#CAPAM2018

15th Annual Capital Market Conference

"Blueprint for Capital Market in New India 2022"

The Experts' Voice

A compendium of articles

September 11, 2018 : Mumbai

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Foreword

In line with the Government's proposal of New India 2022, aimed at holistic development of the country through a structural reform agenda; FICCI's 15th Capital Market Conference - CAPAM 2018 - focuses attention on 'Blueprint for Capital Market in New India 2022'.

A positive investment climate supported by robust macroeconomic performance, stable FDI inflows and regulatory and structural reforms by the Government have all contributed to India emerging as the fastest growing major economy in the world in recent years. Given the present consumption and investment trends, there is reason to believe that this economic performance would continue in the years ahead. In fact, there is an expectation that India could be one of the top three economic powers of the world over the next decade or so. With several significant initiatives already undertaken by the Government and Regulators, and aided by strong structural growth story, a few more steps in the right direction would ensure realization of this ambitious growth in the years to come.

On this occasion, we are pleased to present CAPAM 2018 Knowledge Paper, 'The Experts' Voice', a compendium of articles contributed by members of FICCI Capital Markets Committee focusing on charting out a forward looking growth path for the country's capital market. The articles delve into interventions required to be put in place to ensure abundance of capital, reduced cost of doing business, infrastructure financing, listing of startups and improved business confidence – prerequisites for India to take the pole position amongst nations in terms of growth. 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 Regulator, senior bureaucrats and highly esteemed government officials for their participation in CAPAM 2018 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.

Sunil Sanghai
Chairman

Shilpa Kumar
Co-Chair

Himanshu Kaji
Co-Chair

FICCI Capital Markets Committee

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The New India – Impact on Capital Markets

Sunil Sanghai, *Chairman, FICCI Capital Markets Committee and Founder & CEO, NovaDhruva Capital Pvt Ltd*

Our country achieves 75 years of Independence in 2022. To commemorate this epoch in the life of our nation, our Prime Minister has made a vision statement of New India in 2022! The New India Movement envisages India free from poverty, corruption, terrorism, communalism, casteism and uncleanliness and unites the entire country by adopting righteous governance complimented with best in class technology.

Apart from positively impacting the social construct of the country, this Movement will have a noteworthy economic impact on India. An ethically compliant and an efficiently governed nation will significantly pace the economic growth. An exemplification of this is the discernible movement towards a more formal economy. An increase of c.71% (c.54.2mn) in the total number of income tax returns filed for the year 2018 is indeed a laudable achievement for the country.

The capital markets engine

The vision of New India along with its impact on the economy is bound to re-shape our capital markets by 2022. From a market capitalization of USD 2.3tn in 2017 to an expected USD 5tn in 2022, India is well poised to stage the 3rd/ 4thlargest capital market in the world.

This substantial growth in the market capitalization would indeed positively drive the advancement of primary and secondary market, bond market, fund management sector as well as currency and commodity market. Based on the various current estimates, we expect that the primary market would be facilitating equity resource raising of more than USD 30bn each year by 2022. This will support the growth of secondary market with multiplied volume and higher trading value. We expect secondary market to witness the launch of new and complex products which will enable diverse class of investor's participation.

Bond issuances have grown at a compounded annual growth rate of 15% over the last five years and outstanding issuance, as on March 2018, stands at USD 385bn. Although there has been a shift of investors to debt markets, there is still room to improve their participation in the corporate bond market which is still dominated by government issuances. Going forward, we believe that the bond market will receive a significant impetus through regulatory interventions to ensure engagement of varied participants.

The rising global equity markets and accommodative liquidity conditions coupled with positive business sentiment in India attracted Foreign Portfolio Investors (FPIs) with inflows to the tune of USD 22.6bn. In the last five years, the cumulative equity Assets Under Management of FPIs and domestic institutional investors (mutual funds) has grown 3.6 times. This has put asset management business on the front-seat with significant savings being now deployed in the same, as against the traditional approach of placement in bank deposits. As a result, the industry witnessed substantial growth during 2017-18, backed by strong inflows and increased participation of retail investors, with the Assets under Management (AUM) increasing to c.22% Y-o-Y, which resulted in movement of savings from fixed deposits and non-productive assets to capital markets. The increasing participation of retail investors in the capital market is evident from the growth in SIP inflows by c.64% in 2018, as compared to 2016. However, our pockets of retail savings in the capital market is still much lower compared to developed markets, hence there is a substantial scope for further penetration. We expect the total AUM to likely cross more than USD600bn by 2022.

In the next wave of capital markets growth, apart from the traditional markets i.e. equity, bonds, and currencies, we expect a lot more focus on the commodity markets. Commodity markets play an important role in development of the agricultural sector and related ecosystems. Post the merger of Forward Markets Commission with SEBI, we believe that the integrated capital and commodity markets will evolve much faster.

We are convinced that the journey towards a USD 5tn capital market is real and that the country is equipped with all the appropriate building blocks to successfully achieve the same.

Building an appetite for the anticipated explosion

We brace ourselves with pride given these growth prospects; and we also discern that the robust framework required to manage this explosive growth is mostly in place. It is well understood that a rigorous regulatory framework,robust market infrastructure, mature market participants and most importantly, a seasoned investor base will go a long way to underpin this growth.

In view of the above, SEBI has actively promoted a host of policies and programmes during 2017-18 to provide a sustainable yet empowering ecosystem in order to nurture the capital markets of which a few notable measures worth mentioning are:



- Fair Markets Committee - Constitute a committee under Chairmanship of former law secretary TK Vishwanathan, which has already presented its recommendation for public comments
- Corporate Governance-Approve recommendations by the Kotak Committee which was constituted last year under the Chairmanship of Shri. Uday Kotak to meet the primary objective of improving standards concerning corporate governance of listed companies in India
- Revise framework for non-compliance of listing regulations and amendments to the SEBI (Alternate Investments Funds) Regulations, 2012 to provide ease of business for angel funds
- Provide guidelines for functioning and development of securities market in International Financial Services Centre (IFSC) to facilitate ease of doing business
- Explore new initiatives to tackle the challenge posed by cyber security breaches globally by deploying data analytics and new-age technologies for the marketplace while following necessary data privacy requirements. Additionally, intends to strengthen the algorithmic trading framework to make the capital market more fair, equitable and transparent, while there are plans underway to introduce more commodity options contracts and to put in place new guidelines for index products
- Integrate commodities and securities derivative markets for further streamlining and development of the secondary market. One step forward is that exchanges have been allowed to integrate commodity and equity derivatives from October 1, 2018 to boost participation
- Categorize and rationalize Mutual Fund Schemes to ensure better comparability for investors amongst schemes launched by various fund houses
- Relax start-up net worth requirements and profitability, to allow listing on SME platform such

that small and mid-level startups who cannot list on the main board for higher compliance norms can raise money via this platform

Such a proactive and pragmatic approach of the capital markets regulators is indeed helping establish a transparent and efficient financial ecosystem. However, scraping a little deeper under the skin, we believe that an efficient regulatory intervention in a few more areas could be very useful.

Enabling innovation and the capabilities to foster it, along with financial inclusion

Financial products in India have become quite sophisticated over the years. Liquidity in derivatives products have also increased. Launch of products like options, complex derivative products, hybrid offerings etc. suited to different categories of investors will lead to market size expansion. Besides the ongoing measures, we have now formulated more innovative vehicles such as Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) to allow developers to monetize revenue generating real estate and infrastructure assets, while enabling investors or unit holders to invest in these assets without owning them. For any large and fast-growing market, a certain amount of continuous innovation is needed. We believe, focus on facilitating and regulating globally accepted new products will be an absolute must. To realize our pioneering goal of achieving this pronounced market growth, India requires an ecosystem of robust regulatory framework to safeguard and facilitate the launch of new and innovative products, along with inviolable governance.

The other significant influencer is the impact of Artificial Intelligence. Drawing from it, FinTech is slowly becoming an indispensable plug in the growth story of our economy. Traditionally known for lower rates of technology adoption, Asia is now on path to become a leader in FinTech, led by countries like China and India. These countries have witnessed highest technology adoption rates at c.69% and c.52%,



respectively. Further, with the government laying huge emphasis on entrepreneurship (Start-up India and Stand-up India program, global fund houses setting up offices, etc), we can expect the VC capital flow to be a major factor in shaping the capital market in India. This vaults us to a spurt in VC funding and requires a framework to be in place for VC funds to operate within.

Another area which will propel this growth is financial inclusion. The world's unbanked population has dropped by more than 20% since 2011, with major revelation coming from India, which moved from c.35% to c.80% penetration in 2018. However, it is just the start and the opportunity in India (housing the world's 2nd most unbanked citizens after China) remains huge.

Looking ahead a long winding road

We are aware that this journey may come with its own challenges, and that; only stringent challenges result in exhilarating victories. To begin with one - the current global economic and geo-political situation remains a cause of worry. Recently, in my conversation with one of the global CEOs of a large MNC, I learnt that in the last 400 years of world history, the then existing super-power has been confronted by the next potential super-power on sixteen occasions. Of these, twelve have resulted in a war. In the recent times, we have seen a manifestation of this through the trade related conflicts. While this is unlikely to result in any sort of escalated tensions, it is



indeed a noteworthy development (with similarities to the earlier cold war when there were escalated tensions) to see emerging signals of Trade War.

We are also witnessing significant political, social and institutional changes in the world, which further accentuate the unfolding global dynamics. The kind of unconventional leadership that has been emerging across the globe - be it President Trump's ascension to power or Capt. Imran Khan winning the Pakistan elections - clearly indicates a nationalist phenomenon across the globe. Brexit is also a development in the same direction. Social changes and political alignments in the Middle East, and particularly in Saudi Arabia, are also interesting changes to track.

Additionally, while G7 countries (Canada, France, Germany, Italy, Japan, UK, USA) are still powerful, growing importance of E7 countries (China, India, Brazil, Mexico, Russia, Indonesia and Turkey) is noticeable. Giant establishments like the World Bank and the IMF are losing weight, and newer development institutions like Asian Infrastructure Investment Bank (AIIB) and New Development Bank (NDB) are gradually occupying center stage. The changing global dynamics, leading to rising protectionism, is forcing countries to relook their policies. This is certainly going to impact businesses across the globe, including India. The capital markets would continue to be impacted by an influx of such macro and micro factors. As a country, we must be geared up to manage an ecosystem which would only become more complex.

Reflecting on the past and examining the present, while earmarking the future; we can safely conclude that India has done well and come a long way. Just less than a decade ago, our market capitalization was shy of USD 500bn in 2009; and we managed to successfully quadruple it to USD 2.3tn in 2017. Thus, with the capital market well-aligned to a target of doubling to USD 5tn in the upcoming four years, and with our Prime Minister's vision of 2022, we are looking forward to a bright and New India! ■

Setting the stage for listing of startups - Nurturing India's early stage businesses

Shilpa Kumar, *Co-Chair, FICCI Capital Markets Committee and MD &CEO, ICICI Securities Ltd.*

A startup, which essentially is a company in the first stage of its operations, **requires a smooth interplay of key factors like access to human capital, capital funding, business infrastructure, product markets, government regulations along with taxation structure.** It is relevant to note that the United States (US), which has one of the world's best ecosystems geared to nurture and support growth of startups, is the largest incubator of startups globally with over 83,000 registered startups. Leading US companies like Apple, Alphabet, Microsoft, Amazon and Facebook which are among the largest public companies by market capitalisation also embarked on their journey not long ago in the form of startup ideas.

Over the past decade, however, Asian countries like China and India with over 10,000 startups each have taken significant strides to help transform their entire startup ecosystem. The US, China and India enjoy the natural advantage of having a diversified pool of human capital i.e. entrepreneurs and a skilled workforce. A sizeable population across these geographies also provides access to a deeper and exhaustive product market. Across these countries, with a sizeable startup base, a concerted effort has been undertaken to simplify existing rules and regulations further and provide wider access to capital.

Leading startup countries globally

	India	China	USA
Total no of startups	>10000	>10000	>83000
Tech-based startups	4,300	3,400	48,500
Non-tech based startups	5,700	6,600	34,500
Set up a new business (Days)	30-60	30	4
Corporate tax rate	34%	25%	21%

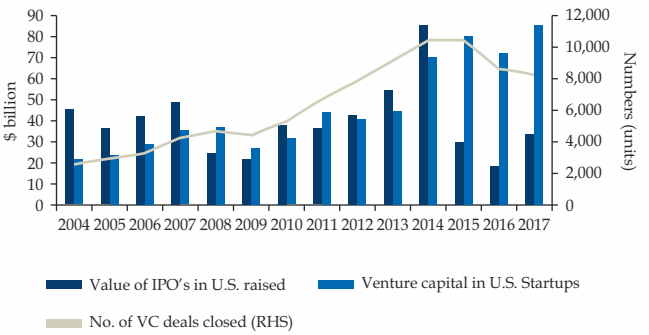
Source: Grant Thornton, Assocham India

Capital funding in US - Where startups thrive and flourish

In terms of capital funding, in 2004-17, venture capital firms cumulatively invested $644 billion on funding startups in the US. Comparatively, the total money raised from IPOs during the same period was $560 billion. This is indicative of the fact that the startup ecosystem is larger than generally expected. Thus, while the absolute startup funding may look sizeable, to put things in perspective, compared to US GDP in 2017, the cumulative amount translates to ~3%.

The US continues to successfully provide investments and timely exits, to both talented entrepreneurs as well as investors in the country. In 2017, over 8,000 venture-backed early stage companies received $85 billion in funding. This represents the highest annual total since 2000. Unicorns (i.e. venture-backed companies valued at $1 billion+) attracted a record $19 billion, translating to ~22% of total capital funding in 2017. Large unicorns (twenty one) gave exits to some of their early investors through IPO (fourteen) and M&A (seven).

Value of money raised through IPO vs. VC funded startups



Source: NVCA 2018

Incentivised taxation structure for startups in US

To promote early stage companies to invest in research and development (R&D) projects, the US Internal Revenue Service (IRS) provides tax sops through a programme called Federal R&D tax credit. Apart from the IRS programme, many local states offer a tax exemption for startups. In New York, a Startup NY initiative is designed to provide 10 years of tax-free business, enabling setting up one's business at a minimal cost. On its part, the federal government also provides several tax benefits for startups, on the whole. Not only are startups offered tax credit and tax exemptions but they are also provided easier access to funding along with partnership with bigger businesses.

Regulatory reforms – Key enabler for development of startups in US

There has been a significant regulatory reform even in the US on the employee equity awards front to retain and reward great talent in a startup. In December-2017, the taxation code was overhauled and passed in the US. Eligible employees of private companies were given an option to pick or defer for up to five years the recognition of income from private company stock acquired due to the exercise of a stock option. Employees faced a tough challenge since the startup was not yet public and could not sell their shares for cash to pay taxes. Now, employees of private companies will be able to defer those taxes for up to five years. To qualify for the tax break, companies must provide stock options to at least 80% of their workforce. This prerequisite would induce startups to widely incentivise their wealth across the firm.

