Y V Reddy: Government-owned investment vehicles and capital flows – Indian perspective

Address by Dr Y V Reddy, Governor of the Reserve Bank of India, at a session on "The Role of Government-owned Investment Vehicles in Global Capital Flows" at the International Capital Markets and Emerging Markets Roundtable, Washington DC, 14 April 2008.

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Chairman Bill Rhodes, distinguished speakers and fellow participants,

I am thankful to the organisers for inviting me to participate in the Roundtable on a subject of great contemporary relevance. The invite has provoked me to deliberate on the subject, hear distinguished speakers and also meet here to interact with friends.

We know that government-owned investment vehicles (GIVs), also referred to as Sovereign Wealth Funds (SWFs), existed for long but they have acquired significance very recently due to their proliferation, growth in size and, above all, active participation in capital infusion in the aftermath of the recently observed financial turbulence. The International Monetary Fund (IMF) has to be complimented for its pioneering work and excellent document on the subject. The role of SWFs in global capital flows is also being debated in several fora, namely, the O.E.C.D., the G7 Ministers, the European Commission, the Peterson Institute for International Economics, the Central Banking Publications, the G 30, the Institute of International Finance and the World Economic Forum.

Towards greater transparency

It is useful to recognise in the above context that, of late, there have been initiatives to increase the transparency of all kinds of pools of capital as evidenced by the reports of the U.K. Hedge Fund Working Group (January 2008), led by Sir Andrew Large, and the Private Equity Working Group on Transparency and Disclosure (November 2007), led by Sir David Walker.

Briefly stated, while there is intense debate on the subject of comfort with SWFs in global capital flows, the present discussion could be considered both as a part of the wider and significant debate on transparency and regulation of certain broad categories of investors and also as one that addresses specific factors relevant to one category, namely SWFs. It is useful to recognise in this regard that there is an overlap among the categories in terms of sources of finance since SWFs invest on their own account and also through hedge funds and private equity funds. In other words, one of the broader issues is regulatory safeguards in place with regard to investors of a kind that may not necessarily assure regulatory comfort to the host country. A related, and in a way the other side of the coin, is the transparency and governance arrangements in regard to operation of SWFs in the home country. It is heartening to note that the IMF has begun covering in its *Global Financial Stability Report*, in addition to the SWFs, the issues relating to hedge funds and private equity funds.

Public policy initiatives on SWFs

The OECD approach in regard to SWFs is that international co-operation can build mutual trust and keep markets open. The OECD Investment Committee and its non-OECD partners have agreed that over the coming period they will follow a two-track approach to these issues. First track would involve dialogue among governments, SWFs and the private sector to improve understanding of both home and host country approaches to foreign investment. The second track would involve exchange of experiences in relation to national security protection, developing shared views on investment policies that observe the principles of proportionality, transparency and predictability, accountability, and that also avoid unnecessary restrictions to international investment, including by SWFs.

The OECD has recently, on 4 April 2008, released a report which is intended to develop guidance for recipient country policies toward investments from SWFs. The OECD has also proposed to work on how governments can maintain their commitment to open international investment policies – including for SWFs – while also protecting essential security interests. The resulting framework is expected to foster mutually beneficial situations where SWFs enjoy fair treatment in the markets of recipient countries and these countries can confidently resist protectionist pressures.

The European Commission (EC) is proposing a common EU approach to respond to concerns over SWFs and enhance the transparency, predictability and accountability of SWFs' investments while maintaining an open investment environment. It has laid out the principles which should shape that approach. These are (a) commitment to an open investment environment both in the EU and elsewhere, including in third countries that operate SWFs; (b) support of multilateral work, in international organisations such as the IMF and OECD; (c) use of existing instruments at EU and Member State level; (d) respect of EC Treaty obligations and international commitments, for example in the WTO framework; and (e) proportionality and transparency.

The recent joint release by United States, Abu Dhabi and Singapore sets out Policy Principles for the SWFs as well as the countries receiving SWF investment. The responsibilities enjoined upon SWFs mainly relate to greater transparency in areas such as purpose, investment objectives, institutional arrangements, and financial information, strong governance structures, internal controls, and operational and risk management systems and the need to respect host-country rules by complying with all applicable regulatory and disclosure requirements of the countries in which they invest. The prescriptions for the SWF host countries stress on transparent inward investment rules, which are “publicly available, clearly articulated, predictable, and supported by strong and consistent rule of law” and favour non-discriminatory treatment for SWFs vis-à-vis other foreign investors.

Of particular interest from a host country perspective, is the Media Release of the Treasurer of the Commonwealth of Australia in February 2008, which illustratively lays down a set of principles to enhance the transparency of Australia’s foreign investment screening regime. The principles set out the main factors that are considered during the screening, which include determining on a case by case basis and consistency with national interest; while assessing the national interest in any given case, a balanced view against principles is proposed. The principles set out the additional factors that need to be considered in relation to investment proposals by foreign governments and their agencies, over and above those that apply to normal private sector proposals. While the Australian Government welcomes foreign investment, the purposes of Australia’s foreign investment screening is to ensure consistency with their national interest. The Treasurer can reject proposals that are deemed contrary to the national interest or impose conditions on them to address the national interest concerns. The concerns may relate to Australia’s national security or economic development. The examination includes implications for other government policies, competition and operations of Australia’s businesses.

