Easing of Foreign Portfolio Investors (FPIs) norms

Sriram Krishnan
Director & Head-Investor Services
Deutsche Bank AG

India has been an attractive investment destination for over two decades now. A lot of things are going well for us at this time. Sriram Krishnan, Head, Securities Services, Deutsche Bank India talks about the previous attempts as well as next steps being contemplated by the regulators to further make market entry norms simpler for foreign investors as part of the Ease of Doing business initiatives.

Overview of the Indian market

The game changing steps rolled out by the Indian policy makers in the last few years have ensured a significant increase in India's growth prospects and continued investor interest, particularly from global investors. As a result, of positive business-friendly policies, India has turned into one of the fastest-growing economies with growth estimated at 7.2% in 2017-18, and further at around 7.7% in 2018-19.

The new growth projections presented by researchers at the Center for International Development at Harvard University (CID) predict the continued rise, making India extremely attractive compared to other countries.

"India is one of those countries that have excellently performing reforms and that is one of the major reasons for the country to maintain one of the highest economic growth rates(in the world)" said Changyong Rhee, director for Asia and Pacific Department at IMF at a press conference in Singapore after presenting Asia and Pacific Regional Outlook report.

What's more, the key economic parameters are in good shape – e.g. FX reserves, inflation, current account deficit, fiscal deficit etc. At USD 386bn (as of June 30, 2017- RBI website), India's foreign exchange reserves are considered rock solid in terms of fall back protection. India's growth is expected to come from large scale spends, particularly around Infrastructure and Real Estate spaces. India is also slowly turning into a consumption fuelled economy, with steady foreign investment inflows over several years. Foreign Investments are now relatively easy to undertake, with a liberalized regime in place, both for portfolio investments as well as direct investments. Almost everyone agrees that the country has the potential to attract further foreign investments.

This has also been re-iterated by the fact that India has retained its numero uno position as the world's top-most greenfield FDI destination for the second consecutive year, attracting US$62.3 billion in the calendar year 2016(source FDI report 2017) .

The Regulatory Push

To attract this amount of foreign investments a market has to be open for foreign investors. In the past, market entry was viewed as somewhat restrictive and also complicated. Only a select set of 16 entities / institution types could access the market. Investors felt the registration processes were long drawn and tedious. The Foreign Institutional Investor (FII) regulations had hardly undergone any significant amendments since being introduced in 1995. That's where the Regulators stepped in to break down the complexity. In 2012, the capital market regulator set up the Committee for Rationalisation of Investment Routes (Chandrasekhar Committee). Deutsche Bank India was a part of this committee, and played a significant role in defining the shape of things to come, together with other market participants such as Stock Exchanges, Depositories, Lawyers and Tax consultants.

The outcome was the creation of a single route of entry for various types of Foreign Portfolio Investors (FPI) by merging the erstwhile FII, Sub Account and Qualified Foreign Investor (QFI) regimes. As a result, India now has common market entry, limit monitoring and reporting norms. At the same time the eligibility process was made jurisdiction dependent irrespective of the constitution type of the entity.

With the additional introduction of a Risk Based Approach, the KYC requirements have been eased significantly, particularly for:

- Category I investors (such as sovereign entities, central banks and multilateral agencies)
- Category II investors (regulated broad based entities such as mutual funds, insurance funds or pension funds)

Other investors are Category III FPIs, and Category III entails slightly heavier KYC requirements.

While the ideas of the committee have been debated at great lengths, the realization that a "one size fits all" approach does not help Category I or II investors was the turning point in the entire process. The recommendations of the committee indeed made it possible for foreign investors to have easier access to the Indian market and the new regime went live in June 2014.

The current FPI regime

Inflows from foreign investors as well as the number of accounts opened have been on the rise after the new market entry simplifications. The year 2016-17 recorded 3,500 fresh registrations as against the total count of 2900 for the previous financial year. The total net investment by FPI/ FII for the financial year 2013-14 stood at USD 9 billion which went up to USD 45 billion for the financial year 2014-15. 2016-17 had a net inflow of USD 7 billion. The year 2017-18 till now has again been another stellar year for Indian foreign investments and the first quarter of this year has already seen net investments of USD 12 billion. The upward trend is expected to be maintained into the future.