Accommodative listing requirement for global firms on NASDAQ

Early stage companies i.e. startups in the US have access to an all-encompassing ecosystem to sustain them. Even on the listing front, constraints such as lack of profitability during early stages of a company lifecycle, the need to raise capital subsequently, etc, are



addressed by the NASDAQ exchange as it offers slightly lenient listing regulations. Each company must comply with the main rules for all companies as well as at least one of the four standard requirements below.

NASDAQ Global market	Income Standard	Equity Standard	Market Value Standard	Total Assets/Total Revenue Standard
Income from operations before taxes (latest fiscal year or in two of last three ficial years)	$1mn	-	-	-
Stockholders' Equity	$15mn	$30mn	-	-
Market Value of Listed Securities	-	-	$75mn	-
Total Assets and Total Revenue (in latest fiscal year or in two of last three fiscal years)	-	-	-	$75mn and $75mn
Publicly Held Shares	1.1mn	1.1mn	1.1mn	1.1mn
Market Value of Publicly Held Shares	$8mn	$18mn	$20mn	$20mn
Bid Price	$4	$4	$4	$4
Shareholders (round I ot holders)	400	400	400	400
Market Makers	3	3	4	4
Operating History	-	2 years	-	-

Source NASDAQ

Alibaba and Baidu are some noteworthy Chinese startups listed on the NASDAQ while Rediff and MakeMyTrip are some of the Indian startups listed on the NASDAQ due to overall benefits derived from listing in the US.

Listing conundrum for startups - China shows the way

Over the past decade, internet technology firms have become dominant players across industries. The untapped potential of the Asian technology sector is no longer a secret. While China has been a breeding ground for some of the world's fastest-growing -- and highest valued -- technology businesses, most Chinese technology startups have opted to list in the US since they were unable to fulfil the listing

requirements of either the Shanghai or Hong Kong exchanges at the time. They faced legal and technical barriers to list on the main bourses.

To facilitate the ambition of Chinese tech entrepreneurs to achieve scale, the government has begun a pilot scheme that provides preference to unicorn startups (companies worth at least $1 billion) with superior technologies to **list ahead of other traditional firms** lined up at the exchange. The regulator is also in discussions with top firms that have high market recognition in key sectors like cloud computing, big data, software and integrated circuit, biotechnology for issuances of **Chinese depositary receipts** (CDR). A CDR is a certificate issued by a custodian bank that represents a pool of foreign equity that is traded on the Chinese exchanges. Thus, Chinese companies listed abroad will be allowed to trade in domestic markets through CDRs.

In July 2018, the Hong Kong Stock Exchange (HKEX) relaxed its listing norms to promote companies from emerging and innovative sectors. High growth technology companies or biotech firms were provided a relaxation in profitability requirements. Another consideration provided by HKEX relates to equity awards, which are offered by startups to grow their business and incentivise talent through share compensation plan. The HKEX has also opened up an additional channel for tech startups to raise funds to support their R&D activities, creating an ecosystem to incubate innovation. Thus, overall, there has been a concerted effort by the Chinese government to promote its startups and provide a conducive environment for them to grow.

Nurturing Indian startup ecosystem

To facilitate the growth of startups, the Government of India has initiated 'Startup India'. Startup India is a flagship initiative with the intention to build a strong ecosystem for nurturing startups in the country that will drive sustainable economic growth and generate large scale employment opportunities. Under the Pradhan Mantri MUDRA Yojana, more than 13 crore people have been provided loans of ticket size | 50,000 to | 10 lakh with ~4 crore people being first time borrowers.

Further, the government has relaxed several criteria to enhance the existing support system for startups. For example, an entity can be considered a startup for up to seven years from its date of incorporation from earlier five years. Also, the scope of definition has been broadened to include a scalable business model with high potential of employment generation or wealth creation. Both Indian exchanges, **Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) have announced the creation of a new alternative 'Startup' platform** that allows startups to list with or without initial public offering and connects them to a pool of varied investors. Both exchanges have announced a relaxation of profitability in their listing criteria. However, they still seek a company that has positive net worth. The listing of startups on such alternative investment platforms will broaden their reach with a diversified investor class. Securities and Exchange Board of India **(Sebi) is expected to come up with new guidelines to boost listing of start-ups on the main platform of both BSE and NSE in India** over the next couple of months. The regulator has been engaging with various stakeholders, including startups, investors and industry bodies such as Nasscom and TiE (The Ind-US Entrepreneurs - A Silicon Valley non-profit supporting startups) to tweak the listing norms for startups. Indian startups are also keen to tap the public market but find the existing norms challenging. Primary among these norms is net worth requirement, profitability and promoter holding norms. Taking a cue from global regulators, there is scope for significant reforms for early stage companies.

Start-ups to act as facilitators of economic development, overall well being

Globally, start-ups have challenged the traditional business models bringing in concomitant disruptions and more efficiency in the system thereby leading to accelerated economic growth. Startups are increasingly finding ingenious ways to directly

connect sellers and buyers, thus creating a physical capital-free business model - wherein companies with limited physical capital compete with capital heavy incumbents - thus challenging the traditional asset heavy businesses. As an illustration, Alibaba holds no inventory, Airbnb owns no real estate while Uber owns no cars. Thus, startups generally possess an asset light business model, a product/platform enterprise and are intellectual property driven establishment. There are three broad contours, which will determine the success of start-ups, going ahead. First is capital efficiency i.e. the ability of these companies to remain lean in their asset deployment and generate incremental higher revenue than risk capital employed. Second is their ability to generate significant employment opportunities for the substantial eligible workforce. Third and last is their



ability to benefit the society, in general i.e. improve economic productivity and the overall development of society. Encouraging a startup ecosystem with a conducive environment is a precursor to equitable socio-economic growth. ■

Corporate Bonds: The Next Frontier for India's Economy

Himanshu Kaji, *Co-Chair, FICCI Capital Markets Committee and Executive Director & Group COO, Edelweiss Financial Services Ltd.*

India is expected to be a $5 trillion economy by 2025. Large, once in a lifetime structural changes such as an increase in the financial inclusion rate in our society, democratization of credit, urbanization and emergence of growth clusters around cities, infrastructure development and other derivative and dependent factors are emerging as strong demand drivers which make this ambition of a $5 trillion economy size realistic. While most of these demand drivers are in place, the supply side needs attention. Interventions are required to be put in place to ensure that the economy secures the capital necessary for this mega growth. Capital markets have historically been key contributors to the "hockey stick" inflexion points of high growth economies elsewhere in the world, and we expect the Indian capital market to discharge this responsibility likewise. Since action precedes outcome, it is important for these supply side structural solutions to be in place in the capital market by 2020 so that the economy can bootstrap towards the $5 trillion size by 2025.

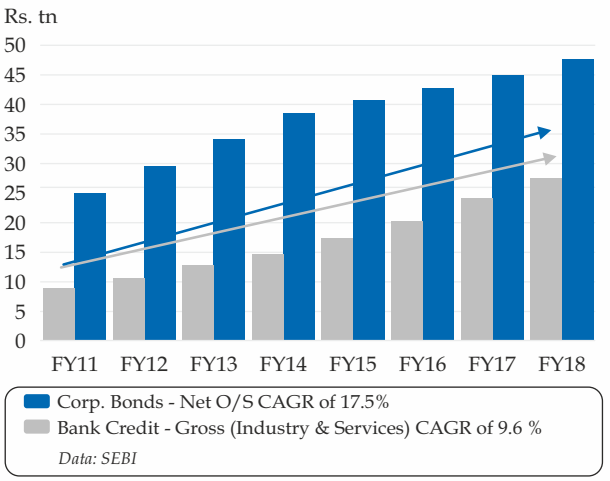
Even as India's equity and government bond markets have gone from strength to strength in the decades following the market reforms of the 1990s, its corporate bond markets have largely remained stranded. India's equity markets are now structurally comparable to the best in the world. One of the factors that still differentiates developed vs developing economies today is the prevalent nature of debt financing. Developed economies have a well-developed corporate bond market free from government involvement while developing ones are ones where bank financing plays a central role. When a full-fledged corporate bond market is present, market forces have a much greater opportunity to assert themselves, thereby reducing systemic risk and the probability of a crisis, such as the NPA situation in India at present. This is because such an environment is associated with greater accounting transparency, a large community of financial analysts and active rating agencies, a wide range of corporate debt securities and derivatives demanding sophisticated credit analysis, and efficient procedures for corporate reorganization and liquidation.

This article focuses on this much talked about but as yet untapped wellspring of growth capital: corporate debt. It aims to examine the current and the recent statistics to understand where we are today, list the lacunae in the corporate debt ecosystem that are preventing it from taking off and finally discuss some interventions which are needed for this asset class to fulfill its potential.

A) Recent Trends

The new issuance of corporate bonds has grown at a CAGR of 14.9% from FY11 to FY18 with a total of Rs. 6,041 bn being mobilized from public issues and private placements in FY18. While FY16-17 saw an increase of 36.1% in new issuances, there was a decrease of 9.8% in FY17-18. This uptick in issuances over the last 7 years has resulted in the total net outstanding of corporate bonds to grow at a CAGR of 17.5% from Rs. 8,895 bn in FY11 to Rs. 27,423 bn in FY18. In contrast, gross loans and advances of the banking sector to the industry and services sector has grown from Rs. 25,040 bn to Rs. 47,497 bn representing a comparatively lower CAGR of 9.6% over this period [refer Chart 1]. While it is a good sign that the corporate bond sector is growing faster than bank loans, we need to see this development in the light of a) the impasse in fresh loan advances by the banking sector given the NPA burden and b) the fact that at 173% (FY18), the ratio of bank loans to corporate bonds is still extremely high as compared to other global financial venues.

Chart 1: Outstanding Corporate Bond Notional vs. Bank Credit



B) Barriers to Scale:

The success of a vibrant corporate debt market would hinge on availability of lower rated paper, investor appetite (including retail) over for the entire ratings spectrum, adequate hedging and risk management infrastructure, reduced market fragmentation, increased secondary market liquidity and an increasing supply of new issues.

Liquidity is perhaps one of the most important requirements for an efficient, developed corporate bond market. The narrow bid-ask spreads in bonds necessitate very high trading volumes for this asset class to be commercially viable for market makers. Due to high nominal amount of government bonds, no market makers at the retail level have been able to come into existence on the dint of trading in government securities alone. The narrow bid-ask spread also has to accommodate the state governments' stamp duties and this burden is another reason for the lack of depth in the corporate bond market. Chart 2 presents the trend of the corporate bonds turnover ratio by plotting the corporate bond traded value calculated as a percentage of net outstanding issued amount. This ratio has hovered in the range of 50% to 70% over the past 7 years with an increasing trend since FY16. This number needs to be seen in the context of more than 80% of Indian corporate bonds being AA rated or higher. The corresponding turnover figures (for high rated corporate bonds) in



developed bond markets are often more than 100%.

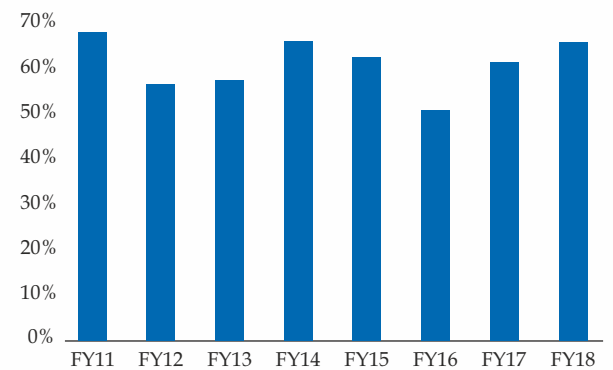
Though the corporate bond market has indeed grown over the years, this growth has mostly been in the area of private placement as it is less onerous and expensive option for corporates.

Even as the new Insolvency Act marks a very positive step towards the development of the corporate bond market, there isn't much of a resolution history behind it for it to make a developmental impact yet. We have to wait and see how this plays out.

C) Market Interventions

The latest proposal to mandate AA and above rated companies to compulsorily raise a fourth of their debt financing in the bond market from FY20 should certainly raise activity levels. A similar solution needs to be found to induce insurers and pensions funds to invest in corporate bonds.

Chart 2: Corporate Bond-Secondary Market Turnover Ration



Data: SEBI

The limits and range for insurance companies to invest in corporate bonds could be enhanced by reducing their current allocation towards central and state government securities and allowing them to invest in lower rated investment grade corporate bonds.

The decision to levy no long-term capital gains tax has been one of the key reasons for the equity cult to be well enshrined among Indian retail investors. Retail investors should be encouraged and appropriately incentivized to increase their participation in corporate bonds, with an aim to increase the secondary market volumes. On similar lines, institutions could also be enticed to invest in longer tenure bonds (> 5 years) by providing appropriate incentives.

It is not just higher tenures, there is very limited activity in India in lower rated corporate bonds as well. There is a case to be made for investments in high yield bonds (and bond funds) to begin to approach levels prevalent in advanced global fixed income markets. A critical dependency on this is a need for reform in the extant policies of and availability of various credit protection and enhancement products. Also, there is an absence of market makers for lower rated and longer tenured bonds today. The recent launch of electronic platforms for repos by BSE and NSE with guaranteed settlement is expected to improve liquidity provided market participants do indeed make use of them to park their surplus liquidity and optimize their asset liability management. However, building up liquidity from scratch is always a stretch for any market. Capital relaxation by way of lowering of risk weights for long tenured bonds (AAA through to unrated) which (and if) are used for market making may be the catalyst which could spur the migration of trading from the OTC to the electronic platforms.



Retail investment in corporate bonds need not compete with banks' deposit-taking function. The gradual financialization of savings in India in the context of a persistently high savings rate demands development of an alternative. Small investors have always had a predilection for debt in India. If the nation plans and educates an entire generation about the attractiveness of investing in corporate bonds and the regulators accommodate by providing incentives to retail investors, a large wellspring of demand for corporate bonds could ensue.

Democracy and the rule of law was a critical factor for the development of the bond markets of Holland in the 18th century, of England in the 19th century and of the U.S. in the 20th century. Effective capital market developed in Holland in the 18th century because there was, for the first time, confidence between the government, its subjects and among the leaders of the various business communities. All structural and commercial impediments aside, an unwavering alignment of the government and market intermediaries is a must for capital markets to develop. A lot of positive steps have been taken in the last few years and it is very much possible for the next bond market development chapter be written about India of the 21st century. ■

Blueprint for Capital Markets in India in 2022: A Deep Corporate Bond Market

Anita M. George, *Executive Vice President – Growth Markets, CDPQ*

Indian stock markets have been on a roll now for over four years, breaking several records in the process. The SENSEX and the NIFTY are both at their respective lifetime peaks. India's vibrant equity market is in sharp contrast however to its counterpart – a dull and inefficient credit market. In fact, the domestic corporate bond market is estimated at a paltry $287 billion, which is around 14 per cent of the nation's GDP and much lower than the equity market, which is around 80 per cent of the country's GDP. In most developed nations, the reverse is usually true, and the bond market is often several multiples larger than the equity market. There is a high degree of secondary market liquidity for debentures and there are effective laws that protects debt holders and ensure that this debt is secured.

