Prospects for Global Financial Institutions In India- Analysis & Suggestions

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Introduction
Global or International Financial Institutions (GFIs /IFIs) are international institutions that provide financing to governments and private companies for social and human development, physical infrastructure projects, trade, investment, establishing new businesses, services delivery, etc. Many IFIs are private corporations such as Citicorp, Merrill Lynch, ICICI and Ing Vysa. Some are government run institutions that operate trans-nationally such as Export Credit Agencies (ECAs) and export-import (ex-im) banks. IFIs are often viewed as the main 'agents' of economic globalization in developing countries since they facilitate one of the most important pre-requisites for globalisation, i.e., capital.

I am an investment advisor to one of the Global Financial Institution (GFI) based at New York, which is interested in expanding it’s business in India .The GFI has sought my professional advice and opinion regarding the proposal, along with an analysis of the Indian financial & Capital Market and my recommendation about the broad areas where the company could do well in the Indian Financial & capital markets. This paper therefore is an attempt to examine and explore the investment climate, regulatory environment and the opportunities open to the Global financial Institutions (GFI), in India and my recommendation to the GFI for its proposed operations in India. (8)

Background
India carried out the first and second-generation reforms, which created a favorable environment for foreign investments in India. The policies of liberalization and the market oriented initiatives taken by the successive governments are boosting economic activity, overall development and the growth in the GDP rate, in India. As the Indian economy prepares itself for competition in the international market, overseas investors, including the GFIs, clearly see the potential for attractive returns from investments in India, which is evident from the several FDI success stories, already achieved. (10)

However there are certain infirmities in the Indian investment climate. The private investment is only 15% of the GDP of India and FDI flows are only 1% of GDP. The industrial sector contributes less than 25% of the GDP and only 7% of total employment is in the organized sector (5). Further, both the financial and the capital markets are still imperfect, with the issues relating to –

a) High fiscal deficits crowding out public and private investment.
b) Severe Infrastructure bottle necks.
c) Widespread government ownership of business and Banking sector
d) FDI restrictions in certain sectors
e) Excessive regulation that increases costs of doing business
f) Sluggish reform process.

Despite all that is imperfect in India, it still remains to be one of the favourite destinations for the GFIs and the FIIs and FDIs and is being regarded as a land of opportunity with –

a) Large and rapidly growing domestic market.
b) Large and low cost labour force
c) Highly skilled labour, well versed with English language.
d) Democracy, freedom, political stability and consensus on economic reforms.
e) Well laid out judicial system
f) Growing infrastructure, private ports and S.E.Z(Special Economic Zones ) for export oriented Industries.

It is therefore necessary to analyse the prospects in India, for a Global Financial Institutions in the backdrop of the existing investment climate , the regulatory framework and the inherent competitive advantages . (14, 16 & 15)

The Investment Climate in India
A look at the Indian Financial & Capital Markets:

The financial markets went through a transformation in the early 1990s, in India. Substantial and far reaching changes were brought about in the banking sector, like elimination of interest rate controls, reductions in reserve and liquidity requirements and an overhaul was done in priority sector lending. The sincere and persistent effort by the Reserve Bank of India (RBI) to put in place an effective supervision and the prudential norms has lifted the country closer to global standards. (15)

The capital markets in India have experienced major changes since the last decade. The market infrastructure
and the corporate governance in India have improved, at par with many other emerging markets. However, when compared to several other developed countries and other Asian economies, the capital markets in India are still quiet shallow and require further reforms, in order to transform India into a world-class financial centre.

India’s capital market also went through an extensive transformation with the help of SEBI (The Securities and Exchange Board of India) in 1992, which was established with an intention to protect investors and promote micro structure of capital markets. The Controller of Capital Issues (CCI) – a regulatory body that administratively controlled the pricing of new equity issues was also repealed. With the introduction of technology and establishment of National Stock Exchange (NSE), India’s financial markets saw a significant rise in the volume of transactions and the emergence of new and important instruments in financial intermediation.

