

G Padmanabhan: FEMA administration – prospects and challenges

Address by Mr G Padmanabhan, Executive Director of the Bank of India, at the Kuwait/Muscat Chapter of Institute of Chartered Accountants of India seminar, Muscat, 5 August 2014.

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1. It is a great pleasure and privilege to be here today. I thank the Kuwait/Muscat Chapter of the Institute of Chartered Accountants of India for the unique opportunity to address its members and a cross section of Indian population in the Gulf Region. The Institute has set high standards in professionalism and contributed greatly to the development of the corporate business. It is heartening to note that the Institute has a large presence in this region and that they are making important contributions to the business world here.

2. India's engagement with the Gulf region has been civilisational, dating back to ancient times and beyond. Located strategically, the Gulf region provided a critical trading node between ancient Indian civilisations, predominantly the Indus Valley urban centres, and the "Fertile Crescent" of Mesopotamia. Archaeological evidence seems to indicate a great deal of human interactions accompanied the trade and possibly, wealthy merchants from Indian principalities had set up base in the Gulf region, not very unlike the case today.

3. Indians have been sea-faring into distant lands from both her eastern as well as western coast down the centuries. But systematic migration was not a phenomenon beyond what was necessary to support buoyant and sustained trade until the colonial era when the need of cheap labour for plantation industries lured large number of Indian labour to foreign shores. During the 1970's, migration from India acquired a different structure which included large scale flow of professional, skilled, and unskilled labour to support the oil-fuelled development and construction activity in the Gulf region. Today, I understand that about six million Indians working in the Gulf region account for about 50% of the total remittance to India. That this magnitude of remittance has significant implications for our Balance of Payments is undeniable. The future engagement has to traverse beyond this in greater trade, commerce, investment and entrepreneurial ventures.

4. As you are aware, the regulatory framework for external sector transactions in India has evolved over the years. The rather restrictive regime of the 1970's progressively yielded space to liberalisations since the mid 1980's. The process of economic liberalisation started in the 1990's hastened the pace of change in the regulatory framework marked by several milestones, including market determined exchange rate of the Rupee and current account convertibility in compliance with the obligations under article VIII of the IMF. The progress thus far was then consolidated in framing a new regulatory framework under the Foreign Exchange Management Act, 1999 the express objective of which was to facilitate external trade and payments and promote orderly development and maintenance of the foreign exchange market in India. With current account fully convertible, except only minimal restrictions necessary to prevent a current account transaction being used as a camouflage for a capital account transaction, the entire focus of the regulatory framework for external sector transactions has been on the capital account transactions. We have not been able to approach full capital account convertibility because some of the necessary preconditions such as persistently low inflation and stable fiscal conditions have not materialised. Notwithstanding this limitation, the capital account has been managed in a way as to meet the needs of the economy in a non-disruptive manner.

5. Why is capital account important? Firstly, India has generally run a current account deficit barring a couple of years a decade back mostly due to relatively benign crude prices.

A current account deficit has to be offset by a capital account surplus: it is an accounting identity. The challenge is to generate capital flows of the desired quality and quantity. I will come to this a little later. Secondly, the Indian economy requires investment on a massive scale not only to sustain a high growth momentum, but also to create the physical and social infrastructure to fulfil the needs of one and a quarter billion aspiring Indians. India has a high rate of savings, but it is inadequate to meet the gargantuan investment needs of today. Thirdly, as the gathering here will appreciate, Indian entrepreneurship is second to none in its business acumen and can surely compete globally. Rather than shackling the Indian businessmen to the domestic arena, the aim has to be to encourage them to set up shop wherever profitable opportunities beckon them.

6. Important as the capital account transactions are, as I have mentioned above, they also usher in potential elements of instability. There was a time when capital account openness or convertibility was extolled as a necessary virtue to hurl the less developed economies into a path of high growth. There were critics of this path then too, but now it is widely accepted that capital account openness has to be approached with caution and in certain situations, capital controls can even constitute a useful policy tool. Essentially, we are wary of short term capital flows that usually feed asset price boom and are susceptible to sudden stops or reversals.

7. Within this general framework, I now turn to our approach to capital account management in some detail. As you know, capital account transactions are transactions in assets and non-residents can hold domestic assets in three forms: equity, debt and immovable property. Investment in equity can further be classified into foreign direct investment and foreign portfolio investment. Similarly, flows relating to debt can be divided into three broad groups, viz., contracted debt, marketed debt and bank deposits.