There is a strong need in India for a more robust bond market. There are three primary reasons that stand out. First, Indian banks are currently in no position to rapidly expand their lending portfolios till they sort out the existing bad loans problem. The Non-Performing Assets (NPAs) accumulated by Indian banks are higher than those of banks in most major world economies including USA, UK, China, and Japan. Therefore, this problem is not going to have a quick and easy solution. Second, the heavy demands on the banking system by large companies in effect crowds out small enterprises from receiving funding. In financial systems of most developed markets, large companies receive most of their funds from the credit markets while banks focus on smaller enterprises. Third, a developed corporate bond market is also arguably a necessity for India to achieve its ambitious GDP growth targets and maintain its status as the fastest growing economy in the world. An 8 percent economic growth cannot be achieved without a robust capex cycle and this will be difficult to achieve given the recent squeeze on bank lending. Bonds are the ideal way to raise financing for certain kinds of long-gestation, capex heavy, infrastructure projects. Typically, infra projects are capital intensive, and it takes years to roll out toll-roads, build ports and attract traffic, dig mines or put steel plants into operation or start generating power. The project developer has no cash flow to service debt until the project is running. This is unacceptable to banks and their plain vanilla loans but is right up the alley for credit lenders who can structure the right financing solutions.

The Indian banking mess also provides an opportunity to ask some more fundamental questions about the structure of the Indian financial system. Banks suffer from asset-liability mismatches in funding such capital-intensive ventures as bank funding is short-tenure in its nature. But unlike a vanilla loan, a bond can be structured to pay up only after a project is up and running. If India does develop a corporate bond market, it would take a lot of pressure off banks, which are still reeling under a cloud of bad debts. It would also make it possible to raise capital for private sector infra-projects, which are currently starved of funding. Retail investors will also get a chance to invest in such projects via debt funds. There would be bigger risks and commensurately bigger rewards.

Below are a few initiatives that could go a long way in building a vibrant bond market in the country:

Robust Insolvency & Bankruptcy Code (IBC)

A robust corporate conflict resolution mechanism will go a long way in building investor confidence in the bond market. Investors will look at corporate bonds as an attractive asset class if they are confident that



conflicts can be resolved quickly and fairly. When the parliament passed the Insolvency and Bankruptcy Code in 2017, the law gave seniority to bond holders and lenders. While there is a need to see more successful cases, this is the right first step. A robust corporate bond market will benefit all issuers, but it will especially provide the greatest benefit for issuers who have a relatively lower credit rating. If the IBC is proven to be an efficient mechanism, then there would be a strong case for large public pension funds and insurance companies to start investing in corporate bonds slightly below investment grade.

Mandate large companies to raise capital from the credit market

India has previously sought to expand its bond market beyond the traditional ambit of sovereign debt. Earlier this year, in the Union Budget speech, the finance minister, Mr Arun Jaitley said that SEBI will consider making it mandatory for large companies to raise about a fourth of their financing needs from the bond market. If large corporates are mandated to meet one-fourth of their funding requirements through the bond market, it will improve the supply of bonds as more companies will tap the debt market.

Expand investor base and create a thriving secondary market

India has no secondary market for corporate bonds to speak of. Investor's risk appetite is key to improving participation in lower-rated bonds. One of the reasons for this is lack of takers for lower-rated and longer papers. For this to change, there is need for regulators such as Pension Fund Regulatory and Development Authority, and Insurance Regulatory and Development Authority to liberalize investment norms for the entities they regulate, who have appetite for lower rated bonds. Again, in the 2018 Union Budget speech, Mr Arun Jaitley spoke about permitting these bodies to invest in 'A' grade paper rather than the previous norm of only 'AA' grade paper.

On the flip side, there are a few structural issues that India still has to get past in order to make this a reality. First, most of the bond market activity has historically been by passive investors who get small private placements and hold these bonds to maturity, thus limiting the growth of a secondary market. Second, the sheer size of the annual government programme to fund the fiscal deficit has killed investor appetite for corporate bonds. Third, there are significant obstacles to risk-based pricing of corporate bonds—ranging from the lack of a robust benchmark interest rate to the relative lack of derivative products which investors can use to hedge.

It is highly unlikely that the corporate bond market will ever replace banks as the primary source of funding. Yet, India needs a more active corporate bond market. An active bond market will provide several advantages: it can play a part in disciplining companies that borrow heavily to fund risky projects, because borrowing costs would spike; it can create new jobs in the finance industry as the country would need professionals that understand this asset class; it can help the twin-problem of capital intensive businesses like manufacturing and infrastructure and smaller, less-credit worthy companies by offering them an alternate source of capital. In conclusion, the vision for a new India in 2020 is to have a thriving bond market where domestic and foreign institutions can participate alike, with

no fear of weak governance laws and illiquidity. This will further escalate India in its growth path and make it a global force to be reckoned with. ■

FinTech – Fast Emerging as Harbinger to Achieve 'Financial Inclusion'

Ashishkumar Chauhan, *MD & CEO, BSE Ltd.*

Introduction

Globally, capital markets have developed over time. The development of capital markets accelerated with the help of innovation, digitalization and disruptive technologies. Over the last few years, convergence of finance and technology to provide financial services, popularly known as FinTech, has come to dominate the financial landscape. FinTech has made a significant impact on the financial services sector. FinTech, not only redefining the development of financial services products but also creating alternate channels of delivery, and providing the opportunity to significantly expand the reach and scope of financial services.

Capital Markets -Advent of FinTech

The FinTech phenomenon first started to evolve in the capital markets industry more than 40 years ago. Currently, accelerated both by the electro notification of trading in the 1990s and the subsequent thrust of the entire financial services industry towards digitization, FinTechs have experienced rapid growth in the capital market domain. The prominent capital market FinTechs have been strongly supported and engaged by the capital market ecosystem that includes players such as custodians, exchanges, clearing-houses, investment banks, etc.

FinTech provides financial service delivery with the use of innovative technology to either enable or compete with other financial institutions. The penetration of mobile telephony and Internet use, availability of high-speed computing, low storage costs driven by cloud storage, innovations in machine learning and data analytics are some of the elements behind the latest FinTech revolution. They have experienced exponential growth in the capital market domain by capitalizing on the power of Internet and mobile to disintermediate and provide direct service delivery to individual customers, using technology. This targeting of the end customer is revolutionary and will shape the future dynamics of the financial services industry.

The major trends in the global capital market revolve around the ramifications of new emerging technologies that aid financial inclusion. FinTech is fast emerging as harbinger to achieve 'financial inclusion'. FinTech and financial inclusion have several benefits to financial services users, digital finance providers, governments and to the overall economy. Notwithstanding its benefits, FinTech and financial inclusion have not adequately permeated vast segments of the population. Still, majority of people across the world lack access to financial services such as low-cost payments systems, diversified investment and savings options, insurance services, or credit.

FinTech Revolution - Opportunity for India

In India, over the last few years, FinTech has made a significant impact on financial services sector. While many associate FinTech in India as largely digital payments, it has evolved considerably with domains like digital wealth management, lending and robotics process automation picking up quite rapidly.

The traditionally cash-driven Indian economy has responded well to the FinTech opportunity, essentially triggered by a surge in e-commerce, and smartphone penetration. The FinTech revolution is being encouraged by the various government initiatives such as Jan Dhan Yojana, Aadhaar and the

emergence of Unified Payments Interface (UPI) that provide a good foundation for FinTech to connect to the last mile and boost financial inclusion in the country. In fact, over 32 crore bank accounts were opened under Jan Dhan Yojana and the number of Aadhar cards issued has surpassed 1.21 billion. Many FinTech companies are working in diverse ways to contribute towards achieving deeper financial inclusion. There are about 650 million mobile phone users in India, and over 300 million of them have a smartphone. This indicates that India is already a bigger smartphone market than the US and second only to China. Adoption rates of FinTech solutions have grown globally and even in India, especially among retail customers. A clear indicator is the growth trajectory of transaction using the UPI - transaction volume has grown multifold from 0.1 million in October 2016 to 246.37 million in June 2018.

The rise of digital finance is catalyzing a paradigm shift in India's financial inclusion landscape wherein the challenges facing the ecosystem shift from willingness and ability to access and regular usage.

BSE - Contribution towards Financial Inclusion through FinTech

BSE is playing a leadership role in adopting modern technologies to the growing and ever changing needs of India like it has done for over 143 years. India's financial distribution system is changing rapidly and BSE utilizing FinTech is taking the entire process online to reduce the transaction processing and turnaround time.

The ongoing steady development in the FinTech space has facilitated all market intermediaries working towards making all payments and settlements happen electronically. BSE has developed a Mutual Fund (MF) Distribution Platform, BSE StAR MF, a web-based transaction processing platform for purchase and redemption of mutual funds. This has democratized mutual fund distribution by providing all schemes of all -- AMCs in a single window. Digital platforms like BSE StAR MF has served an opportunity for distributors to rapidly expand and reach potential investors in the financial services space. In FY2018, BSE StAR MF has become the largest mutual fund distribution infrastructure with close to 80% market share in Exchanges. In FY2018, over 1.75 Crore transactions amounting to over INR 1.1 lakh Crore were processed. On August 10, 2018, BSE StAR MF platform received a record high of over 5 lakh orders, with a total value of these orders was over Rs.700 crore. From Financial Inclusion perspective, the platform predominantly caters to retail category with over 99% in terms of transactions and over 76% in terms of value of transactions. The digital platform has enabled BSE to establish a strong presence in mutual fund distribution. Additionally, to enable greater participation in the insurance sector, BSE intends to launch a similar framework.

The Exchange has formed a joint venture - BSE Ebix Insurance Broking Services Ltd. with Nasdaq-listed Ebix Inc. to develop an insurance distribution network in India. The platform will provide a single window framework for both life and general insurance, and also provide claim support. Thus, BSE wants to extensively use FinTech and its large distribution reach to ensure penetration of insurance products across the country and thereby contribute to financial inclusion in the country.

BSE has not only limited itself to platforms but in its endeavour to make markets safe, it has harnessed the





benefits of technology with Big Data and artificial intelligence implementation for real time surveillance and fraud detection. Extending the scope of surveillance beyond the traditional means, BSE has effectively implemented the Social Media analytics to verify rumours and noise on various media including social media, vernacular news, using language to text tools. The Exchange has also implemented a state of art Next Generation Cyber Security Operations Center (CSOC), which is a role model for the country and various institutions both national and international.

BSE is re-thinking and reviewing processes to cope with changing customer expectations, increasing competitive pressures, challenging macroeconomic conditions and dynamic regulatory environment. Transforming digitally will help in customer acquisition and retention, revenue generation, cost optimization and operational efficiency. It will also assist in effective monitoring, regulatory compliance and risk mitigation. Thus, the Exchange can maximize customer experience and gain a competitive advantage in the market. In essence, the emergence of FinTech has provided an opportunity for BSE to make financial products more efficient and inclusive.

Conclusion

A financial revolution is taking place around the globe, backed by technology that will transform financial services. A consensus is fast emerging globally that technology-driven change is inevitable and capital markets are no exception. FinTech's focus is on creating new value propositions or improving existing ones by reducing costs through automation and simplification for the end user.

India's capital markets have reached a high level of sophistication, maturity and robustness. But, still there is a long journey ahead, one that aims at making the markets more vibrant, then achieving global competitiveness and finally claiming global leadership.

BSE is poised to play a catalytic role in shaping the new India and bring solutions, which are of strategic importance and relevance to our business, economy, country and the common man as well. BSE will continue to use latest technology to achieve customer satisfaction and leverage on FinTech to bring in greater 'Financial Inclusion' in India. ■

A Repo Platform – Boost for Corporate Bonds

Bourses launch triparty repos, will provide much needed liquidity

Ashu Suyash, *MD & CEO, CRISIL*

The National Stock Exchange and the Bombay Stock Exchange have launched electronic platforms for triparty repurchase agreements (repo) in corporate bonds. This is following the directions on triparty repos by the Reserve Bank of India (RBI) on August 10, 2017, allowing stock exchanges to operationalise the platforms for it with guaranteed settlement.

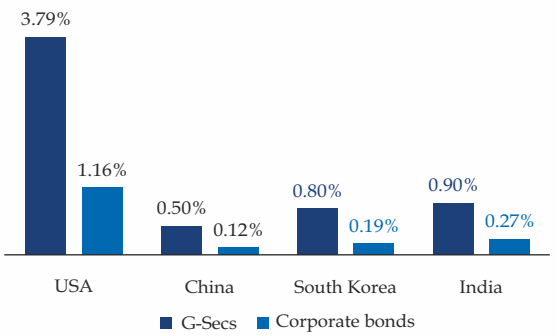
Based on the H R Khan Committee recommendations, a series of measures were implemented in the past two years to improve the depth of the domestic corporate bond market. An electronic market platform with guaranteed settlement for repos was also one of the suggestions.

The introduction of electronic platforms for triparty repo in corporate bonds by the leading stock exchanges is expected to improve the liquidity of, and investor appetite for, these securities.

Liquidity in corporate bond markets

Globally, repos play a critical role in imparting liquidity to corporate bonds, which typically suffer from lower trading ratio relative to government securities *(see Chart 1)*.

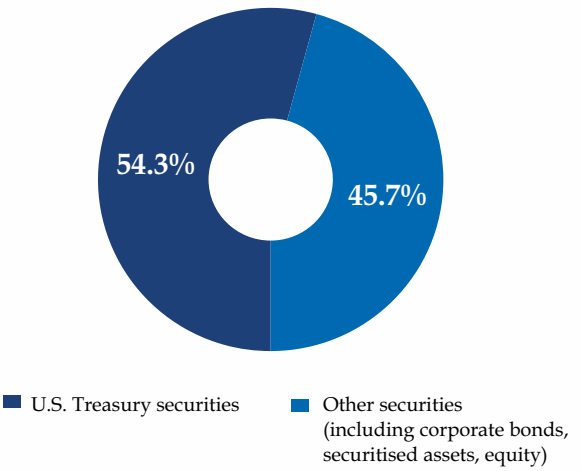
Chart 1: Trading ratio[1] (daily traded volume divided by outstanding amount) of G-secs and corporate bonds



Source: SIFMA, ADB Online, SEBI, CCIL

Globally, corporate bonds are not traded heavily because investors tend to hold them till maturity. For instance, the trading ratio (daily traded volume divided by outstanding amount of corporate bonds) is just 0.27% in India, 0.12% in China, 0.19% for South Korea, and 1.16% for the US. Higher liquidity in the US is supported by a strong repo market worth $2.3 trillion[2]. Of this, ~45% employ non-government securities as collateral *(see Chart 2)*.

Chart 2: Collateral in the US repo market[3]



Source: US Repo Market Factsheet, 2017, SIFMA

How can repos enhance bond liquidity?

Repos facilitate swift conversion of bonds into cash, which helps investors manage liquidity without having to sell, and thus improve liquidity.