India now has in place an equity market that is dynamic and vibrant. The fantastic performance displayed by the stock exchanges in India since 2003, reflects the improving macroeconomic fundamentals in this country. New /Innovative instruments and products have been launched in the financial markets of India, like, ‘securitised debt’ and ‘fund products’, which are based on alternative assets. (16 & 15)

An analysis of the bond segment reveals that it is of the size of around 40% of GDP of India, which is comparable with the figures in many emerging market economies. However the corporate bond market is small when compared with the countries like US, Malaysia and South Korea. The bond market is dominated by government bonds (nearly 90% of the domestic bonds are government bonds), which marginalises the corporate and other marketable securities. Most of these bonds are issued either to contain the persistent and high fiscal deficit or as a mechanism of manipulating the money supply through the regulatory Monetary policy. (18)

Securitisation is a growing segment in India’s debt markets. Activities in this segment for the present are primarily between banks, non-bank financial institutions and asset reconstruction companies through private placements. It is expected that the proposed changes to the Securities Contracts Regulation Act, would facilitate reclassification of securitised debt as true marketable securities, in the secondary market. Asset-backed securities (ABS) are the primary asset class in India’s securitised segment due to the large component of retail loans in banks’ and non-bank in the balance sheets of the financial institutions’.

With the Indian government’s plan to modernise its infrastructure, the need to develop the structured finance segment becomes crucial. Collateralised mortgage backed securities (CMBS), collateralised loan obligations (CLO) and collateralised debt obligations (CDO), which are actively traded in the United States, are the innovations awaiting the Indian market in line with a maturing economy. Allowing foreign investors in the Indian market will play a significant role in pricing and transparency. (13)

One of the positive developments in India has been the strengthening of Market infrastructure through steady reforms. Both the government bond and equity markets have moved to T+1 and T+2 ‘rolling settlement cycles’ in recent years, which significantly compressed the transfer of cash and securities to the counterparties and has reduced the settlement risks. The movement to shorter settlement period has been possible due to the introduction of electronic transfer of securities, which ensures transparency and reduces the settlement cost. Further, the ‘dematerialisation’ ensured a paper-free securities market, which eliminated the possibility of ‘forgery’ of share certificates. Further a direct- through processing automated the complete workflow of a financial transaction, thus eliminating multiple data re-entry and avoiding delays and errors. The Clearing Corporation of India Limited (CCIL) established in 2001, facilitated the clearing of trades and transactions in the foreign exchange and fixed income markets, propelled by the extensive use of information technology. (6)

Persistent and committed efforts by the SEBI, to upgrade the corporate governance framework have paid rich dividends to the nation. India is now placed at an above-average level against other emerging market economies, according to the Institute of International Finance (IIF), the global association of financial institutions. Since March 2006, listed companies have been required to submit quarterly compliance reports to the SEBI, facilitating the valuation of companies and bringing it in line with the Sarbanes-Oxley Act. (7,13 & 16)

However, enforcement remains a challenge due to a limited number of adequately trained staff to implement the rules. Further the companies too are not subject to substantial fines or legal sanctions, which reduce their incentives to comply. This in fact reflects the ongoing gaps in India’s legal system, and to a large extent undermines the steps to promote India’s capital markets further. Although India does have a strong functional legal system, the country’s law enforcement still lags behind the more advanced economies of Hong Kong and Singapore according to the World Bank. This implies that efforts to raise corporate governance need to be accompanied not only by a much stronger legal framework
Foreign Direct Investment (FDI) is permitted as under the following forms of investments: (3 & 21)

a) Through financial collaborations.
b) Through joint ventures and technical collaborations.
c) Through capital markets via Euro issues.
d) Through private placements or preferential allotments.

Forbidden Territories:
FDI is not permitted in the following industrial sectors:

a) Arms and ammunition.
b) Atomic Energy.
c) Railway Transport.
d) Coal and lignite.
e) Mining of iron, manganese, chrome, gypsum, sulphur, gold, diamonds, copper, zinc.

