

# India: Restraining inflows

While the precise outcome of the recently announced stock market measures is still uncertain, we think it is unlikely to alter inflows in the medium- and longer-term

Recent inflows have been difficult to absorb. Investors should not rule out more controls if the pace does not slow.

Measures should be restricted to slowing the pace of inflows – we expect no constraints to be imposed on outflow

The measures especially affect PNs with derivatives as underlying and sub-accounts of FIIs

## Summary

The Securities Exchange Board of India (SEBI) proposed a set of measures on Oct 16 to restrict flows to the stock market that come through the route of offshore derivative instruments (ODI) typically called as “participatory notes” (PN). PNs are used by unregistered investors to invest in the Indian stock market. They are issued by SEBI registered foreign institutional investors or FII and their sub-accounts. According to the Finance Minister, the measures would become effective with or without modifications on Oct 25. The authority is meanwhile open to feedback on the measures until this Friday.

Thus, while the precise outcome of the proposed measures is still uncertain, we think it is unlikely to alter multi-month dynamics of flows in this or the final form of the regulations. In fact, we do not rule out more controls from the government as and when they see unusually large flows. However, we think their measures are likely to be restricted to targeting and moderating such flows rather than slowing foreign investment flows overall.

## Background

The underlying asset against which a PN is issued may be stocks or derivatives. The RBI and the Finance Ministry have had differing views on PNs made public by both in the past few years. The RBI believes PNs should be banned entirely while the Finance Ministry welcomes flows via the PN route. The new regulations suggest that the Finance Ministry is also concerned about the recent large inflows (FX reserves rose circa USD 16bn in Sep07) especially given the combination of leverage and anonymity that PNs (especially PNs with underlying as derivative rather than stocks) provide. It is difficult to talk about the changes in the regulations without going into the definitions of FII, sub-accounts and PNs.

In policy documents on FII flows and PNs, the Finance Ministry said the following about FIIs, sub-accounts and PNs:

**FII:** The Government guidelines for FII allow overseas pension funds, mutual funds, investment trust, asset management company, nominee company, bank, institutional portfolio manager, university funds, endowments, foundations, charitable trusts, charitable societies, a trustee or power of attorney holder incorporated or established outside India proposing to make proprietary investments to register as an FII.

**Sub-accounts:** The sub account is generally the underlying fund on whose behalf the FII invests. The following entities are eligible to be registered as sub-accounts, viz. partnership firms, private company, public company, pension fund, investment trust, and individuals.

**PN:** Participatory notes (PNs) are derivative instrument issued against an underlying security which permits the holder to share in the capital appreciation/income from the underlying security. PNs are like contract notes and are issued by FIIs, registered in the country, to their overseas clients who may not be eligible to invest in the Indian stock markets. PNs are used as an alternative to sub-accounts by ultimate investors generally based on considerations related to transactions costs and recordkeeping overheads.

### What are the measures?

- 1) The measures require sub-accounts (not FIIs themselves) to wind up all outstanding PN positions (derivative as underlying or not) over the next 18 months.
- 2) FIIs and their sub-accounts are also to stop issuance of derivatives and to wind up all derivative PN positions over the next 18 months (i.e.: non-sub-account PNs that do not have derivative as underlying may remain).
- 3) It also bars fresh PN issuance where the PNs (excl those that have derivatives as underlying) already exceed 40% of assets under custody, except against cancellation/redemption. If the 40% mark is not hit, then fresh issuance should be in increments of 5% of their assets under custody (time frame not stated).

### Who is affected?

Three categories of investors are affected:

- 1) Those who invested in derivative products offshore - the notional value of such derivatives stood at USD 30bn at end-Aug07 - about 30% of total outstanding p-note notional value;
- 2) Those who bought PNs via sub-accounts rather than the FII directly - this amount is not known but could be substantial and potentially even the bulk of PNs;
- 3) Sub-accounts are unable to issue p-notes and hence are affected. As well, FIIs who have hit the 40% limit are affected.

### Options available to those affected

It would be useful to figure what the affected parties can do so that they can still get exposure to Indian stocks but meet the new regulations. The FII and foreign participation regulations suggest:

- 1) An investor could potentially go to another FII and buy p-notes from those who have not hit the 40% limit
- 2) An investor could buy stocks via a registered FII rather than invest in p-notes
- 3) A sub-account with an FII can instead register as an FII and buy stocks

### How big are these flows likely to be?

According to the SEBI, the notional value of outstanding PNs rose to almost USD 90bn as at end-Aug07 and PNs that had derivatives as underlying rose to USD 30bn. Also, the notional value of PNs excluding derivatives was 34.5% of assets under custody (vs the 40% limit). Even with these numbers, the exact size of outflows is hard to determine. For one, it is not clear which investors can shift from being a sub-account to a registered FII. What proportion of p-notes is issued by sub-accounts is also not clear. Also, those who presently invest in p-notes may simply start investing via registered FIIs instead not minding the additional costs involved. Therefore, it becomes all the more important to note the intention of the authority first. It is also important to have an idea on the proportion of genuine investors who would not mind the additional costs of operating via an FII or by directly registering as an FII. For this, we have to go back to the view on the fundamentals of the economy and the market.

### Back to basics: policy intent and fundamentals

It is important to consider the intention behind these measures. This is because there is uncertainty surrounding the actual outcome of the measures. Should the outcome be more disruptive to the markets than expected, then the measures could be modified. We think the intention of the measures is three-fold:

- 1) One is to tame the sharp pace of flows into the stock market in recent months. In September alone, FX reserves rose by USD 16bn even as the INR rose over 1%

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Given the uncertainty involved, it becomes all the more important to consider the intention of the authorities and the fundamentals of the markets

against the USD to 39.30. It is for this reason probably that sub-accounts are banned from issuing PNs;

2) To increase transparency with regards to the ownership of these inflows;

3) The third motivation is to reduce leverage in the market and the risk of volatility. This is the main intention in banning PNs with derivatives as underlying.

**We expect net FII flows should still be positive around USD 8-10bn annually in the next 2-3 years**

Coming to economic fundamentals, our view for India's potential growth rate is in the high end of market expectations and we see it rising in general (see *India: Reassessing potential growth*). We expect 9% growth in FY2008, higher than the 8.4% expected in FY07. This is above current consensus and, if correct, could lead to further inflows in the future.

If this were to occur, one cannot rule out more controls from the government. However, it is important to note that measures are likely to be restricted to moderating inflows – we expect no constraints will be imposed on outflows. In particular, we do not expect any sharp or sudden increase in taxes that would alter expected returns, as was the case in Thailand when controls were imposed haphazardly in late-2006. We expect any future measures to instead still leave the country open to annual capital flows of around USD 30-50bn or 3-5% of GDP larger than the expected 1-2% current account deficit. This should leave the BoP surplus at 2-3% of GDP. After the experience of Mar 2007, we think the RBI would not want to simply absorb all of this like they attempted in 2005 and 2006 only to see USD/INR crashing later in 2007.

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