In the absence of repos, market makers need to hold a large inventory of bonds to provide liquidity to the

1 *Trading ratios as of June 2017*
2 *Repo agreements outstanding as of June 2017*
3 *Data as of June, 2017*

secondary market. This raises the cost of market-making and hampers the role of market makers. Repos will, hence, play a critical role of lowering the cost of market-making and that, in turn, should enliven market-making in the secondary market. Transferability of securities collateralised under the repo to the lender of funds will be critical for the market-making function of the repo market to materialise.

Investors such as mutual funds, primary dealers, banks and insurers can use corporate bond repos to manage liquidity and asset-liability mismatches. Mutual funds can manage redemptions and secure short-term cash investments. Insurers can start investing more in corporate bonds as they will be able to optimise asset-liability management and duration better through repos without having to sell from their bond portfolios.

Repos collateralised by high-quality corporate bonds will be a valuable tool for risk-averse end-investors to park temporary cash balances. They will also be another avenue for banks to deploy surplus liquidity.

Evolution of repo market in India

The RBI had introduced repos in corporate bonds way back in 2010, but the repo was restricted to listed corporate bonds rated AA or above, and with original maturity of more than one year. Moreover, a haircut





of 25% was to be applied on the collateral. Over the years, the RBI had introduced several changes to the initial directions on corporate repos, including allowing commercial papers, certificates of deposits, and non-convertible debentures of original maturity of less than a year and ratings of A2 and above as eligible collateral for repo. The RBI had also lowered the haircuts for eligible collateral and linked these haircuts to the ratings of the securities. However, despite these efforts, the response had been lukewarm because of non-availability of guaranteed settlement and an electronic dealing platform.

The introduction of the electronic platforms by stock exchanges providing guaranteed settlement is expected to provide the much needed fillip to the corporate bond repo market.

Stock exchanges have introduced basket repos with guaranteed settlement only in select AAA category bonds, A1+ rated commercial papers and certificates of deposit. The BSE has introduced two sub-types of repos - transferable repos, where the underlying securities are transferred to the lender; and non-transferable repos.

Over the medium term, the expansion of basket repos to include AA rating category bonds, in line with the RBI directions, will help deepen liquidity because secondary trading in such papers constitutes only a fifth of the overall corporate bond trading volume.

Also, the repo platform is made available to members of the dedicated debt segment of stock exchanges.

The current membership on the debt segment is low which may constrain the activity on the repo platform. Hence, there is a need to increase the membership in debt segment by permitting NBFCs, HFCs, and encouraging mutual funds to become eligible participants. There is also a need for higher flexibility in the repo platform to enhance market-making in corporate bonds. Overall, success of the repo platform will be a function of interest shown by banks, primary dealers, NBFCs, financial institutions, mutual funds, insurers, and housing finance companies.

In summary

The introduction of electronic platforms with guaranteed settlement for triparty repo in corporate bonds can help enhance the liquidity of corporate bonds. Repos will enable efficient market-making, and lower the cost of issuances in the capital market. Repos will also enable investors to better manage their liquidity requirements, and provide attractive avenues to park their surplus funds. The expansion of basket repos to include AA rating category papers over the medium term can help materially improve their liquidity. ■

Unboxing the 'GIFT'

Keyur Shah, *Partner and Leader, Financial Services – Tax & Regulatory Services, Ernst & Young LLP*
Brenden Saldanha, *Partner, Financial Services – Tax & Regulatory Services, Ernst & Young LLP*

The idea of Gujarat International Financial Tech City (GIFT) was conceived in 2007 when Shri Narendra Modi was the Chief Minister of Gujarat with the aim of creating a world class financial city by offering an unrivalled business environment to global and local financial services enterprises. Shri Narendra Modi has envisioned that in 10 years, GIFT should become the price-setter for at least a few of the largest traded instruments in the world, whether in commodities, currencies, equities, interest rates or any other financial instrument.

Since its inception, GIFT has come a long way; whether it being inauguration of Gujarat's tallest tower or laying foundation stones for development of schools or development of multispecialty hospital, district cooling system, automated waste collection system, data centre and so on. GIFT has consistently managed to develop world class infrastructure and facilities.

Aside from the undisputed positive facets on the infrastructure front, the real questions that arises is whether India's first International Financial Services Centre (IFSC) is making an impact on the financial services sector India– Is the business fraternity suitably incentivised to invest and reap the benefits that GIFT has to offer? Is GIFT on the right path to meet global expectations? Is GIFT ready to be a competitive force among global financial services centres?

The beginning

GIFT was conceived on the back of incredible success stories of global financial centres like Shanghai, Paris, London, Hong Kong, Singapore and Dubai and is expected to become a global financial and IT services hub, designed to be at par or above these centres. GIFT intends to cater to India's large financial services potential (refer chart below) by offering global firms world-class infrastructure and facilities at a comparatively cheaper cost.





Progress so far

With the intention of utilising GIFT as an investment gateway between India and rest of the world, akin to what Hong Kong has been to China, several Indian enterprises from the FS sector have already established their presence in GIFT (viz. SBI, HDFC Bank, IND INX, NSE IFSC, LIC, Edelweiss, etc). It is also known that some of the foreign banks are keen on establishing operations in GIFT and are in various stages of discussions with the Reserve Bank of India.

In order to accelerate the progress of GIFT and to attract investors and companies, the Government is leaving no stone unturned and has introduced many constructive regulatory and tax reforms. Commencing with the Government notifying GIFT as India's first IFSC, the Securities and Exchange Board of India (SEBI) has already put in place regulations permitting trading of vast range of products and the finance ministry has followed through,with offering tax benefits that have enabled a framework that allows for the rapid development of a financial services ecosystem that can cater to the global markets. In particular, SEBI has been pro-active in addressing various issues raised by stakeholders, including:

- Permitting segregated nominee account structure in IFSC;
- Outlining permissible investments for portfolio managers, alternate investment funds and mutual funds operating in IFSC;
- Permitting Clearing Corporations in IFSC to invest their own funds in AAA rated Foreign Sovereign Securities;
- Participation of Foreign Portfolio Investors (FPIs) in Commodity Derivatives in IFSC;
- Introducing liquidity enhancement scheme; and
- Guidelines on issuance, listing and trading of debt securities on exchanges in International Financial Services Centres.

- **Capital markets**

As far as the capital markets are concerned, IND INX was the first International Exchange set up in GIFT. In

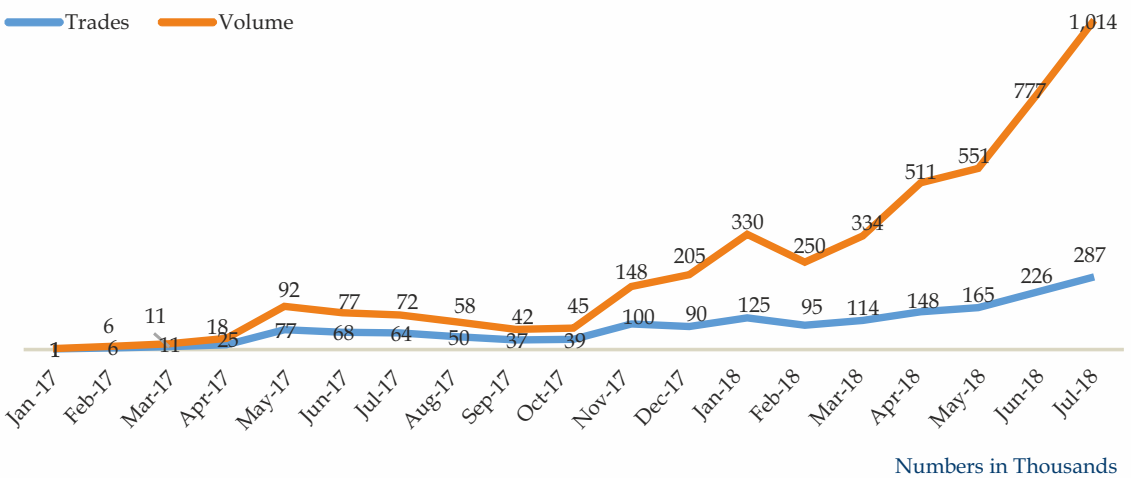
GIFT, it has been permitted to offer a diversified portfolio of domestic and international financial products. In order to differentiate and compete with global exchanges located in Hong Kong, Singapore, Dubai, London and New York, IND INX renders services at a cost which is far more competitive and operates for an extended period of 22 hours a day. As a result of these efforts and various other factors, IND INX is consistently witnessing an increase in the trading volumes which are crossing US$500 million regularly over past couple of months with its daily turnover peaking on 31 May 2018 at US$664.53 mn. With a view to mitigating the constant flow of volumes linked to Indian securities (such as the immensely popular SGX-Nifty), NSE's move to stop providing data feeds to foreign bourses, the permission to FPIs to invest via omnibus structures in GIFT coupled with Budget 2018's tax exemption on capital gains on derivatives traded in exchanges in GIFT have provided the necessary fillip to trade volumes on the exchanges located in GIFT (see table below).

However, the true success of the international exchanges in GIFT would be in providing adequate depth to the market that would excite global investors to trade on these exchanges and become price setters. Currently, when compared to its counterparts, the volumes on the exchanges in GIFT appear to be meagre. In order to reverse the tide and attract more investors, the Regulators and the Government need to



take dynamic and proactive measures. We have illustrated below certain measures which could play a pivotal role in the success of IND INX:

- Simplification of KYC norms for eligible foreign investors (EFIs) - KYC norms need to be clearly prescribed and be sufficiently relaxed to incentivize participation. Presently, there are no prescribed guidelines on the manner in which KYC is to be undertaken for EFIs desirous of opening a trading and clearing account for transacting on the GIFT stock exchanges. Lack of prescribed guidelines may lead to trading members adopting differing norms and thus creating uncertainty. In this regard, GIFT could follow take some cues from Dubai International Financial Centre where there are minimal exchange controls and liberal KYC norms.



(Source: http://www.indiainx.com/markets/daywisemarketsummary.aspx)

- Permitting leverage to FPIs - FPIs could be permitted to have access to local leverage for investing in stock exchanges in GIFT. This would help improve trade volatility and volumes. This would also result in increased overall money flow and increasing market efficiencies.

- Obtaining Commodity Futures Trading Commission (CFTC)foreign part 30 license - CFTC exemption enables members to trade in derivatives for US investors without the member having to register with the CFTC. Further, it also provides US investors with increased access to foreign futures markets i.e. members of the Indian exchange are permitted to accept US customer funds directly for trading without registration.

- **Alternate Investment Funds (AIFs)**

In its endeavour to attract global funds to be based in India, the Government of India (GOI) is also promoting GIFT as a pooling jurisdiction to the global investor fraternity. However, despite these efforts and GOI's best intent, the extant regulatory and tax regime for Funds poses challenges (such as certainty of regime, fund flow permissibility, investment route, etc.).

Under the current IFSC regulations, it is unclear whether an AIF set-up in the IFSC can be managed by a manager located outside the IFSC. In this regard, the Regulators would do well to put AIFs at par with offshore Funds by:



- Permitting investment in Indian domestic market by AIFs set up in IFSC under all existing foreign investment routes (as against only FPI route);

- Liberalising outbound investments by AIFs set-up in an IFSC; and

- Allowing sponsors/ managers of domestic AIFs to open a branch/ set-up a company in IFSC.

Where such issues are addressed successfully, GIFT has the potential to enable primary capital inflow into India, enable outbound investments from AIFs in GIFT, increased market depth, incremental taxation revenues from additional businesses and most importantly, job stimulation in the domestic market.

- **Tax benefits**

With respect to financial services centres based out of GIFT, the overall tax framework has been worked out to provide a competitive tax regime with a reduction in Minimum Alternate Tax rate from 18.5% to 9%, exemption from Dividend Distribution Tax, Securities Transaction tax and Commodities Transaction Tax. The Government of Gujarat has also exempted stamp duty for entities having registered office in GIFT for capital market activities.

Further, a tax holiday period has also been provided for 10 years on profits earned by entities established in GIFT. However, given that GIFT is still in its incubation stage and pending the development of its ecosystem, broadening and deepening of its capital markets, acceptability with global players, such establishments would take several years before they turn profitable. Towards this, incentivising entities with a longer tax holiday period would encourage global MNCs which are currently sitting on the fence to participate more meaningfully and be part of the success of GIFT.

Point of Unwrap

GIFT is being developed as a city which is in India but per se not a part of India. This is being achieved through smart urban infrastructure, better quality of life and business friendly regulatory and tax

environment. Similar to how China has strategically used Hong Kong to bring trillions of dollars of investments which has in-turn made China the centre of manufacturing in the world, the government is optimistic to repeat such success through GIFT (and thereafter through multiple such IFSC's). GIFT has the potential to become an investment gateway for India and bring the much needed foreign investments.

The September 2017 edition of Global Financial Centres Index 22 - London has placed GIFT in the top 15 emerging Global Financial Centres (10th position). Having said this, while the IFSC has been ranked ahead of some leading financial hubs, in terms of numbers and depth, GIFT has not yet created the impact that the GOI had expected it to achieve. While the IFSC policy permits various opportunities on a regulatory front, it remains to see how these actually translate into operations. FPIs, currently trading in Singapore or other IFSCs may not be willing to set up a new base in Gujarat when their clients can trade in Indian products overseas with better tax and regulatory certainty.



Amongst other things, a clear regulatory and tax policy from the Government would go a long way in establishing the credibility of GIFT as an investor friendly IFSC. With several significant initiatives that GOI has already taken and aided by strong structural growth story, a few more steps in the right direction would ensure that this GIFT would be appreciated by the investor fraternity across the globe. ■

Regulatory push apart, attracting a wider set of investors imperative for the development of the debt capital markets

Naresh Takkar, *MD & Group CEO, ICRA Ltd*

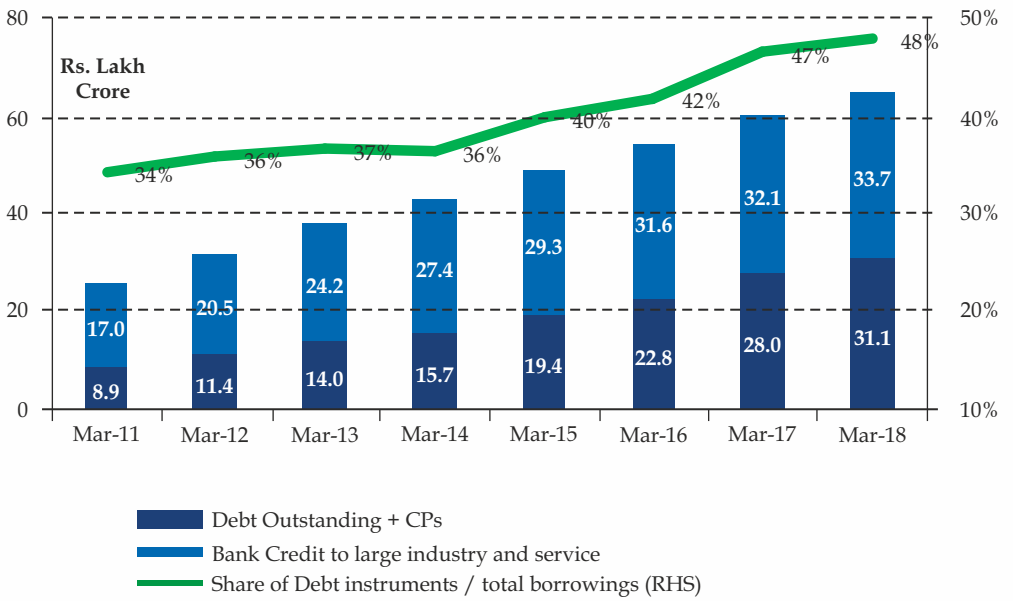
India is expected to remain one of the fastest growing large economies in the world in the medium term. Accordingly, the investment requirements (both debt and equity) to cater to the ever-growing demand for goods, services and infrastructure are likely to remain substantial for the next many decades to come.

