

Corpsec Hotline

September 02, 2006

CAPITAL ACCOUNT CONVERTIBILITY : FINALLY A REALITY?

The Tarapore Committee (Committee), set up by the Reserve Bank of India (RBI) on March 20, 2006 to prepare a road map for capital account convertibility, has submitted its report to the RBI.

The Committee has proposed for India's shifting to fuller capital account convertibility in three phases, over a period of five years. Some of the important recommendations given by the Committee are:

- The facility for Indian individuals, who are currently allowed to freely remit up to USD 25,000 per calendar year, to be raised to USD 50,000 in phase I, USD 100,000 in phase II and USD 200,000 in phase III;
- Non resident corporates be allowed to invest in the Indian stock markets through SEBI-registered entities, including mutual funds and portfolio management schemes;
- The limit for investing in the overseas corporates be raised to 400% of the Indian investing company's net worth, from the existing 200%;
- The norms on the External Commercial Borrowings (ECBs) to be eased out, viz. companies can raise ECBs up to USD 1 billion by phase III without any prior regulatory approval and no ceiling on the long-term and rupee-denominated ECBs;
- Foreign companies can raise rupee loans, bonds in India;
- Banks can raise up to 100% of their capital through ECBs in phase III;
- Industrial houses to hold equity stakes in Indian banks or to promote new banks;

While recommending the liberalizations as above, the Committee was also cautious by suggesting certain restrictions, such as:

- special tax concessions for Mauritius-based entities to go;
- the FIIs should be prohibited from investing through Participatory Notes (PNs) and that the existing PNs should be phased out completely within one year, by providing the PN holders with an exit route;
- the FIIs to set aside reserves with the RBI, as a temporary measure, in case of any volatility in the market;
- the tax exemptions currently enjoyed by the NRIs on the interest on bank deposits, be stopped;

The RBI has formed an internal committee to examine these recommendations vis-a-vis the regulations and to suggest measures to ease the rupee convertibility, by December, 2006.

Implications:

What the proposed road map would achieve is greater competitiveness for the Indian companies in expanding overseas, a phenomenon which has gathered momentum over the last few years and will create truly global Indian MNCs.

Further, relaxation in the ECB guidelines, both in terms of end use and the ceilings, would ensure better accessibility to the Indian corporates to foreign debt at a cheaper alternative. This would also remove the so called 'protective regime' as regards domestic banks and financial institutions through imposition of end-use restrictions and interest rate caps. Further, allowing Indian banks to borrow from overseas would bring a better equilibrium between the interest rates regime in the domestic and the international debt markets.

From the foreign investors' perspective, opening up of the capital markets and the Indian debt markets would mean an attractive source of capital as well as leveraging on the growing depth of the Indian capital markets. Hopefully, the disparities between different classes of investors such as NRIs versus FIIs, would be ironed out ensuring a level playing field for all the investors.

It further appears that to an extent, the Committee has gone beyond its mandate in recommending the removal of tax concessions to Mauritius-based entities, since the tax treaties, as confirmed by the Supreme Court in its ruling in 2003 on India-Mauritius treaty, had clearly stated that the tax treaties are a central government's prerogative to facilitate and expand international trade. Further, any such move, without the corresponding reforms in the domestic tax laws, could be detrimental to the Indian economy.

Finally, it appears that the Committee has also been influenced by the RBI's perspective on PNs and has recommended abolishment of PNs. While in spirit it appears that the intention is to ensure more transparency into the type of capital flowing into the country through the PNs, unless the FII regime is significantly liberalized to facilitate

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participation by any eligible investor, subject of course to strong KYC requirements, such an abolition could seriously impact the FII flow into the country..

To conclude...

While on the face of it, this appears to be a significant step towards free economy bolstered by the strong growth in the fundamentals of the domestic economy supported by growing forex reserves, what really needs to be seen is the commitment of the Government and more importantly the RBI in implementing these measures. Besides policy changes, what is more important is the mind set change that would determine how successful the implementation of these policy changes would be.

- Kishore Joshi & Siddharth Shah

You can direct your queries or comments to the authors

Source: *RBI Press Release, dated September 1, 2006*

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