent predictability that a matched order will clear through the traders' CCP of choice. BATS CHI-X Europe adopted full clearing house interoperability since January 2012. LCH.Clearnet has interoperability arrangement with Swiss clear (Six x-clear) since 2008. It also entered an interoperable agreement with Oslo Børs whereby equities and ETFs traded on Oslo Børs and Oslo Axess can be cleared through LCH.Clearnet. The London Stock Exchange has three interoperable CCPs , LCH.Clearnet, EuroCCP and Six-X Clear, that support the trading at its exchange. A three by three initiative is proposed whereby the three exchanges, NASDAQ, Six Swiss Exchange and Oslo Børs will be cleared across the three clearing houses Euro CPP, LCH.Clearnet and SIX x-clear. Fig (1), summarizes the current interoperability between the various clearing houses and the exchanges in Europe.

American scenario

In US, the equity market structure consists of



competing exchanges and trading platforms, but a single clearing corporation and central depositary (DTCC) having common ownership serves the national equities market. The futures market and the commodities markets have in house clearing that continues to be with exchanges, with a more vertical model adopted. The clearing corporations are product specific i.e. equity, fixed income and options. The two major corporations include DTCC that offers equity clearing through its subsidiary NSCC and fixed income clearing through its subsidiary FICC and Options Clearing Corporation (OCC) that offers options clearing for exchange traded and OTC option contracts For certain options that are listed on NYSE, NASDAQ, BATS, BATS Y, EDGA / EDGX markets, there is a limited multilateral netting contract between NSCC and OCC, which got SEC Approval on January 1st, 2003. CME Clearing and OCC have a cross margining agreement since 1989 for offsetting values

Fig (2): Interoperable CCPs in the US

Exchanges	NSCC	FICC	OCC	CME Clearing	New York Portfolio Clearing	ICE Clear US	LCH. Clearnet
NYSE MKT LLC	Options		FnO				
BATS Exchange	Options, Corp & Mun Bonds	Bonds	FnO				
BATS Y Exchange	Options		FnO				
NASDAQ Stock Market	Options, Corp & Mun Bonds	Bonds	FnO				Options
EDGA / EDGX	Options, Corp & Mun Bonds	Bonds	Derivatives				
ICE US		Bonds	FnO		Bonds	FnO & Bonds	
CME Group Exchanges		Bonds	FnO	FnO, Corp Bonds			

Fig (3): Interoperable CCPs in ASIA					
Exchanges	CME Clearing	HKEX	ChinaClear	SGX-DC	EUREX
CME Group Exchanges	Options			Options	
Hong Kong Stock Exchange		Equity	Equity		
Shanghai Stock Exchange		Equity	Equity		
Singapore Stock Exchange	Options			Options	
Korean Stock Exchange	Options				Options

of hedged positions of clearing members at the CME Group Exchanges. As on January 1st, 2011 SEC granted approval for a limited netting contract across several US Exchanges including Nasdaq, BATS and EDGA / EDGX stock exchanges for corporate / municipal bonds traded, cleared through NSCC and FICC. In the US, interoperability not clearly defined as there is a common derivative, bond and equity clearing corporation through NSCC, FICC and OCC. NSCC and FICC are subsidiaries of DTCC which acts a clearing corporation through its subsidiaries. Fig (2) gives the details for the interoperability arrangements between exchanges and the various CCPs in US.

Asian scenario

Interoperability through various link agreements has been established between the Asian and US markets. This allows for geographical expansion and an increased possibility of trades across time zones. Fig (3) gives the details for the interoperability arrangements between exchanges and the various CCPs in Asia. The CME Clearing and SGX-DC signed a mutual offset agreement in futures contract at CME Group Exchanges and the Singapore Stock Exchange, allowing participants to trade across markets. It enables trades to open a futures position on one exchange and liquidate it on the other. Hong Kong Stock Exchange has link agreement with Shanghai and Shenzhen stock exchanges to ensure mutual market access for participants between the Mainland and Hong Kong, agreeing to clear their trades through local clearing houses HKEX and ChinaClear (Nov 2014). Also China Securities and Depositary Corporation is the central counterparty for securities and cash settlement on Shanghai and Shenzhen stock exchanges. In addition there is the successful link between Eurex and Korean Exchangefor Kospi 200 options. It allows the market participants to continue trading during theEuropean and U.S. trading day, when the Korean Exchange is closed.

Interoperability in India

SEBI in November, 2012 set up an expert committee "Committee on Clearing Corporation", headed by Shri. K.V. Kamath. The committee in its report submitted in July 2015 recommended interoperability between clearing corporations. This committee was set up in considerations of the recommendations of an earlier committee headed by Shri. Bimal Jalan on "Review of ownership and governance of market infrastructure institutions" that submitted its report in November 2010. It had also recommended interoperability amongst clearing corporations as against the creation of a single independent clearing corporation as this could increase the systemic risk in the financial market. The discussion on feasibility of "Interoperability of clearing corporations in India" and its choice over having a single clearing corporation has been a question of major debate recently. The Securities and Exchange Board of India (SEBI) board in its meeting on November 30, 2015 postponed the decision to introducing a single



clearing corporation (CC) or introduce interoperability between different CCs.

In India, interoperability has been implemented between the two central securities depositories (CDSL and NSDL) way back in 1999. This was successfully carried out by regulatory intervention. NSDL and CDSL have improvised their services, improved their systems and provide value-added services that has been beneficial to the market participants. The Thomas Murray, while reviewing the CSD competition in Asia in February 2014, wrote, "In India, the NSDL and the CDSL both offer services to exchange-traded securities. This pushed NSDL and CDSL to fine-tune their services, improve their systems and innovate to better serve the largely retail Indian market. NSDL and CDSL have also diversified into providing value-added services which have advanced the market and bolstered their respective revenue. It appears that CDSL and NSDL have thrived in the competitive landscape with both posting consistent net profits going back several years."

Given the recent developments and technological advances in the financial markets in India, implementing interoperability in the "clearing" should also be possibility. Exactly similar instruments traded in Indian markets, including standard derivative contracts as specified by SEBI, making it easier to map them across the CCPs. Risk mitigation measures are now time tested given the experience in the existing interoperable markets like Europe. The benefits of interoperability will be to the market participants who can choose their trading venue and also the CCP based on the costs benefits available to them. Given the competitive nature of the markets improving revenues by cost reduction is a preferred strategy by the investors and the clearing corporations can work towards the same. The reduction in trade barriers can also help to shift the OTC markets towards exchange.

Finally, to implement interoperability, both the trading venues and CCs need to jointly agree and implement the systems to support. With regulatory approvals, the CCs need to agree on an inter-CC risk management model. These models need to be standardized, tested and also scalable. There is a need to build data transfer connectivity that is fully tested between the CCs, trading venues and users. With a strong and sustainable set up in the local markets, it could prove to be the first step towards future international CCP links.



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