While our equity capital markets can be benchmarked to various developing and developed economies, the same is not true for our debt capital markets. The market capitalisation of listed equity securities at ~100% of GDP is comparable to even the developed economies around the globe. However, the penetration of our debt capital markets is significantly lower than the peer set, with the value of corporate debt (including commercial paper and certificate of deposits but excluding government securities) at just 19% of GDP, much lower than many other developing and developed economies.

Being historically dependent on bank funding, the debt financing needs for investments have predominantly been met through the banking channel until now. As seen in the Exhibit 1, Bank funding accounted for ~two-third of the borrowings of large corporates till as recently as FY2014.

With the beginning of the rate reduction cycle by the Reserve Bank of India (RBI) in January 2015, that was supported by lower inflation levels, improving current account and fiscal deficit position of

Exhibit 1: Share of bank funding vs debt instruments in overall borrowings of large corporates



Source: SEBI, RBI, ICRA Research

Government of India (GoI), debt issuances and the share of debt instruments in the overall borrowings of large corporates started rising during last three-four years.

The Demonetization exercise during FY2017 and the consequent surplus in domestic systemic liquidity sharply brought down the bond yields. This spurred the magnitude of bond issuances and boosted the share of debt instruments in overall borrowings to almost 50% levels. Apart from the above factors, the weak capital position of the public sector banks (PSBs) and rising capital requirements also constrained their lending ability, restricting their ability to grow bank credit.

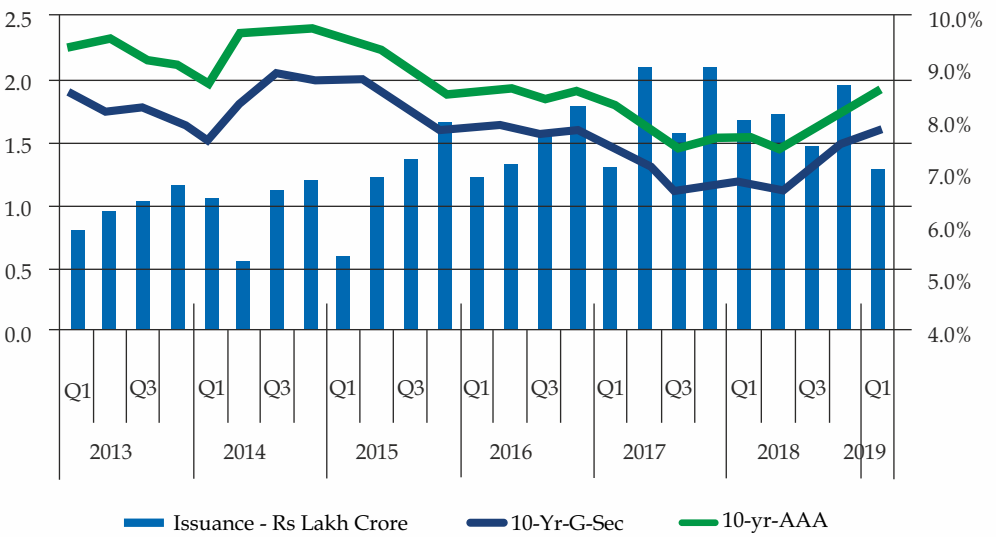
While the issues related to capital constraints of the PSBs are expected to continue for a couple of years, impacting the credit supply from the Indian banking system, however, rising bond yields have adversely impacted the volume of debt issuances, which have taken a hit in recent quarter as can be seen in Exhibit 2. Rising crude oil prices, the consequent weakening of the current account deficit and global trends added



pressure on the exchange rate. Such factors, coupled with concerns on the size and quality of the fiscal deficit of the state and central governments, and a global uptrend in bond yields, promoted arise in Indian bond yields, contributing to a YoY decline in the fresh bond issuance volumes during FY2018 and Q1 FY2019.

Our analysis reflects that economies with low levels of fiscal and current account deficit, low and stable inflation levels, high institutional strength and better

Exhibit 2: Corporate Bond Issuance vs Bond Yields



Source: SEBI, Bloomberg, ICRA Research

rankings on ease of doing business, have more developed debt markets. If India has to develop its debt markets, we need to reduce the inherent volatility in the domestic interest rates, thereby enhancing the certainty that can be provided to the issuers and investors. Precedence shows that while the investors refrain from fresh investments during a rising yield scenario, to avoid losses, the issuers refrain from issuing fresh issuances in a declining interest rate scenario to avoid locking in high cost borrowings. Though interest rate swaps are available in the country for banks, primary dealers, financial institutions and corporates however these are currently available for hedging purposes only. Further, low participation and absence of market makers results in weak price discovery and high transactional costs for the participants. Broadening the participant base and improving the volumes will reduce the associated transactional costs through better price discovery.

Notwithstanding the recent decline in bond issuances, the regulatory push towards broadening of the debt markets is expected to support a continue growth of domestic debt issuances.

The Union Budget for 2018-19 proposed that the Capital market regulator - Securities and Exchange Board of India (SEBI) - will mandate large companies to raise atleast 25% of their borrowings from the corporate bond markets. In this regard, SEBI has also recently issued a draft consultation paper proposing that companies with long-term borrowings of more than Rs. 100 crore and having a credit rating of AA and above (later proposed to be reduced to A) shall borrow 25% of its incremental borrowing through corporate bonds. This is proposed to be implemented from April 1, 2019. Earlier, the RBI had also issued guidelines for large borrowers having borrowings of over Rs. 25,000 crore from the banking system in fiscal year 2018, requiring them to borrow 50% of their incremental borrowings through debt instruments. The limit for large borrowers has been progressively reduced to Rs. 15,000 crore for FY2019 and will be brought down to Rs. 10,000 crore, thereafter. In case these large borrowers continue to borrow from banks, then additional provisions and need to maintain higher capital for such borrowers is likely to increase the funding costs from banks which is expected to improve competitiveness of bond markets. Both the above steps are likely to push the borrowers to the debt capital markets for their funding requirements, increase the supply of debt while broadening the issuer base and reducing the concentration risks on the balance sheets of the banks.

Currently top 30 issuers account for ~60% of value of debt issuances and ~84% of debt issuance in value terms is concentrated in AA or above rating categories. As a step towards further broadening the issuer base, products like credit guarantees/ insurances and credit default swaps needs to be further promoted. At times, the costs of availing these credit enhancements can be prohibitory for the issuers and effectively increasing the overall costs of borrowing. Incentivizing banks and financial institutions by lowering the capital charge can reduce the costs of such credit enhancement costs for issuers and reduce the overall costs of such credit enhanced bonds and widen the issuer base.

Although various steps have been taken to push issuers to the debt capital markets, however an equal effort needs to be made to attract a wider set of



investors in the debt capital markets. Typically, the participation in the corporate debt market was largely driven by banks; however, with increasing institutional flows and improved awareness among retail investors, the participation from mutual funds has also improved. The debt assets under management (AUMs) have increased at compounded annual growth rate (CAGR) of 17% during last three years to Rs. 13.44 lakh crore as on June 30, 2018.While the debt AUMs have increased, the retail investor participation in debt mutual funds remains low at 42% of AUMs of mutual funds as compared to 87% of AUMs under equity mutual funds. Further, insurance companies and pension funds having large pool of long-term savings have largely limited their corporate bond investments to AAA rated instruments despite a lower regulatory threshold of AA rated instruments. The recent budgetary proposal to lower the regulatory threshold to A rating level may hence take some time before these investors develop some risk-appetite for these bonds.

Unlike banks and financial institutions, who require core equity / risk capital to support the credit growth and hence have limitations on supporting credit growth; capital light structures like mutual funds / pension funds can scale up their debt investments without capital constraints. Similar capital light models include infrastructure investment Trusts (InvITs) and real estate investment trusts (REITs), which have potential to mobilise large pool of savings by offering high quality debt instruments by leveraging their cash flows generating assets. There is a need to create more investor awareness and recycle more cash flow generating assets, which will widen both issuer as well as investor base.

Further, the investment considerations continue to be influenced by the tax rates, with nil tax rates on gains from equity investments (upto Rs. 1 lakh / year now), whereas the capital gains from debt mutual funds continue to remain taxable. Tax is also driven by the holding period, with lower tax rates for longer holding periods and vice versa. Parity in taxation structure, irrespective of nature of investments, route for investments and holding period, can improve investors' participation in the Indian debt markets.

The debt markets in India have largely remained as hold to maturity markets, with limited activity in the secondary markets. The daily trading volumes have been miniscule at 0.3% of the volume of corporate debt outstanding (excluding government securities). Absence of adequate liquidity in the corporate bond markets also creates a disincentive for investors, as it increases the uncertainty on their ability to timely liquidate their holdings at an appropriate price.

Various attempts have been done to increase the liquidity in corporate bonds such as REPO among market participants for corporate bonds, however the volumes continue to remain negligible. To improve the liquidity, incentives such as changes in taxation structure, funding availability at competitive rates depending on the quality of bond portfolios can be considered for market makers, which will provide depth in the secondary bond markets.

Another reason for poor liquidity in debt markets has been the low stock of securities outstanding against a given International Securities Identification Number (ISIN), as fresh debt raising through reissuances under a given ISIN have generally been limited. From April 1, 2018, SEBI has addressed this issue by limiting the ISINs maturing in any given year to twelve. This is expected to promote debt reissuances under a single





ISIN, thereby boosting the number of securities outstanding under a given ISIN and thus improving the liquidity. Greater liquidity in debt securities would also help in better market-driven price discovery and remove subjectivity in their valuation.

Last but not the least, is the improvement in availability of information related to debt securities. Unlike equity shares of a company, which will have a single ISIN, a company can have multiple live ISINs (even more than 100) for its debt securities. With cash flows, principal amortization schedule and other terms such as put/call options, redemption premium, security cover differing for each security, all such information shall be made available to investors at a single place. Reducing information asymmetry will further improve upon the price discovery of these debt instruments and boost liquidity. ■

Promoters in the context of Indian Capital Markets: Need to rethink the regulatory framework?

Nikhil Naredi, *Partner, Shardul Amarchand Mangaldas & Co.*
Monal Mukherjee, *Partner, Shardul Amarchand Mangaldas & Co.*

Introduction

Indian companies continue to be, more often than not, family run businesses that have evolved with time. These companies have typically been owned, controlled and operated by a select few individuals or family offices and identification of select individuals as '*promoters*' of these companies has largely been an easy task for regulators in India.

Many aspects of India's current regulatory framework vis-a`-vis promoters illustrate a hangover from the early 1990s, which saw many fly-by-night operators take the public offer route, as well as a lack of depth in Indian capital markets, which would have resulted in extreme volatility and hardship to small investors if and when a promoter chose to exit or sell a large stake in a company soon after listing. As the Indian securities markets acquire depth and resilience, and as corporate disclosure and corporate governance standards continue to improve with each passing year, certain prisms through which we have traditionally viewed promoters and companies in India have begun to change.

This article looks at developments in certain key regulatory aspects and examines whether there is further scope in revisiting this conceptual framework for this regulatory regime.

Identification of Promoters - Implications

Under the applicable provisions of the Companies Act, 2013 and the SEBI ICDR Regulations, the definition of the term 'promoter' hinges on the ability to exercise 'control', which, in turn,is dependent on the ability to appoint the majority of directors or the extent to which management or policy decisions are made by such parties in 'control' (and not necessarily on the level of shareholding).

SEBI, in a discussion paper in 2016, sought to introduce a bright-line test (holding 25% of the share capital) for identifying promoters, but this proposal was not given effect to because of the implications that it may have had. For example, a private equity investor who may have had participated in successive rounds of capital raising by a company (which is quite likely the case for an early stage investor if growth capital is not available at favorable terms in subsequent rounds), may have ended up with more than 25% of the company and would have been classified as a promoter even without playing any role in corporate decision-making.

Therefore, identification of 'promoters' is likely to continue to be subjective in nature. However, SEBI has prescribed extensive disclosure norms, where promoters are required to provide numerous disclosures in relation to themselves (including corporate/personal information, litigation etc.) in public offer documents and their relatives as well as entities in which they have invested, identified as 'promoter group' under the SEBI ICDR Regulations. In addition, promoters are also responsible for disclosures in relation to themselves as well as the issuer company, with the applicable regulation prescribing civil (as well as criminal in certain cases) liabilities for the promoter for any material misstatements and omissions in public offer documents. Moreover, to establish their continued support to the issuer company, promoters are mandated to lock in 20% of their post-IPO shareholding for a period of three years.

Post listing, promoters have to comply with specific requirements under the SEBI Takeover Regulations and the SEBI Insider Trading Regulations. Acquisitions up to a certain threshold prescribed under the SEBI Takeover Regulations (such as 2% or

5% acquisition of share or voting rights) mandate specific disclosure requirements, while acquisitions crossing particular thresholds may result in the acquirer having to make an open offer of the shares of the target company. Under the SEBI Insider Trading Regulations, an insider is, among other things, prohibited from dealing in the securities of a listed company when in possession of unpublished price sensitive information. The Insider Trading Regulations also provide disclosure obligations for shareholders holding more than a pre-defined percentage, with respect to their shareholding in the company, and the changes therein. In addition, the promoters of a company undertaking an IPO may be required to allow an exit opportunity to dissenting shareholders, in the event of a post-IPO variation in the objects for which the company has raised money from the public through an offer document.

Even the identification and disclosure requirements involving 'members of the promoter group' at times becomes onerous on the issuer company, as such individuals and entities, which may be in the nature of financial or treasury investments made or inherited (perhaps historically) by relatives of the promoters, may not be directly connected with the activities of the company or the promoter and, therefore, be disinclined to take on obligations in connection with a public fundraise.

As indicated above, this trajectory of promoter-related regulations and disclosure requirements has formed over time in India, largely as a regulatory response to certain non-compliances by promoters of Indian companies in the past, which impacted the welfare of investors in India and the development of our securities markets in general. More recently, however, we have observed a new generation of companies, particularly in the technology or services sectors, where founders or financers may not necessarily be promoters.

'Promoter-less' companies

Although the SEBI ICDR Regulations do provide for companies that do not have identified promoters to go public, or for financial investors to provide shares for



post-IPO lock-in even where they may not be named as promoters, it is still extremely rare to see such transactions. It is understood that the regulators in India prefer to identify and regulate ultimate owners/persons involved in the functioning of the companies and the burden of proof to establish that a company is purely professionally managed, with "no identifiable promoter", is typically challenging, particularly so perhaps for foreign investors who are not familiar with extensive promoter-related restrictions and disclosures in overseas jurisdictions. However, certain 'board-managed' listed companies continue to function in India within the realm of existing regulations. Therein lies a dichotomy which will need to be further examined, as India moves forward.