8. Of all capital flows, FDI occupies the highest tier in preference order and therefore has the most permissive regime. In line with the FDI policy framed by the Government of India, the only restrictions in FDI relate to investment caps in certain sectors, depending upon our comfort with the degree of foreign control motivated by strategic or socio-economic considerations. Reflecting the same concern, while a large majority of sectors are open to FDI through the automatic route, a few require a prior approval. The FDI policy framework is not exactly static and is open to review. It is evident from the Honourable Finance Minister's recent budget speech wherein proposals to increase foreign investment ceiling in Defence sector from 26% to 49% and also a similar increase in insurance sector have been announced.

9. While on the subject of FDI, I want to mention two specific policy developments of the last one year that have evinced a great deal of interest.

a. In January this year, we allowed companies to issue shares with inbuilt optionality clause where the issuer of shares writes a put option so that the investor can exit at the specified time by selling the share to the issuer. The key feature is that the sale would take place not at a pre-determined price but at the "fair price" prevailing at the time of exit. An option without a predetermined strike price may seem to be a bit of a problem, but there is a logic behind it. Please appreciate that an equity that has a put option at a given strike price upon exercise becomes a debt instrument and therefore, is contrary to a policy regime where there is a great deal of control on debt flows. However, we realise that in certain risky investments, it is natural for an investor to be assured of a floor on the expected returns and venture capital investment has indeed been granted that latitude. Allowing such an arrangement on a secular basis is a matter for future policy.

b. It is a fair requirement that an asset must be sold at its fair value to an investor. Underpricing the sale of an asset to a non-resident investor is a stratagem to dodge tax and transfer value and accordingly the regulatory framework prescribed a specific valuation methodology – the Discounted Cash Flow (DCF) method – for

sale of shares of unlisted companies. Surely, notwithstanding its problems, the DCF method may be the most appropriate; but with a view to affording the investors and investees greater freedom in carrying out their transactions, we have last month amended the regulations to permit any internationally accepted valuation methodology at an arm's length basis.

10. As far as portfolio investment is concerned, the access to foreign investors is fairly well defined – the only constraint, consistent with the international norm, is that portfolio investment by an individual investor cannot exceed 10% of the outstanding stock of a company and the aggregate portfolio investment cannot exceed 24% or such higher limit as may be decided by the company concerned. This is subject to the sectoral caps, wherever applicable. Earlier this year SEBI has put in place a comprehensive regime for registration of potential portfolio investors, which has also been notified under FEMA, 1999. An important relaxation that I like to mention here is that RBI has dispensed with additional KYC requirement for a bank account that a registered foreign portfolio investor has to open for the purpose of investment. The Finance Minister, in his budget speech, has sought to address a long-standing demand for level playing field in respect of tax treatment of foreign funds whose fund managers are India-based. I am sure this will bring more professional employment and income to Indian shores.

11. While on the subject of foreign investment, it is important to note about the proposed revamping of the regulatory framework for Depository Receipts. Depository Receipts are essentially instruments to address the home-country bias of international investing communities and over the years has proved a useful tool for Indian companies to raise capital abroad. With a view to further expanding the scope of these instruments, a Government of India appointed Committee (Chairman: Shri M S Sahoo) recently looked into the entire gamut of issues and its recommendations are being taken up for implementation. Without going into details, the overarching principle that has guided the work of this Committee is that whichever asset class is open to a non-resident to invest in the domestic markets, should also be accessible to non-residents in international market through an appropriate institutional framework and safety measures, including compliance with KYC and other international norms.

12. As indicated earlier, the policy regime in respect of debt flows, particularly contracted borrowings commonly known as ECB, has a pronounced bias towards long term flows. The other restrictions at present relate to the type of lender, the type of borrower, the end use and the cost of borrowing. It is to be appreciated that these restrictions are aimed at controlling indiscriminate borrowing which has potential stability implications. Recognising the large and typical borrowing needs of the Infrastructure sector, we have effected several relaxations in this area. Even though a framework of general permission may not be in place, we are open to the specific needs depending upon the compulsions of the borrower and the international practice.