Recent reports suggest that Germany is contemplating a legislation which will enable it to block “unwanted” investments by SWFs. The proposed law is expected to enable scrutiny of all investments where the investor’s stake in the investee entity is likely to exceed 25 per cent, even up to three months after the investment has been made. This concern seems to stem from the suspicion that some of the SWFs may be driven by “political and other motivations” and not purely by economic and commercial considerations.

India as a host country

In India, the regulatory regime governing capital inflows does not recognise SWFs as a distinct category. Hence, their investments are subject to normal regulations governing capital flows under the category of Foreign Direct Investment (FDI) and Foreign Institutional Investments (FII). In regard to some sectors, such as banking and financial market infrastructure companies, there are limits on individual holdings and the investment proposals are subject to an element of due diligence processing with regard to fit and proper requirements. For this purpose, no discrimination is made between a domestic investor and a foreign investor, or between SWFs and others, as long as the policy criteria are met. Let me further elaborate on this position.

The existing FDI policy permits investments under the “automatic route” and the “approval route” in most, though not all, of the activities. Under the automatic route, the investors are allowed to invest in the identified sectors up to the threshold specified for those sectors, without the need for a prior approval from regulators or the Foreign Investment Promotion Board (FIPB). In respect of the other sectors, the investors will need a prior approval of the FIPB, before undertaking any investment. The FIPB is functioning under the aegis of the Ministry of Finance and comprises representatives of various government departments, who are expected to ensure that the proposed investment addresses the administrative and other concerns before allowing investments in the concerned activity. Similarly, under the FII route, the FIIs registered with the securities market regulator (the Securities and Exchange Board of India – SEBI) can invest in the secondary market, without prior approval, subject to certain limits on individual FIIs and an overall aggregate limit for all FIIs, as a category, as well as the sectoral thresholds and other conditions applicable to FDI. SWFs can also invest directly as an FII or indirectly as a “sub-account” of a registered FII, which include hedge funds and investment funds. Accordingly, any SWF can invest under the FDI route (automatic or approval routes, as the case may be) or under FII route either directly or indirectly. Thus, on the inflows, there is generally no discrimination on the basis of the country of origin of the foreign investor or on the basis of category of foreign investors.

The policy, however, does provide for a framework in regard to ownership and management of the entity investing in some sectors, particularly the financial sector, which is applicable equally to resident as well as non-resident investors.

In respect of banks, acknowledgement from RBI for acquisition/transfer of shares is required for all cases of acquisition of shares which will take the aggregate holding (direct and indirect, beneficial or otherwise) of an individual or group to equivalent of 5 percent or more of the paid-up capital of the bank. The relevant factors for “fit and proper” assessment of the investor include the source of funds for the acquisition and, where the investor is a body corporate, its track record of reputation for operating in a manner that is consistent with the standards of good corporate governance, financial strength and integrity. The process also envisages a higher level of due diligence when the share holding of the investor exceeds 10 per cent in the investee bank’s paid up capital, which includes fit and proper status of the investor entity.

An amendment to the Banking Regulation Act has been proposed which envisages prior approval of the Reserve Bank for acquisition of more than five per cent of the paid up share capital of a bank by any investor “directly or indirectly, by himself or acting in concert with any person”. The approval will be accorded after ensuring that the investor would be “fit and proper” from the perspective of public interest, interest of banking policy, emerging trends in banking and international best practices, and the interest of banking and financial system in India.

In the case of investments in financial market infrastructure companies, such as stock exchanges, the guidelines stipulate a desirable dispersal of ownership. Investment by individual entities, including investments by persons acting in concert, is subject to a threshold of five per cent of the equity in these companies.

In regard to Securitisation and Reconstruction Companies (SRC), the RBI conducts due diligence on the sponsors / investors before giving a certificate of registration to the SRC. Any subsequent investment by any individual entity in excess of 10 per cent of the paid up equity capital of the SRC also acquires the status of a "sponsor" and requires prior permission of RBI which, as the regulator, is required to satisfy itself, among other things, of the "fit and proper" credentials of the investor.

Foreign investment in an Indian company in the financial services sector, through acquisitions, requires prior permission of the Reserve Bank which allows such investments only after ensuring that the regulatory concerns, if any, are appropriately addressed and that the bonafides of the overseas investor are satisfactory. Wherever necessary, the clearance or comments of the home country regulators of the investing entity are also sought while examining the requests.

In case of investments by foreign investors in activities other than the financial services sector, where there are security or other administrative concerns, for instance, in defence and strategic industries, and print media and broadcasting sectors, investments are allowed only under the "approval route".