With the increase in entrepreneurial activity in the sunshine sectors, the economy is expected to see more ventures based on partnership of various investors/professionals coming to market and the regulatory approach will have to keep pace with this evolution in the manner of doing business.

Evolving corporate structure and change in the role played by Promoters

With the evolution of the Indian corporate sector, we see a paradigm shift in the structure of Indian companies today, with ever-increasing involvement of financial investors, as providers of capital and in driving corporate policy and decision-making. In this

context, the role of the promoters of the companies is undergoing a change. While promoters are inextricably involved in the overall operations of the company, any strategic decision impacting the future of the company is typically subject to vote from parties who hold financial interest in the company. Furthermore, companies prior to undertaking an IPO, typically invest in a broad-based board of directors and senior management. The induction of sophisticated private equity investors in itself may generally result in higher standards of professional management and improved transparency with shareholders.

To an extent, the regulatory framework regarding promoters and promoter group in India may restrict funding options for certain growth stage companies and their backers, which may prefer to explore debt financing or private equity, rather than coming forward to tap public funds.

We have also observed instances in the recent past where certain members of the so-called promoter group are not inclined to be considered as such, or where their lack of cooperation or involvement, or other compliance issues regarding such entities, may become an impediment to the listing of a company.

Therefore, when a company decides to raise public capital, imputation of responsibilities and liabilities as regards the regulatory and statutory obligations on the promoters and promoter group (in addition to the issuer company) need to be examined further.

Reclassification of 'promoter' to 'non-promoter'

Considering the dynamic nature of the corporate structure and, on occasion, the nature of the shareholder itself (which may be a fund, or a foreign entity), a shareholder may not be in a position to expose itself to the enhanced level of exposure and continuing obligations that come with promoter classification, which in some cases may affect the fund raising avenues open to such a company.

There may also be genuine instances, where a separation of certain individuals from their direct relatives (and their holdings) may be required to be established, as the stakeholders in the company are not (or no longer) all jointly and directly involved as if it were a business operated by a conventional Indian joint family of the past.

Prior to 2015, the regulatory regime was not entirely clear on '*de-promoterisation*'. In 2015, SEBI introduced a specific regulation on reclassification of promoters, i.e., regulation 31A of the SEBI (Listing and Disclosure Requirements) Regulations, 2015,which required certain conditions to be fulfilled. While this regulation identifies the concept of 'professionally managed companies', the threshold for identifying a company as a 'professionally managed company' - no group of shareholders (excluding certain institutional shareholders), including existing promoter (and person acting in concert)holding more than 1% of the total shareholding of the company - was regarded by many in the market as inflexible or difficult to achieve. Coupled with this, the language of this regulation suggested that an existing promoter can be reclassified only if being replaced by an incoming new promoter, which may not be the case in all instances.

Based on industry feedback received, SEBI has proposed simplification of the regulation pertaining to reclassification of promoters, which is a welcome move. It broadly recommends a single set of conditions applicable to all situations of reclassification of promoters, with an objective that



such reclassification is done in a fair and transparent manner and in the interest of public shareholders. The process envisaged involves:

a. an application being made by such promoter seeking to be 'declassified';

b. such request to be placed before the board of directors of the company along with the recommendation of the board of directors, which may be either positive or negative and such request to be approved by the shareholders of the company;

c. such applicant should not hold 10% or more of the total voting power in the company;

d. such applicant should not exercise any control over the affairs of the company either directly or indirectly;

e. such applicant should not have any special right with respect to the company through any formal or informal arrangement including through a shareholders agreement;

f. such applicant should not be represented on the board of directors of the company;

g. such applicant should not act as a key managerial personnel in the company; and

h. such applicant should not be identified as a willful defaulter under the guidelines of the Reserve Bank of India during the period such request application is being made.

In the last couple of years, we have also seen IPOs where private equity investors have been classified as promoters in offer documents. However, such transactions are typically difficult to achieve and different market participants have approached this question in slightly different ways. The proposed measures set out above are expected to go a long way in clearing the former uncertainty surrounding promoter reclassification.

Conclusion

Considering the evolution of the Indian securities market to its current state, and the diverse nature of



issuers and market participants, it may be difficult for the regulator to entirely move the regulatory needle away from the promoters and entirely adopt the sort of "promoter-less" corporate regulatory framework that is currently existing in certain overseas jurisdictions. Indeed, in the recent past, SEBI passed several orders against promoters with respect to misstatements and omissions in offer documents for securities offerings. In some instances, promoters have been debarred from accessing capital markets directly or indirectly on account of these non-compliances. While such orders do bring about greater accountability and deterrence from non-compliances, regulators must tread a delicate balance to ensure that the Indian regulatory framework continues to be conducive to fund raising.

In our view, as we move closer to ensuring that India's disclosure and corporate governance framework for listed and to-be-listed companies is at par with the developed capital markets of the world, certain anomalies in the Indian market will be corrected, and there will be growing opportunities for companies that could not have come to market previously, to access public funds in a more conducive and transparent environment. ■

(Reema Dash, Senior Associate, assisted in writing this Article)

Blueprint for Capital Market in New India 2022

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

The root of this exercise for me is how we can make the future better. What I want to ask is, will our entrepreneurs have access to risk capital easily *(and swiftly)* and on tap. Will our industries be able to raise long term and turnkey debt from the primary debt market? Will an organic farmer from deep Chhattisgarh or Arunachal Pradesh be able to raise credit efficiently if she wants to build a brand? Will a tourist operator residing in a Zanskar valley be able to invest easily and purposefully in equity, debt or mutual fund if she so desires. Or, Will an old grandmother in Tenkasi have her SWP income credited into her bank account; and then a portion of it debited to buy a new age company share based on a strategy that she herself has designed.

The answer to these questions is where the market may find its future. For these answers to come through, we would need to strengthen India's software and hardware both.

We have now begun to develop significant top level hardware. The roads, the railways, the ports, the data network all of it is getting built up at maniac pace. However, the archaic bureaucracy remains. An uneven education and health delivery system is still a drag on the country. And our law and order setup requires much work and effectiveness. In summation, our hardware is increasingly Asian, but our software is very Sub-Saharan.Without this in place, there is a shackle to how much we can grow and at what pace.

An offshoot of the above is: Why can't capital chase opportunity, responsibility and enterprise - rather than the other way round? *(It does to some extent)*. For this to happen more regularly, the capital has to be in overflowing quantity. The risk levels for both debt and equity investors have to decline; and the entrepreneurial and investment opportunity has to be in plenty.

Currently capital market regulations, and costs requires the MSME borrowers and marginal savers to jump through many hoops and pits. And in this process we end up losing them to the informal segment. The future needs to be simple. A driver does not need to know the concepts of automobile engineering to drive a car. Auto industry has made buying a car as well as hiring a car relatively cheap – *(notwithstanding the complexity involved in making it).*

Likewise, the future capital market requires that the entrepreneur need not suffer the long, tedious and costly process of raising capital. The investing process and information of opportunities too needs to be simplified and readily available. Lack of information must be lesser and lesser reason for people to remain 'un-wealthy`'.

Quite naturally, this simplification and ready availability of opportunities requires top notch technology. The problem is, how to adapt and create path breaking solutions without suffering white elephant projects. This in my view creates business conditions for disruption.

Big players have an institutionalised pace, a direction and an inertial agility. Their sizes also makes many of the players too big to fail. It necessarily leads to caution in technology and/or model adaption - lest it change the business *(what is also called the Maginot line mentality)*. This often leaves the space for nubile startups made of people with nothing to lose but a screwdriver(and/or VCs money) to come in and start surprising the markets.

As a religious man, while I believe that disruptions in financial industry are inevitable *(even necessary)* they must also be predictable. Yes, I see the paradox but the request is legitimate. Like oil, data, and food: capital too is a strategic asset. Capital markets impact the lives of hundreds of millions, and in ways many can't even fathom. Therefore a strong sense and a nose to smell the tenth order of impact for major changes may be needed. We have seen ample 'Tulip-manias' in history. And without smooth and predictable disruptions, the upheavals may be too much to handle.

Point is: capital market must provide solutions that are politically and socially sustainable in pursuit of wealth and innovation. I am not saying this as a well-worn cliché. There is an economic necessity to it. Capital markets core value is in its efficiency to allocate capital for nation's needs. Any misallocation causes jobs, respect, reputation, sentiment and belief in the system. This in turn undermines faith in common sense economics, which then boomerangs onto the market.

Political and social sustainability is also important for another reason. Technology and super-specialisation may increasingly lead to 'superstar effect'. This may over a period of time lead to sharp and unsustainable inequality. This is a problem looking for a capital market solution. Integrating the wide population with the mainstream financial market will give them participation, stake and desire in success. Moreover, capital markets by means of interest, dividends and capital gains; can abundantly distribute wealth and prosperity. Thus, a wide penetration of high value investment assets amongst our population is needed. It is also good business.

The only certainty with future is in its uncertainty and capital markets dislike that. To resolve that, a whole new science of risk management was developed. But the 2007-08 crisis only shows that the market risks have the tendency to surprise the best brains(even when put together). This happens because rationality trumps bias when humans are interacting.



Capital markets would need to resolve this thick smoke of emotion that clouds decisions and triggers cycles. I would not get into the Keynes vs Hayek debate here. But I think, technology and knowledge systems can help. If only the right motivation was in place. As an example, there are technologies coming in which can potentially create smart contracts and help mitigate many of the trust issues in trading, remittance, accounting, transparency etc. This in itself can reduce the information gap and risks sizeably.

Finally, India is at a cusp of realising her potential. She will need mega-infrastructureinvestments and projects to do that. She will need those investments to be as productive as possible. India's investments will have to have the competitive edge to out-produce and out-price the present competitors.

We cannot take 12 years to make a bridge at five times the original cost; and then expect that the goods paying tolls on that bridge will be competitive with those produced in China or in Thailand. Our capital markets may need to help bridge this productivity gap for the industry. Because, as India grows, capital market's stakes and its criticality will grow. Our capital markets may need to begin to imagine and fund projects of scale that are extraordinary. This risk and the costs of this risk will be different then. So the preparation needs to begin now. This imagination needs to begin now. Wishing all the very best. ■

PPP in roads – Evolution and InvIT as a way forward

R. Govindan, *Executive Vice President – Corporate Finance & Risk Management, L&T Ltd.*

The focus on development of Roads infrastructure in the country started in a big way with National Highway Development Project in the period 1999-2004. The Government announced plans like the Golden Quadrilateral, NSEW corridors apart from other specific regional initiatives. NHAI evolved as a primary road development agency in the country and roads cess was introduced as a way of financing the road development plans. However, the Government soon realized that even with the budgetary support and roads cess, there will still be a need to attract private sector funds into this sector for the pace of development to be fast enough to sustain GDP growth aspirations of the country. Accordingly, Public Private Partnership (PPP) framework was conceptualized.

In the initial period, the framework evolved in a consultative mode between the Govt and private sector as well as sector experts. The framework (both contractual and economic) was balanced in terms of risks and obligations between the Govt and private sector. As a result, the initial Build Operate Transfer (BOT) model bids that were announced saw participation from the large private sector players and the bids were also reasonably priced commensurate with the inherent risks. The Government also performed its role in terms of better project readiness and performance obligations like timely land acquisitions and providing clearances and approvals to facilitate completion of projects on time. Thus, the initial projects undertaken performed reasonably well signifying partnership between both the parties. Higher economic growth of the country during this period also helped in terms of achieving better traffic growth in initial years being in line or better than what were priced into the bids.

However, with the initial successes becoming well publicised, by 2008-2010 period, a lot of new and smaller developers started entering the fray. The government also sensed the initial benefits of PPP framework for the private sector and mistakenly believed that there was need for higher participation for more competitive bids and thus more value creation for the public/government. With increased competition and higher economic growth climate of 9-10% GDP growth, the bids in this period were more aggressive and in the process many developers inappropriately factored in higher than feasible long-term traffic growths. The subsequent economic downturn and regional issues like public unrest relating to tolling, mining ban, violations etc. resulted in a sharp drop in traffic compared to projected numbers leading to a lot of projects coming under financial stress.

However, the contractual framework did not provide for any cash compensation to projects genuinely stressed due to problems which can be directly attributed to Government action/inaction. The framework typically only provided for compensation by way of concession extension which does not reduce cash stress of the project at that point in time. The last straw on camel's back came in the form of negative WPI growth on account of fall in oil prices in 2013-14 which led to drop in toll tariffs as well.

Hence given the above mix of issues on government side like project readiness like land handover, utility, railway and forest clearances and situations created by the private sector like aggressive bidding, higher leverage, taking on order book beyond financial and operational capacity, situation deteriorated post 2012 resulting in incomplete projects, lower returns and eventual stress/NPA for large number of road projects in the country. The situation could have been



better managed if the spirit of partnership envisaged in the PPP model initially had been kept alive by the Government and more discerning financial strength parameters been employed in choice of private partners. For such stressed projects, the stronger partner i.e. Govt could have exercised termination provisions in the concessions where concessionaire was at fault or accepted the terminations gracefully where the Government was at fault eventually taking over the projects, repaying bank debts and then maybe re-auctioning the projects to a new private partner. Instead, termination provisions were neglected and contested to delay bank loan payments to further accentuate problems of stuck projects leading to accumulation of NPAs on bank books.

Since most of the earlier large developers with strong balance sheets were now either under stress or disillusioned with the BOT PPP model, further bids from NHAI saw much reduced participation. As a result, NHAI had to move towards developing road projects on EPC basis. It took a further couple of years for the sector to revive with some positive steps from the Government:

- Fast tracking of land acquisition and awards being finalized only once 80% of land required was acquired and clearance of other issues for stuck projects
- Removing the uncertain traffic risk from PPP projects by introducing Hybrid Annuity model
- Deferment of premium for projects with lower than estimated traffic to decongest stuck projects
- Release of 75% of arbitration amount in case of challenge in higher courts

However, by this time some of the large developers had their balance sheet extremely leveraged and had no ability to put-in further equity in new projects even under HAM model. It took some time for the HAM model to gather acceptance from banks and developers alike. Though the HAM model has seen reasonable success since then, it saw emergence of newer set of players completely different from the earlier set of players in the first phase of PPP. With the launch of HAM model, the Government's agenda of road development was continued however the earlier stuck and distressed road projects continued to clog the developers and banks' balance sheets. Some of the developers managed to find financial investors in bilateral transactions to sell some of their better assets or a mixed bundle of assets at distressed prices to be able to deleverage. However most of the early PPP developers have either exited this sector or are now interested only in EPC or HAM projects.

Introduction of InvIT as a product

Access to the capital markets was considered as a way-out to refinance the equity stuck in stable operational projects of the developers. Government in conjunction with SEBI conceptualized InvIT as a product to provide the developers with an option to transfer their existing operational road assets releasing the contributed equity for new projects. However, it took multiple rounds of consultations and tweaks to the regulations as well as suitable tax concessions to be made available to InvITs before the first such transaction could happen in 2017.