13. The policy regime in respect of Rupee denominated marketable securities – both sovereign and corporate debt – has undergone change over time mainly by way of consolidation and expansion of limits. At present, foreign portfolio investors are allowed to invest up to USD 25 billion in dated government securities and an additional USD 5 billion is available to the long term investors. Similarly, a limit of USD 51 billion is available for investment in corporate debt. As a conscious policy stance, we have been trying to nudge the foreign portfolio investors towards investing in long term papers. It is to be appreciated that investment in short dated papers, treasury bills and commercial papers are essentially volatile and constitute interest rate play. This is not in sync with our policy imperative. Accordingly, we have mandated last month that all fresh investment upon sale or redemption of existing investment in sovereign debt has to be necessarily in government dated security of a minimum residual maturity of 3 years. There is no lock in period and no restriction on selling the bonds to residents irrespective of their residual maturity.

14. Let me state in this context, brief details of a pilot initiative taken last year. We were approached by IFC for floating a rupee denominated paper in international market with a view to investing the proceeds in the Indian markets. IFC was permitted to issue USD one billion worth of such papers, which it has executed successfully. Subsequently, Asian Development Bank has also been permitted to float a similar issue of USD 500 million. Because of capital account restrictions, we had earlier been averse to the idea of such rupee linked offshore bonds abroad because of its potential impact on domestic currency and debt markets. The permissions to IFC and ADB are essentially testing the waters, as it were, and the future view on such floatation will depend on the experience.

15. Overseas direct investment is an inalienable part of India's progressive integration with the world economy. Apart from the quest for profitable business opportunities, overseas presence enriches the Indian corporate in adapting itself to global competition and imbibing the best management practice. It is also expected to serve the strategic interests of the economy as well. With this in view, the regulatory regime has been fairly encouraging. For a capital-scarce economy like India, the cumulative overseas investment position at about USD 140 billion is no small achievement. At the height of Rupee volatility last year, as a purely temporary measure, RBI had reduced the "automatic route" investment limit from 400% of the Indian company's net worth to 100% – a measure mistakenly dubbed by some as capital control. Even when the restriction was in force, RBI's approval was not denied to any productive venture. This measure was rolled back once the markets stabilised.

16. It is a matter of some concern that the overseas investment has not been yielding as much return as should be expected. The need for deployment of the surplus generated in expansion activities is well recognised. But in reality, tax arbitrage also plays an important role which needs to be addressed.

17. Recognising the benefit of asset diversification for the domestic investor, the regulatory regime permits an individual to invest abroad in any asset class, including in real estate, up to USD 125,000 per year. Though a major part of the remittance under this category is made for various current account transactions simply because of the ease of procedure, the route nevertheless does enable the domestic individual to own foreign asset in her portfolio. To deal with the home country bias of the Indian investor and also to make the ownership of foreign security easily accessible, we have permitted Indian Depository Receipts under FEMA since 2009. Ironically, the only IDR floatation we have had till date has been predominantly invested in by the FIIs! In this context, I may mention that the Sahoo Committee that I had mentioned earlier also suggested exhaustive revamping of the regulatory framework for IDR. The Finance Minister too, in his budget speech, has proposed a liberal and ambitious Depository Receipt scheme styled Bharat Depository Scheme (BhDR). I am sure this is going to give a quantum fillip to the Indian capital markets.

18. Speaking here before an assembly of predominantly non-resident Indians, I shall be failing in my duty if I do not mention the foreign exchange framework as it relates to the NRIs. At the outset, I must pay my encomium to Indian Diaspora for its support to the Indian economy in its moments of need. It is the buoyant remittances from the hardworking Indians that provided the first glimmer of hope during the gloomy 1970's when the acute foreign exchange crisis almost stalled the Indian development story. As I have mentioned earlier, it still provides a much needed support to India's Balance of Payments.

19. The regulatory framework for foreign exchange has also always recognised the contributions of the Diaspora. In the early stages when the access to the Indian economy was rather restrictive for non-residents, the NRIs enjoyed a preferential regime in investment, bank deposits, etc. With gradual opening up of the Indian economy and financial liberalisation, some of the preferential treatment has become superfluous but still many remain. For instance, an NRI individual can invest up to 5% of the outstanding stock of a company through the portfolio investment scheme and has unlimited access to the debt securities at par with a resident Indian.