Foreign Investment through GDRs (Euro Issues)
Foreign Investment through GDRs is treated as Foreign Direct Investment. Indian companies are allowed to raise equity capital in the international market through the issue of Global Depository Receipt (GDRs). GDRs are designated in dollars and are not subject to any ceilings on investment. An applicant company seeking Government’s approval in this regard should have consistent track record for good performance (financial or otherwise) for a minimum period of 3 years. This condition would be relaxed for infrastructure projects such as power generation, telecommunication, petroleum exploration and refining, ports, airports and roads.

Clearance from FIPB-(Foreign Investment promotion board)
There is no restriction on the number of Euro-issue to be floated by a company or a group of companies in the financial year. A company engaged in the manufacture of items covered under Annex-III of the New Industrial Policy whose direct foreign investment after a proposed Euro issue is likely to exceed 51% or which is implementing a project not contained in Annex-III, would need to obtain prior FIPB clearance before seeking final approval from Ministry of Finance.

Use of Global Depository Receipts
The proceeds of the GDRs can be used for financing capital goods imports, capital expenditure including domestic purchase/installation of plant, equipment and building and investment in software development, pre-payment or scheduled repayment of earlier external borrowings, and equity investment in JV/WOSs in India.

Restrictions
However, investment in stock markets and real estate will not be permitted. Companies may retain the proceeds abroad or may remit funds into India in anticipation of the use of funds for approved end uses. Any investment from a foreign firm into India requires the prior approval of the Government of India.

Tax Issues (21)
The Central Government, under Section 90 of the Income Tax Act, has been authorised to enter into Double Tax Avoidance Agreements (tax treaties) with other countries. The object of such agreements is to evolve an equitable basis for the allocation of the right to tax different types of income between the 'source' and 'residence' states ensuring in that process tax neutrality in transactions between residents and non-residents.

Tax treaties serve the purpose of providing protection to tax payers against double taxation and thus preventing the discouragement which taxation may provide in the free flow of international trade, international investment and international transfer of technology. These treaties also aim at preventing discrimination between the tax payers in the international field and providing a reasonable element of legal and fiscal certainty within a legal framework. In addition, such treaties contain provisions for mutual exchange of information and for reducing litigation by providing for mutual assistance procedure.

These agreements give the right of taxation in respect of the income of the nature of interest, dividend, royalty and fees for technical services to the country of residence. However, the source country is also given the right but such taxation in the source country has to be limited to the rates prescribed in the agreement. The rate of taxation is on gross receipts without deduction of expenses.

Recommendation and Conclusion
Gradually, India is being seen as a market which can offer high-end and mission critical support services. Functions being offshored have graduated from the support functions such as F&A support and voice based services to complex functions including financial model-
ling, equity research support and portfolio tracking. In fact over the last two years research and analytics has emerged as a service area that has picked up steam. With the growing maturity of vendors, functions with increasing complexity are being off-shored. The global financial institutions are doing that through different models of outsourcing that are in vogue currently in the market. While captive and the third party models are being traditionally followed, financial service companies are constantly experimenting with new models and their innovations are likely to drive BPO sourcing as a whole in the country. The latest to emerge is hybridisation of sourcing models that calls for multi-locational sourcing as well as combination of captive, third party and joint venture sourcing models. (3)

In the light of the foregoing analysis, as India opens up its economy and enters to the advanced phase of liberalisation, I am of the view that India shall be a very good option for doing business in this country, particularly in the following areas (to name a few) –

Setting up BPOs, Offshore business ventures, Joint venture Financing, Export Credit and Industry Credit Financing, Long term Financing & Institutional Investment and Merchant Banking operations, Project financing – with special emphasis on Infrastructure, Pharma, Energy and Oil sectors, Advisory and facilitating roles in takeovers and mergers, financial consultancy and investment banking opportunities, Micro finance and Micro Insurance. (1, 20 & 21)

References and Bibliography
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