Given that an InvIT is a hybrid product lying somewhere in between equity and debt in terms of its risk profile, ideally the return expectations from an InvIT for the investors should also be intermediate. However, the experience so far indicates that investor expectations of returns from an InvIT are not very

different from equity returns expectations. This may be due to lack of product understanding on the part of investors or simply the desire to garner higher returns in a market where the seller/issuer is under stress to deleverage the projects. In the process, the primary objective of the InvIT to provide an avenue for developers to release stuck equity to facilitate further developmental investments remains un-addressed. Also, lack of coordination between different regulators is also leading to some lack of liquidity in this market. For example, IRDA has put a cap of 5% of InvIT issue size on investment by an insurance company into InvIT which precludes insurance companies, for which this is an ideal long-term investment product from investing in them in big way, lack of clarity on where this product can be housed in MF portfolios etc.

Presently, the secondary road asset market for acquisitions by an InvIT primarily consists of toll projects which are either facing asset related or promoter related problems.

The asset related problems can be broadly classified into pre-COD issues like land acquisition or traffic related issues. These are inherent problems and cannot be fixed by transfer of assets to third parties or trusts. Although it can result in lower enterprise value for the buyers to consider, any value erosion lower than the debt outstanding involves complex and lengthy lender procedure. Since it seldom involves meaningful equity pay-out to the original developer, the process inherently defeats the purpose of the value unlocking for the developers to invest in new projects.

Stable operational assets where promoter is under financial stress due to excessive leverage are attractive options to acquire by the InvITs. However, the opportunities often come as a package with mix of good and bad assets. The quantum of funds required to buy-out such a package is significant and will involve fresh fund raising from the InvIT investors given the limit of external debt of 49% for the InvIT. Also, if the InvIT investors' return expectations remain pegged at normal equity return kind of ranges,



such transactions may again proceed slowly. Also, projects which have ongoing legal disputes with NHAI, MORTH or state governments may not be taken up by InvIT investors.

New PPP project pipeline

There has been a strategic shift on part of NHAI to move to Hybrid Annuity mode (HAM) for delivering PPP projects. The structure of HAM involves much lower equity requirement (~12-15% of overall project cost) during construction phase compared earlier PPP modes like Toll and pure Annuity. Due to certainty of cash flows from a HAM project, once the construction risk is over, it is much easier to refinance/structure the project loan over the whole project life. In the process, significant amount of the contributed equity may be released to promoter which can be invested in fresh projects. For putting HAM projects in InvIT, essentially the project debt will be replaced by investor equity resulting in lower equity return compared to the investors' expectations. Thus, the pipeline of new HAM projects does not seem to be attractive for InvIT.

TOT model

NHAI, for its asset monetization programme has launched Toll-Operate-Transfer model to transfer the NHAI projects / transferred Annuity projects for tolling to private long term investors. While the first bid has been successful (though the IECV payment is yet to happen), the contractual framework for TOT

has introduced certain new risks for private sector while de-risking the authority completely from its performance obligations. This is likely to be a dampener on wider participation in this program. A good example of this is the requirement for a common performance security from the bidder for the entire TOT package which can be encashed by NHAI anytime to recover any penalties imposed by NHAI due to perceived or actual gaps in performance by the concessionaire. If invoked, the BG needs to be replenished by the bidder within 15 days else it is a concessionaire EOD which could lead to package termination. This has the following implications for the bidder:

A. A disproportionate risk-reward equation whereby the bidder can never risk disputing any penalty imposed by NHAI given the risk of cancellation of whole package. Hence even if the security face value is small at inception, the amount of loss could be much higher for the bidder.

B. Unlike earlier BOT model where the risks could be ring-fenced by the developer to the single Project SPV, given a common performance security across multiple road projects, it may have to be issued by the bidder directly or by the SPV but with recourse to bidder which then precludes such ringfencing by bring in an explicit recourse to the bidder directly.

NHAI is also planning to launch its own InvIT to diversify their source of funds to finance the HAM and EPC projects. Between TOT packages and InvIT, the appetite of foreign investors to look at existing stuck projects may be small and also these two strategies of NHAI will likely reduce investor appetite for private sector InvITs.

Way ahead

The government should look at improving the terms of trade in BOT PPP model (more on the lines of HAM model) in order tore-attract risk capital back in this sector. Unless, of course, the Government is looking at only HAM and EPC models as the way ahead. However, as mentioned above, in such a scenario the future growth of platforms such as InvIT will be limited. Some of the prudent steps from Government may include

- Revival of the BOT-Toll in a modified form which will restrict transfer of entire traffic risk to the developer. The focus should be more on the quality and maintenance of roads with options built in to actually realise the threshold return in case of economic downturn/lower traffic and/or fixed increment of tariff. The authority may consider a minimum equity return (revenue guarantee to achieve that return) and maximum return (revenue sharing beyond threshold revenue) to compensate for adverse scenarios and participate as a partner in upside.
- Promote the growth of pure-play developers with better financial capability, governance structure by introducing thorough assessment of financial strength (other than only networth assessment), lender relationships and risk ratings, operational history etc. to ensure successful financial closure and project completion.
- Rework on the one-sided contractual provisions in the TOT model to balance the risks and rewards equally between Government and investors which will prevent future problems for the sector and Government alike.
- Bidding of NHAI constructed operational EPC projects (with less traffic density not suitable for



TOT) on Annuity basis with longer concession period while keeping the tolling with NHAI - InvITs should be allowed to bid for such projects and it should be in bundle (~2000-3000 cr) facilitating lower equity raise required for such acquisition.

- Allowing InvIT to issue debt securities on the exchanges to finance future acquisitions which will free up bank capital
- Allowing IDFs to fund projects once it achieves COD instead of present regulation of one year to fast track deleveraging projects of bank borrowings.
- Relaxing norms of 2 years post COD for divesting 100% stake into InvIT with the promoter holding



mandatory 15% stake. The promoter may be required to hold on 15% stake for specified number of years after such acquisition byInvIT. ■

Green Bonds - Financing for a Greener Tomorrow

***Sandip Biswas**, Group Executive Vice President Finance, Tata Steel Limited*

Background:

With global focus on sustainability there is an increased urgency for the finance sector both to adapt and to help bring about the necessary mitigation to aid against climate change, environmental degradation and irrational resource development. One of the important medium of attaining sustainable development is through cleaner production adopting green, energy efficient technologies which helps in lesser waste, positive impact on environment and thus, leading to greater sustainability. However, developing and adopting environment-friendly technology measures require a tremendous amount of capital. United Nations Conference on Trade and Development (UNCTAD) estimates that realizing the sustainable development goals (SDGs) will require US $5-7 trillion annually over the next 15 years, as the world will need to invest around US $90 trillion in infrastructure assets. If sustainable development goals are to be respected, this money will have to be spent on low-carbon and energy-efficient projects. The financing needs of sustainable development require new sources of funding to be explored which can provide not only the requisite financing, but may also help in reducing the cost of the capital. Green bonds may be one of the effective ways of using debt capital markets to fund sustainable growth. A Green Bond is a debt instrument, wherein, the issuer publicly states it is raising capital to fund 'green' projects, assets or business activities with an environmental benefit, such as renewable energy, energy efficiency, sustainable waste management, sustainable land use, biodiversity conservation, clean transportation, sustainable water management, climate change adaptation, among others.

In light of the global commitment to shift to a low carbon economy reducing global warming by 2° Celsius), this is an ideal moment to tap into investors' growing appetite for green bonds, especially for India.. Green bonds have the same financial characteristics as standard bonds with the added feature that their proceeds are earmarked for eligible green projects with explicit environmental benefits.

Market:

The Global Market for Green Bond has been increasing rapidly with annual green bond issuance of USD155.5bn for CY2017, a 78% increase from USD87.2bn in CY2016.As per Climate Bonds Initiative, the forecast for CY2018 is USD250-300bn, implying a growth of over 60% Y-o-Y. During the 2017's 'One Planet Summit' in Paris, Multilateral Development Banks (MDBs) including the World Bank and European Investment Bank announced their commitments to increasing capital flows directed to support the transition to a low carbon economy. For instance, the International Finance Corporation initiated work on Amundi's new USD2bn Cornerstone Green Bond Fund, which will invest in bonds issued by banks in emerging markets. The IFC has committed up to USD325m and the European Bank for Reconstruction & Development intends to invest up to USD100m.

The Green Bond issuance in India has been increasing but is only a fraction of the World Issuance. In comparison, China, the US and Europe remain dominant issuers. The total Green Bond issuance from Indian issuers more than doubled in CY2018 and reached USD4.3bn, making it the 10th largest globally, but still less than 3% of total global volumes.



An investment of US$2.5 trillion is required to meet India's climate change mitigation targets by 2030 and approximately US$1trillion investment in infrastructure every five years to satisfy demand. Around half of the total investment is expected to come from the private sector. As banks' balance sheets become increasingly constrained by sector exposure limits and capital ratio requirements, capital markets are expected to play a bigger role. Domestic investors in India have already shown strong demand for green bonds - two of the Top 10 investors globally with the largest green bond holdings are India based- ICICI prudential Asset Management and Reliance Capital Trustee Co. Ltd. Investor demand for green product is growing, the **potential now exists for India to attract significant international capital via a robust green bond market** to meet national climate and development goals.

Suggestions:

1. For developing and growing country like ours, Green finance must be seen as conscious trade-off between the need for expansion of basic services with focus on carbon footprint reduction. One thing China has done, which has widened the asset base for them is that they have **included 'clean coal' as part of the assets that can be counted as green.** Therefore, the definition of eligible Green Projects should be wide to include projects having indirect benefits. In other words, need for green and sustainable investment must be linked to the critical challenge to meet infrastructure and energy needs, improve health and enable efficiency and access to finance. Therefore, even substantial energy efficient improvements in the predominantly used fossil fuels may be considered as a 'green' project. The term 'Green Projects' should include all projects that are in line with the Environmental goals of the Government (i.e. as part of the Paris Agreement, India has pledged that renewable energy will be 40% of the country's expected electricity generation capacity in 2030, along with a 35% reduction in carbon intensity by 2030 from 2005 levels.

2. Apart from general guidelines, it is equally important to provide **sector specific guidelines** on what constitute Green Projects. For instance, in case of Steel industry, the different site conditions including, site configurations and product mix, meaning that various options are needed to reduce CO2 emissions and energy consumption. However, key factors that affect CO2 intensity provide potential options for reducing the CO2 intensity. These are:

   - Raw material selection (Iron-ore quality beneficiated to reach 63% Fe DWt min, Coal quality)
   - Reducing agent rate: (Coke + PCI + other fuels)/ pig iron
   - Switching into carbon lean or Hydrogen containing fuels: Coke ? Coal ? Natural Gas
   - Increase in PCI (coke replacement): limitation of addition of PCI
   - Natural gas injection into BF (PCI replacement): depending on technical limitation and affordability of Natural gas.
   - Heat or Energy Recovery.
   - CO2 reduction technologies implementation

3. In order to develop Green Bonds, Green Projects in the country require new sources to be explored

which can provide not only the requisite financing, but may also help in reducing the cost of the capital. The following should be considered to make Green Bonds more attractive for the Investors and the Issuers:

- There should be monetary benefits, including reduction in applicable interest rate for Green Bonds. Further compliance relaxation should also be given to smaller entities for pursuing green projects to reduce the administrative burden of incompatible environmental standards and monitoring requirements.
- Domestic investment towards Green Bonds should qualify as Priority Sector Lending (PSL).
- A dedicated Green Bond Guarantee Institution needs to be established to provide risk mitigation at scale. Alternatively, Insurance Cover/ Credit Enhancement to be provided by Government (Similar to ECA backed facilities) to reduce cost.
- Currently, Income Tax Act still requires a withholding tax of 5% on the interest paid on the offshore rupee denominated bonds, which increases the overall all-in-cost for the Issuer. Green Bonds should be exempted from Withholding tax.
- In order to increase private and foreign funds investment in Green Bonds, investor- protection measures and dispute-resolution mechanisms must be considered.

4. Increasing the Green Pool of Capital:

- Government needs to provide a dedicated corpus for investing in Green Bonds. For example, China has been promoting new financing methods to help pay for the country's transition to cleaner modes of growth. In June 2017, it launched five "green finance" pilot zones, where at least 3 trillion yuan a year will be spent over 2017-2020 to cut pollution and greenhouse gas emissions.



- Regulators need to make it mandatory for portfolio managers to dedicate a portion of their portfolio specifically towards Green Bonds.

Way forward:

To make green bonds popular, you need an 'investor pull' factor along with a 'regulator push' factor. The regulators can kick-start the market, but to sustain it, you will eventually need investors to have a natural demand for the product. Currently, on the demand side, the bulk of investors in green bonds are still conventional investors who buy purely on credit fundamentals as opposed to green fundamentals. Clearly, this would require more investors to reserve a portion of their portfolios for such climate-friendly bonds. As the market matures, perhaps a better RWA (risk-weighted assets) impact for green bonds versus conventional bonds for bank investors could also have the effect of incentivising such investments. The European Commission consideration of lower capital requirements for lending against energy efficient buildings and electric cars is an example. Further, to incentivise investors, investment/ compliance norms to be relaxed for investors investing in Green Bonds. Monetary incentives for investors the form of tax benefits, both at retail and institutional level will also help strengthen the investor appetite for Green Bonds. ■

Is it time to re-examine the robustness of our public enforcement regime?

Ulka Bhattacharyya, *Research Fellow, Vidhi Centre for Legal Policy*

Introduction

The role of adequate enforcement is often missed out in the popular discourse on securities regulation and corporate law in the Indian context. Without effective enforcement, even the best of laws and regulations may fail to achieve the desired outcomes.

In practice, typically two distinct modes of enforcement are relevant - public and private. Public enforcement involves the regulator or the government initiating appropriate investigations and prosecutions against wrongful conduct for the collective benefit of all stakeholders. Private enforcement, on the other hand, involves the affected party initiating action with the aim of remedying the particular harm. Given the challenges associated with costs, asymmetries of information and collective action problems, public enforcement is usually seen as a more effective means of deterring wrongful conduct, especially in emerging markets where such challenges can be more acute.

The importance of enforcement is best highlighted by the recent spate of controversies to have hit India's capital markets, and the responses of the Securities and Exchange Board of India ('SEBI') and the Ministry of Corporate Affairs ('MCA') in several high profile cases. In the recent past, SEBI has initiated enforcement action against the National Stock exchange (and others, including SEBI's own employees) in the co-location case, and has conducted investigations into the alleged leak of sensitive financial information of listed companies over WhatsApp. The MCA has also been aggressively pursuing the alleged fraud involving Gitanjali Gems and the controversy surrounding ICICI Bank. Additionally, MCA's Serious Fraud Investigation Office ('SFIO')has made its first arrest since its existence, by arresting the erstwhile promoter of Bhushan Steel, for allegedly siphoning off funds. The intensity with which these and many other cases involving listed companies are being pursued, suggests that the idea of effective enforcement is finally gaining the importance it deserves.