20. For the large number of Indian migrant workers, remittance home is extremely important. Over the years, we have enabled multiple channels to provide easy and efficient remittance facility both for the remitter and the receiver. Apart from the traditional banking channel, the exchange houses and money transfer service agents have been handling the large volume of remittances. If KYC requirement at both ends is sometimes viewed as onerous, we must bear in mind that we live in difficult times and measures like KYC is a price we pay for the safety and security of our society. At the same time we took a series of measures towards electronification of the payment systems in India. Today payment to India and across India happens in matter of seconds in a safe and secure manner. Secondly, we are proactively enabling alternate payment methods so that you are not required to carry or use physical cash.

21. I understand that acquisition of immovable property is a very important concern for not only the Non- Resident Indians – I mean Indian citizens residing abroad – but also Persons of Indian Origin. I wish to make it clear that the regulatory framework is pretty liberal inasmuch as it permits both NRIs as well as PIOs to acquire any immovable property except agriculture property, plantations or farmhouse. The acquisition however is required to be funded through the banking channel, which is a fair stipulation. While there is no restriction on NRIs for sale, gift or otherwise transfer any property so acquired, PIOs can sell the acquired properties only to resident Indians. There is also a restriction on NRIs/PIOs acquiring property in India jointly with their spouse if she/he is neither resident in India nor an NRI nor a PIO. Such cases require prior approval of RBI and of late, there has been an increase in number of such cases. This is an issue that requires examination in consultation with the Government of India. In fact, I have directed an comprehensive review of FEMA 21 before I embarked on this trip.

22. Let me mention in passing the problem of gold, as I realise the gulf region provides perhaps the largest gold market with an Indian connection on the western side. The control on gold imports was imposed with a view to getting an immediate handle on the burgeoning current account deficit. The insatiable Indian appetite for gold is well known. It had probably been further whetted by persistent inflation on the one hand and increased prosperity on the other. Thus restriction on gold import provided a much needed immediate reprieve for restoring the imbalance in the current account. But it is well recognised this cannot be a long term measure lest it engenders undesirable consequences. It will be a challenge to blunt the lure for gold, but it has to be faced in the medium to long term.

23. So far, I have attempted to paint a broad-brush picture of our approach to the management of India's external sector. The narrative has been fairly simple: gradual opening up of the capital account with a cautious eye on the potentially disruptive impact of unbridled capital flows like what countries in several regions have faced in the past and may be facing now, as we talk. Notwithstanding the straightforward approach, the devil is in the detail, as they say. From my vantage position, I cannot really say that the regulatory regime that a foreign investor seeking to engage with the Indian markets faces is as simple or transparent as one would wish it to be. There are many reasons for the complexity of the regulatory regime that obtains today. Let me mention just two. First, the external factors have changed rapidly in the past. The post-Pokhran II sanctions during the closing years of the last millennium and early years of this millennium; the global liquidity glut and unprecedented capital inflows of 2006–07; the global financial crisis and its aftermath – all these events elicited regulatory response to deal with the fallouts. The responses varied depending not only upon the external factor, but also the state of the economy. Secondly, the regulatory regime has often to respond to the way market participants exploit the gaps and even benign relaxations to game the regulatory regime to their advantage, against the spirit of the game. Be that as it may, the fact remains that there is an urgent need today to make the regulatory regime simple, transparent and easily comprehensible. The Government of India and we in the RBI are making efforts at several levels to address this issue and I am sure that soon we shall make progress in this regard.

24. In this complex world of international business, the need for professional expertise cannot be overemphasised. It has been rightly said that the foundation of the modern society owes as much to Luca Pacioli, the 15th century Franciscan Friar who perfected the double entry book-keeping, as to anyone else. The development of the post-industrial-revolution corporate sector would not have been possible but for the efforts of competent, diligent and credible accounting professionals. Rapid economic development is a revolutionary necessity for India today, so that the aspirations of one and a quarter billion Indians can be realised. This process requires growing integration with the global economy: in trade and commerce as well as in finance and investment. I am sure the profession of chartered accountants shall play the role of a facilitating catalyst in this endeavour. Having said this, I would also like to call upon the professionals to equip themselves to render correct advice within the letter and spirit of FEMA to avoid compounding complications later. This is important to facilitate speedier enablement of simpler procedures that are less intrusive.

25. Let me end by reiterating that we are open to receiving suggestions to make FEMA administration more user friendly, particularly from an important stake holder like the NRI community.

Thank you for your patience.