While the intention has been to increase the foreign inflow through the Portfolio Investment System (PIS) route and there are ongoing steps to review and further rationalize the existing norms, the regulator has also been simultaneously taking steps towards ensuring transparency in terms of money inflow by streamlining and tightening the conditions for issuance and reporting of Overseas Derivative Instruments by FPIs registered with SEBI.

The next wave

● **Common Application Form**

Budget 2017 spoke about online registration of financial market intermediaries in order to facilitate ease of operations in terms of applying for registration, reporting and various compliances. Accordingly, SEBI as part of 'Ease of doing business' initiative intends to introduce an online Common Application Form (CAF) for FPIs.

SEBI has further issued a fresh consultation paper seeking feedback on further liberalization. Let us examine some of these new ideas and how they could help clients:

● **Expansion of eligible jurisdictions for grant of FPI registration to category I FPIs**

There are currently 114 signatories to the IOSCO MMoU and 22 Security Regulators who have signed Bilateral Memorandum of Understandings (MoUs) with SEBI. The proposed regulations will help Category I applicants like Central Banks, Government Agencies, Sovereign Wealth Funds etc. whose countries have diplomatic ties with India but do not fit into the existing regulatory framework to register as Category I FPIs.

● **Simplification of broad based requirement and other related clarifications**

The criteria of broad based fund is to be extended wherein the FPI applicants has a Bank, Sovereign Wealth Fund, Insurance / Reinsurance Companies, Pension Funds, Exchange Traded Funds etc as its underlying investors subject to the condition that the underlying investor (s) in the Fund shall either individually or jointly hold majority stake in the applicant fund at all times. This proposal would enable more FPI aspirants to meet the eligibility norms and may possibly result in increase in the number of Category II FPI registrations.

● **Exemption to FPIs having Multiple Investment Managers (MIM) structure from seeking prior approval from SEBI in case of Free of Cost (FOC) transfer of assets**

Investors often use multiple Investment Managers to manage the money. Given commonality of beneficial ownership, SEBI has proposed that FOC transfer of assets from one Investment Manager to another can take place automatically, which would be welcomed by the Investors as a huge welcome step.

● **Permitting appropriately regulated Private Bank/ Merchant Bank to invest on their behalf and also on behalf of their clients**

This proposal could encourage Investors that were earlier accessing the ODI route to invest through Private and Merchant Banks subject to compliance (by such Private and Merchant Banks) with the required disclosure and transparency around reporting.

● **Definition of "appropriately regulated persons" to be expanded to include additional regulated entities such as broker dealer, swap dealer, etc.**

Proposed to broaden the definition of appropriately regulated entities by extending the application to broker dealer, swap dealer to be classified as Category II provided such entities provide beneficial ownership details of their clients to SEBI and/or any other enforcement agencies, as and when required. If approved, this proposal shall broaden the FPI base and encourage broker dealers, swap dealers that are 'appropriately regulated' to seek FPI registration.

The Way Forward

The Indian regulators have been continuously working towards simplifying a once complex entry process. However, the process that has gathered momentum needs to be continued and apart from the areas put up for public feedback, there are couple of further suggestions that can be expedited by the regulators to further simplify the market for FPIs:

A. Online framework for investing in Government Securities

Indian fixed income securities (particularly Government bonds) have always been attractive, given the good track record and attractive yields. The proposed way forward is to replace the auction mechanism with an online real time system that will reflect the foreign investor limit utilisation levels.This will also bring down the cost of investments.

B. Expanding the list of eligible asset classes

FPIs are currently permitted to invest in most of the available asset classes. The only exception to this rule is investment in unlisted equities and commodity derivatives. Having more institutional participation in the commodity derivative market will bring in much needed liquidity. FPIs have also shown interest in participating in the commodity derivatives.

In summary, Indian regulators have been open to feedback from investors and the stakeholders in the market. The openness has already brought a significant amount of positive change, and as we can see, more is on the way.