In the Indian context, the present mechanism for the public enforcement of securities regulation and corporate law, is scattered across several laws and regulations, with SEBI, MCA and authorities there under being the primary enforcement authorities. This article attempts to make a case for a detailed re-examination of the state of public enforcement of securities regulation and corporate law in India (hereinafter referred to as 'public enforcement') and its interrelationship with the development of India's capital markets.

The importance of public enforcement: a theoretical perspective

Theory suggests that the adequate enforcement of securities regulation is important for developing and strengthening capital markets by ensuring that all stakeholders play by the rules of the game, such that the integrity of the market is maintained at all times. Ensuring market integrity is especially important for deepening the market by promoting wider participation. Theory also shows a direct correlation between the resources spent on public enforcement and the depth of capital markets.

However, public enforcement is not without its problems - having too much or too little of it is equally damaging and must be guarded against. Too much public enforcement, where a regulator goes on to prosecute every single violation may not necessarily

be the most efficient or effective way of encouraging a culture of compliance. Most regulators have limited budgets and staffing and choosing to prosecute every single violation with equal effort and intensity may therefore not be ideal. Additionally, over-enforcement may also have a chilling effect on regular trading and genuine risk-taking, which can also undermine market integrity. Similarly, too little public enforcement can also be damaging by causing inadequate deterrence. Thus, having the optimum level of public enforcement is crucial, and regulators should ideally try to achieve this balance.

The legal regime governing public enforcement in India

The regulatory framework for securities regulation and corporate law in India has undergone significant change in the last three decades. Additionally, this framework is dispersed, with multiple regulators deriving authority to initiate public enforcement actions through multiple laws and subordinate legislation. SEBI was set up with the twin aims of '*protecting the interests of investors in securities*' and '*to promote the development of, and to regulate, the securities market*', which is reflected in the Preamble to the SEBI Act. It is the primary authority to investigate violations of various provisions of the SEBI Act and regulations issued under it. Its public enforcement tool-kit broadly comprises administrative/civil enforcement and criminal enforcement. Administrative/civil enforcement practices include issuing directions/prohibitions in the interest of investors in the securities markets,



issuing suspension orders, issuing cease and desist orders, issuing directions to restrain access to securities markets, suspending/cancelling licenses of intermediaries, imposing monetary penalties for contravening various provisions of securities laws and indulging in activities such as insider trading and fraudulent and unfair trade practices, conducting settlement proceedings, conducting summary proceedings and the like. Criminal proceedings involve the filing of criminal complaints before competent courts.

SEBI is complemented in its public enforcement efforts by the MCA, which investigates violations of the Companies Act (for both listed and unlisted companies). Under the provisions of the Companies Act, the MCA, through its Regional Directors and Registrars of Companies ('RoC'), enjoys powers including conducting investigations, inspecting records and imposing penalties in relation to non-compliance on part of companies and their directors/officers. This is in addition to the SFIO also being empowered under the Companies Act to initiate and conduct investigations into the affairs of companies.

While the SEBI Act and the Companies Act provide the primary framework for public enforcement, other regulators/agencies may also institute public enforcement actions. These regulators include the Reserve Bank of India ('RBI') and the Insurance Regulatory and Development Authority ('IRDA'), which may initiate enforcement actions, under the ambit of the respective laws enforced by them. While these regulators do not initiate enforcement actions for the violation of securities regulation or corporate law in the strict sense of the term, public enforcement actions instituted by them may have a potential interface with public enforcement actions initiated by SEBI and MCA. This may occur in respect of entities which are under the regulatory jurisdiction of all of these regulators such as listed banking companies or listed insurance companies.

Another aspect relating to public enforcement of securities regulation and corporate law is that

potentially even criminal proceedings may be instituted by authorities such as the Central Bureau of Investigation ('CBI') and state police, in terms of general penal law such as the Indian Penal Code, 1860.

Some issues in the current public enforcement framework

Dispersed nature of public enforcement framework: As indicated in the preceding section, the present public enforcement system in India is dispersed across multiple laws and regulations. To any observer of the system, who is not initiated with its intricacies, the system is especially chaotic. Moreover, the present regulatory framework grants powers of public enforcement not only to SEBI and MCA, but also to other sectoral regulators such as the RBI and IRDA. This again is in addition to public enforcement powers enjoyed by enforcement agencies such as the CBI and the state police, who are authorised to investigate and bring enforcement actions against companies, insofar as they relate to general criminal law.

Need to achieve efficient outcomes and greater co-operation: An important concern regarding the present public enforcement framework stems from its dispersed nature. When there are multiple regulatory authorities, a natural question is whether such agencies are able to achieve the most efficient outcome in their public enforcement actions. The present framework theoretically allows for multiple regulators to initiate multiple enforcement actions in respect of the same entity, and hence the question of actual co-ordination between regulators becomes important. For instance, in theory, public enforcement actions could be brought against a listed banking company or a listed insurance company, by multiple regulatory agencies including SEBI, RBI/IRDA and MCA. In a situation of this nature, the absence of formal co-ordination mechanisms in practice may lead to multiple, inefficient regulatory actions, and frittering away limited resources, where each regulatory agency follows a siloed approach to enforcement. Though regulators have come together in the past in certain instances to co-ordinate regulatory efforts and actions as was done in the case



of 'vanishing companies' by the MCA and SEBI, the particular issue of increased inter-regulatory co-operation should be seriously deliberated upon. Having a formal co-ordination mechanism will enhance efficiency and effectiveness from the perspective of regulators, who can pool in their joint regulatory resources, to ensure more credible and efficient enforcement actions. At the same time, this also ensures that regulated entities are not faced with defending themselves against multiple enforcement actions by multiple regulators at the same time.

Functioning of existing public enforcement mechanism: Another concern regarding the present public enforcement framework concerns the adequacy of India's existing public enforcement systems (especially when compared to those in developed markets), in terms of their track record of successful prosecutions and enforcement capabilities. The observations made by the Parliamentary Standing Committee on Finance in March 2018 are particularly relevant in this regard. The Standing Committee has noted with concern certain aspects relating to the functioning of the MCA and the SFIO, while suggesting that serious thought should be given towards reforming the existing system. Some of the concerns raised by the Standing Committee include: the under-utilization of budgeted funds of the MCA in light of its vast mandate and responsibilities, the slow functioning and track-record of the SFIO (in the past) and related inefficiencies in its working, and the substantial pendency of cases at the level of the ROCs along with the need to build capacity and

infrastructure at all levels in ROCs to tackle these issues. Even insofar as SEBI is concerned, though arguably it is one of India's most efficient regulators, concerns have been expressed about its need to enhance criminal enforcement, as well as strengthen its staffing to increase its monitoring and enforcement functions, especially in light of SEBI's American counterpart, the Securities and Exchange Commission having at least six times SEBI's staff strength. Though SEBI and the MCA have been reportedly taking steps to improve their enforcement practices, there is a lot which still needs to be done, and (historically) their limited budgets and staffing constraints have posed challenges in undertaking and sustaining enforcement actions. The Central Government and the Parliament definitely need to do more to support SEBI and the MCA. There is a definite need to make concerted efforts to massively improve the track-record on public enforcement, through measures which may indicatively include: increasing budgets, focusing on hiring more officers to speed-up the backlog of pending investigations, providing appropriate prosecution support, as well as more pro-active and concerted enforcement actions by regulators against newer instances of wrongful conduct.

Conclusion: Time for renewed thinking on public enforcement?

A credible and robust public enforcement mechanism is an important part of any legal system, especially in relation to securities regulation and corporate law, since it ensures integrity, transparency and the deepening of capital markets. When public enforcement mechanisms are effective, they lead to a culture of greater compliance and increased deterrence for potential offenders, thereby increasing the confidence of both domestic and foreign investors in the capital markets.

The present public enforcement mechanism in India, as discussed, though seemingly comprehensive, is not functioning as well as it should, and additionally lacks



formalised co-operation mechanisms between regulators. The recent push towards regulatory reform, as evidenced by the recent Report of the Fair Market Conduct Committee and the Report on the Settlement Mechanism indicates a renewed focus on reviewing and strengthening existing regulatory mechanisms, especially in relation to India's capital markets.

Historically, calls to strengthen enforcement and enforcement intensity have increased in response to scandals and fizzled out there after. There is a need to break out of this cycle and create an unwavering and consistent culture of enforcement. The impact of newer and more enhanced regulation is best realised by complementing the same with adequate attention to enforcement capabilities. Issues such as increasing budgets and ramping up hiring of enforcement officials, training existing enforcement personnel in best practices and adopting technological solutions to monitor and prevent wrongful conduct, in order to strengthen India's public enforcement system, should be a priority. For too long, we have had a constant supply of regulation or software to fix the ills plaguing India's capital markets, without devoting enough attention and resources to making the enforcement infrastructure or the hardware more robust. It is now time to correct this anomaly for good. ■

From the Realms of Imagination – 2022
A Journey from "Share Capital" To "Shared" Capital

V S Parthasarathy, *Group CFO, Group CIO and Member of the Group Executive Board*
Mahindra & Mahindra

At the time when Uberization is the Buzz word, can the world of Capital Markets be immune to the onslaught of 'shared' economy? The mesmerising concept, which has taken the global business models by storm, is all but knocking on the doors of Financial Markets. For instance, Peer-to-peer (P2P) lending is a new method of debt financing that allows people to borrow and lend money without a financial institution. Harnessing technology and big data, P2P platforms connect borrowers to investors faster and cheaper than any bank. The journey from lending platforms to capital markets is to say the least convoluted, but not beyond realms of imagination.

Traditional Capital Markets:

Capital Markets comprise primarily of Equity and Bonds. The instruments may differ, while the underlying tone is either ownership (i.e. equity) or loan/debt financing (i.e. Bonds). A lot has been already written on either. In Indian context, both play a significant role in ensuring that the economy and the businesses are well oiled in terms of liquidity.

Just to recap the current levels, in Indian context, raising funds from equity markets touched an all time high of about Rs. 1.77 lakh crore during 2017-18. The amount raised was 3.5 times the money mobilised during 2016-17, and beat the previous high of Rs. 86,710 crore achieved in 2009-10. Money raised through initial public offerings (IPOs) also hit a record Rs. 84,357 crore during 2017-18. This is more than double the amount raised during the previous high achieved in 2007-08. Of the total amount of Rs. 1.77 lakhs crore, the amount raised through fresh capital was Rs. 91K crore, the remaining Rs. 86K crore being offers for sale (OFS).

While there was buoyancy in the equity markets, the bond markets were not to be left behind. In the financial year ended March 31, 2018, Indian companies raised a whopping Rs. 6-lakh crore through private placements, via 2,706 issuances. This is the second-highest issuance in terms of funds mopped up by India Inc since the private placement of corporate bonds opened in 2007. The highest was in FY17, when Indian companies raised about Rs. 7-lakh crore via 671 issuances.

As a proportion of GDP, India's total equity market capitalisation was 90% in 2017. This is comparable to the World average of 112%, but lags far behind countries such as Hong Kong (1274%), Singapore (243%) and USA (166%).

However, as a proportion of GDP, India's bond market ranks way below its peer countries even in the Asia-Pacific region, and in particular the corporate bond markets are significantly underdeveloped.

There have been all round efforts to deepen the bond markets and India's corporate bond markets have seen a healthy growth in the last few years, supported by several structural and cyclical factors. A series of favourable steps taken by regulators and policy makers to broaden the bond markets has been one of the key influences.

FY2018-19 budget speech indicates that the government continues to be focused on developing bond markets. Three steps announced in Budget 2018-19 can significantly expand the role played by the corporate bond markets over the medium term. These include :

a) nudging large corporates to meet 25% of their funding needs through bond markets;

b) considering regulatory recognition for investment in bonds to include A rated bonds as well (in addition to existing stipulations of only up to AA rating); and

c) attempting to introduce uniform stamp duty for issuance of bonds across the country.

While both equity and bond markets will further evolve and develop, the thought to ponder over is that, can there be a transformation, such that the entire process of capital structuring gets a new meaning. As we dwell over the past, it will be worthwhile to reimagine the future. What can / could change as things unfold. Imagination ignites passion, our imagination and thoughts create our future, imagination stimulates creativity and innovation and this is an attempt to imagine the journey from "Share Capital" to "Shared" Capital.

"Shared" Capital Markets:

Let us try to understand how the world of Shared Capital operates and how can it distinct from both Share Capital as well as Bond.

An investor in Share Capital gets a sense of ownership, with no guarantee for returns, but full participation (proportionate to holding) in profits / loss. A bond investor on the other hand is assured of a fixed / variable return as per agreed terms. They do not get to participate in upside but at the same time is protected of the downside.



Perhaps the time is just right to move to a Capital Market instrument on a shared platform, such that it imbibes the best of both worlds. The instrument can and should give a sense of ownership but at the same time provide window to the investor to reap the benefits in a more assured or rather structured manner. It should, while giving participation in profit / losses, also provide exit option which is otherwise not available to share holder. The instrument will hence carry a coupon which will be directly derived from / linked to the returns of the product / platform for which the Capital is raised. It will also allow for participation in upside (also implies participation in downside) while providing an exit at fixed interval of time. In summary, "shared" capital works by combining aspects of convertible instruments and derivatives.

Take a case where the Company either in the Pharmaceutical or Automotive space floats a "Shared" Capital platform for an identified formulation / product. The platform has all details on the formulation / productlisted therein. The access to the information of the formulation / product is restricted. Only after necessary due diligence will the investor(s) be able to access the data room of respective formulation / product. The exchange of KYC and due diligence, as well as the data room info, can happen on a blockchain in a secured environment. Investors, after necessary exchange of information or perusal of data room documents (akin to Information Memorandum (IM)) propose to co-invest in the formulation / product development project. The returns to the Investors would be linked to the success of the formulation / product volumes/revenue/profitability as is decided upfront. The returns will be entirely contingent on successful development of the formulation/ product/platform and performance of such formulation / product / platform. In case the formulation / product / platform is abandoned for whatsoever reason, or the development is not completed, in such case the



investor will forego his capital. In the alternative if the formulation / product is launched but does not perform in the market per expectation, then the investor will have to settle for lower returns. At the same time if the formulation / product is a major success the investor can reap full benefit of such excess returns. Thus, while ordinary Share Capital gives rights to ownership in entire Company and thereby a proportionate right to profitability / loss of all projects developed within the Company,(as well as proportionate right in the entire Group profitability / assets through sum of the parts valuation),a "Shared Capital" investor's fortunes is linked to fortunes of only the selected formulation / product in which such investor has decided to participate. You can have multiple investors in multiple product lines / platforms. As the structure evolves, so will the regulations and regulators (e.g. SEBI / Income Tax /Company Law Board etc) will lay down the guidelines to effectively manage such new instrument. Today, there might be few funds investing in product development where returns are linked to the success of the new product. Globally this is in vogue in few geographies. The next level could be instead of one person taking the entire risk, it becomes a platform where risks and rewards are aggregated and shared by many. For now, Uberisation of Capital market is some distance away, and while there may be delays, the path seems certain! ■

Notes

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