In order to assess the eligibility of an entity to be registered as FII or as Foreign Venture Capital Investor, SEBI takes into account all factors relevant to the grant of a certificate and in particular the applicant's track record, professional competence, financial soundness, experience, general reputation of fairness and integrity as well as the fact whether the applicant is regulated by an appropriate foreign regulatory authority.

In brief, India is yet to consider a policy addressing investments by SWFs, except as a part of due diligence in regard to all investors.

India as a home country

In India, the foreign exchange reserves are on the balance sheet of the Reserve Bank of India (RBI) and are managed as per the provisions of the RBI Act, consistent with the global best practices. The Reserve Bank adheres to appropriate prudential norms and the transparency and data dissemination standards in regard to reserves management.

Given the significant increase in the level of foreign exchange reserves, there is an increasing expectation in regard to returns. The returns on the foreign exchange reserves, under the present framework, are constrained by the mandate to Reserve Bank of India, which understandably lays a greater emphasis on safety and liquidity.

It may, however, be possible to argue that a part of the reserves, which may be considered to be in excess of the usual requirements, be managed with the primary objective of earning higher returns. Given the limitations placed on the central bank by its mandate, it can be held that it will be appropriate to bestow this responsibility on a different sovereign entity. If and when the country considers setting up of a SWF for the purpose, one of the methodologies could be to fund SWF by purchasing the foreign exchange from the central bank, to the extent required. These foreign currency funds could then be used by the sovereign entity for seeking higher returns by investing in assets, which a central bank's mandate may not permit. As the SWF will be a public enterprise, it will be required to conform to the applicable governance, transparency and disclosure standards.

While it is possible to make a case for an Indian SWF, there are also weighty arguments for caution in this regard. First, it would be very difficult to reckon in the Indian context – as is the case with many other countries, the "reserve adequacy" in a dynamic setting and on that basis divert a part of "excess" reserves for a higher return from riskier assets. The current reserves management policy recognises this, based on experience during periods of both net inflows and outflows and, therefore, the overall approach to the management of India's foreign exchange reserves takes into account the changing composition of the balance of payments and endeavours to reflect the "liquidity risks" associated with different types of flows and other requirements.

Second, while most other countries that have set up SWFs have amassed large reserves either on account of persistent current account surpluses or due to revenue gains from commodity exports, in particular of oil and gas, the Indian economy has twin deficits – a current account deficit as also a fiscal deficit. India's export basket is diversified and does not have any dominant "exportable" natural resource output, which might promise significant revenue gains at the current juncture.

Third, India has experienced consistent but manageable current account deficits barring very few years of a modest surplus. India is also having a negative international investment position (IIP) with liabilities far exceeding the assets. The large reserves have been built, over time, mostly on account of capital flows like foreign direct investments (FDI), portfolio flows through foreign institutional investors (FII), external commercial borrowing (ECB) and short-term credit. Further, the increasing reserves also reflect, in part, the lower absorption capacity of the economy, which may pick up with the economy moving on to a higher growth trajectory.

In brief, the public policy is yet to take a conscious view on the desirability of establishing a SWF.

SPV for use of reserves

In the context of growing developmental needs, particularly of the infrastructure sector, a step in the direction of using a small part of reserves for development has recently been taken after considerable deliberations. An announcement was made by the Finance Minister in the budget Speech 2007-2008 on February 28, 2007 to "use a small part of the foreign exchange reserves without the risk of monetary expansion" for the purpose of financing infrastructure development projects. Accordingly a scheme has been finalized which envisages RBI investing, in tranches, up to an aggregate amount of USD 5 billion in fully Government guaranteed foreign currency denominated bonds issued by an overseas SPV of the India Infrastructure Finance Corporation Ltd. (IIFCL), a wholly owned company of Government of India. The funds, thus raised, are to be utilized by the company for on-lending to the Indian companies implementing infrastructure projects in India and/or to co-finance the ECBs of such projects for capital expenditure outside India without creating any monetary impact. The lending by the SPV under the arrangement would be treated as external commercial borrowings (ECB) and would be subject to the prescribed reporting and disclosure requirements. The bonds will carry a floating rate of interest. The investment by the RBI in the foreign currency denominated bonds issued by the SPV will not be reckoned as a part of the foreign exchange reserves, but will be a foreign currency asset on the RBI balance sheet.

It is noteworthy that this arrangement is distinct in the sense that India is both a home and a host for the IIFCL's subsidiary, as it is basically a SPV for channelising foreign exchange funds for meeting the requirements of the Indian private sector for infrastructure projects in India by drawing upon the foreign exchange reserves of the country available with the central bank.

Summing up

To sum up, India has not yet considered regulatory initiatives specifically addressing SWFs. Existing provisions in regard to fit-and-proper or take-over code are, however, applicable to all investors, including SWFs. Currently, the *pros* and *cons* for the establishment of an Indian SWF, as generally understood now, are still under debate. India is monitoring recent developments in regard to enhancing transparency and disclosure in respect of hedge funds, private equity and SWFs. In particular, India is watching with great interest the development of global codes, standards and practices in regard to SWFs, both in view of the presence of SWFs in the Indian financial markets and the ongoing debate on establishing an Indian SWF.