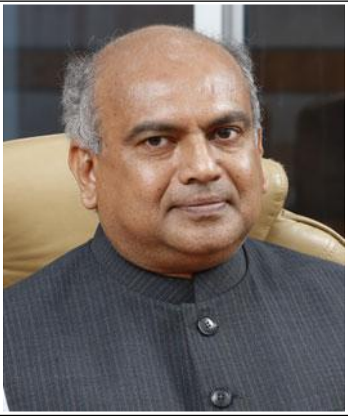
Indian Capital Markets vulnerability to FPI flows



Ramesh NGS
Managing Director & CEO
Stock Holding Corp.of India Ltd.

In a capital starved country, increasing the capital flows has always been a priority & concern for policy makers, lenders & borrowers in India. India remains an attractive investment destination. The improvement on the ease of Doing Business Index, low external and household debt, reform-friendly government and the enormously big domestic market makes India an attractive proposition.

Foreign Portfolio Investors have been aggressively investing in Indian equities in the first six months on 2019 despite increased volatility and short term uncertainty during the pre-run period to the elections. FIIs were net buyers of local equities worth $11.41 billion between January and June, the most since the corresponding period of 2014. In line with the strong FPI inflows, the benchmark indices too have risen sharply.

According to published data, the FPIs invested a net 11, 182 crore in February; Rs. 45,981 crore in March & Rs. 16,093 crore in April in 2019 in the capital markets (both equity & debt).

FPIs continue to show interest in Indian markets, especially from a long-term perspective, though investments were impacted due to global factors and tightening of the debt investment route. Over 600 new FPIs registered with Securities and Exchange Board of India (Sebi) in 2018 — the steepest rise in FPI count since 2014, when the market regulator overhauled rules for offshore investors and introduced the FPI regime. There are now close to 10,000 FPIs active in the country.

Some of the top jurisdictions from where investments are flowing into India are United States, Mauritius, Luxembourg, Singapore, UK & others like Japan, Canada, and Norway

India and Mauritius signed a Protocol to amend their 33 year old tax treaty caused seismic changes in the tax world. The change in the tax treaty will help tackle the issue of treaty abuse & round tripping of funds and improve the quality of FPIs in India.

There has been a change in the Investors preference to use other jurisdictions such as Netherlands & France for investments into India, these treaty amendments signal India's shift to moderate the tax investment regime.

The market regulator SEBI further took several moves to enhance the participation and also to improve the quality of Investors coming in as Foreign Portfolio Investors in the Indian market.

Due to the regulatory tightening, the quality of FPI investments has improved and investments from larger and more long haul investors like the CAT I & CAT II FPIs has increased.

SEBI has also brought in more clarity with respect to the beneficial ownership norms for the FPIs. As per the new norms, where one or more NRIs, OCIs & PIOs have controlling ownership interest of 25 percent in case of company & 15 percent in case of a Partnership Firms, Trust & Unincorporated Associations of Persons would be considered as beneficial owners.

SEBI's move to allow FPIs who have direct exposure in Indian Commodity futures market will help increase the volumes in this segment. SEBI has allowed Mutual Funds & Portfolio Managers in to invest in Commodity Derivatives, a move that would boost the commodities market.

Further the Market Regulator SEBI allowed Custodial Services in the Commodity Derivatives market which would enable participation of institutional investors, including mutual funds, AIFs in the segment.

The RBI relaxed the concentration norms applicable to FPIs within the general investment limits. Another significant move was the removal of the 20% corporate bond exposure cap. The RBI also introduced Voluntary Retention Route (VRR) for FPI in both Govt -securities and corporate bonds, as an alternate route for FPIs. The limits for investments for the VRR were further increased.

Broadly, investments through the VRR will be free of the macro-prudential and other regulatory norms applicable to FPI investments in debt markets, provided FPIs voluntarily commit to retain a required minimum percentage of their investments in India for a minimum retention period of 3 years.

Further, a working group under the HR Khan committee constituted by SEBI has proposed certain recommendations with the objective of simplification & rationalization of FPI regime. These recommendations have tried to address several issues with respect to quickening the FPI registration process like fast track on-boarding process for select CAT II FPIs , deemed broad based status to certain entities for CAT II FPI registration , simplification of the KYC documentation, Liberalisation of the investment caps & permitting FPI investments in prohibited sectors and other aspects like permitting FPIs to do off market transfer of securities that are unlisted or suspended to a domestic investor.

Further in the budget, the key proposals which were a positive for FPIs were the increase in the default limit for

FPI investment in Indian equities from 24% to the sectoral limit giving more room to invest and also the FPIs are now permitted to subscribe to listed debt securities issued by REITs & INVITs providing two more new avenues and merging the NRI & FPI under a single regime.

Also among the key tax incentives to encourage investments in IFSC were the Capital gains exemption to Category III AIFs, Entities set up in IFSC exempt from dividend distribution tax.

While the regulators and policy makers recognise that FPI investments are a key source of capital, they are constantly working to provide a harmonized and hassle-free investment experience to them.

Finally, India's faster growth and demographic advantage and the efforts of the regulators will keep attracting the long term Foreign Portfolio Investors and from more legalized sources and will also to quite an extant reduce the market's vulnerability to FPI flows and short – term fluctuations.