FPI related: Improving India's competitiveness, Increasing Inflows, Reducing costs

Paying interest on FPI balances to FPIs

Introduction:

RBI Foreign Exchange Department Notification No. FEMA 5(R)/2016-RB of April 01, 2016 (Amended upto November 09, 2018) wrt Foreign Exchange Management (Deposit) Regulations, 2016 states:

"In exercise of the powers conferred by clause (f) of sub-section (3) of section 6, sub-section (2) of section 47 of the Foreign Exchange Management Act, 1999 (42 of 1999) and in supersession of Notification No. FEMA 5/2000-RB dated May 3, 2000, as amended from time to time, the Reserve Bank contains the following regulations relating to deposits between a person resident in India and a person resident outside India, namely:

SCHEDULE 4 [See Regulation 5(4)] :Special Non-Resident Rupee Account - SNRR account

1. [6]Any person resident outside India, having a business interest in India, may open Special Non-Resident Rupee Account (SNRR account) with an authorised dealer for the purpose of putting through bona fide transactions in rupees, not involving any violation of the provisions of the Act, rules and regulations made thereunder. The business interest, apart from generic business interest, shall include the following INR transactions, namely, :-

i. Investments made in India in accordance with Foreign Exchange Management (Non-debt Instruments) Rules, 2019 dated October 17, 2019 and Foreign Exchange Management (Debt Instruments) Regulations, 2019 notified vide notification no. FEMA 396/2019-RB dated October 17, 2019, as applicable, as amended from time to time

v. Business related transactions outside International Financial Service Centre (IFSC) by IFSC units at GIFT city like administrative expenses in INR outside IFSC, INR amount from sale of scrap, government incentives in INR, etc. The account will be maintained with bank in India (outside IFSC).

[6] Amended vide Notification No. FEMA 5(R)(3)/2019-RB dated November 13, 2019. Prior to amendment, it read as "Any person resident outside India, having a business interest in India, may open Special Non-Resident Rupee Account (SNRR account) with an authorised dealer for the purpose of putting through bona fide transactions in rupees, not involving any violation of the provisions of the Act, rules and regulations made thereunder."

2. [7]The SNRR account shall carry the nomenclature of the specific business for which it is in operation. Indian bank may, at its discretion, maintain separate SNRR Account for each category of transactions or a single SNRR Account for a person resident outside India engaged in multiple categories of transactions provided it is able to identify/ segregate and account them category-wise.
3. The operations in the SNRR account [8]shall not result in the account holder making available foreign exchange to any person resident in India against reimbursement in rupees or in any other manner.
4. The SNRR account shall not bear any interest.
5. The debits and credits in the SNRR account [8]shall be specific/ incidental to the business proposed to be done by the account holder.

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Foreign Portfolio investors(FPI)

- As on date over 9700 FPIs are registered with SEBI across Cat I and Cat II. The numbers are growing ever since the relaxation happened in 2019 and ease of Business in 2019. The total AUC exceeds $ 400 Billion and growing.
- Foreign Portfolio investors(FPI) are also guided by the above RBI Regulations.
- FPIs appoint Brokerages to execute transactions, Authorised Dealers and Custodians for settlement of transactions.
- Regulations do not permit any of the Financial Market Intermediaries to prefund a FPI transaction/ provide credit.
- FPIs are required to pre-fund the transaction(mostly overnight or atleast one day in advance).
- Sighting of funds is a necessity, prior to execution of the transaction. Similarly, on Sale of Securities funds cannot be remitted, unless a tax Certificate is issued by the Tax firms, evidencing Tax has been paid.

Cost of Funding:

- Since FPIs have to prefunding their transactions, it is a Cost of Capital for them.
- India doesn't offer Full Capital Convertibility. Thus, Cost of Capital increases as the settlement has to be in Indian Rupees(lack of capital Convertibility) requiring FX services(converting foreign currency into INR in case of Purchases and vice versa in case of Sale). Thus, FX conversion costs becomes additional costs of doing business for the FPIs, while being a revenue stream for the Authorised Dealer Banks.
- Cost go up given that SNRR account shall not bear any interest.
- A combination of the three as well as differing internal policies of ADs(Authorised Dealers) leads to FPIs being required to bring in balances of upto 1 days prior to the Execution of the deals. These balances, which are not committed as on the day of receipt are regarded as Float balances(in Custodian terminology).
- There are approx. over 50 lines of Cost for FPIs, reducing India's competitiveness, especially in volatile FX market.

Float Balances:

Float Balances exist in most of the markets, advanced and emerging. Long cash generally earns interest, but at a very low rate, as the custodian would use the cash to generate their own revenue flow. It is additional flows for custodians. The reverse applies in volatile currencies where negative interest is charged.

India's case is an anomaly as it does not permit interest to be paid to offshore account holders(FPIs). That's why custodian Banks in India can charge zero fees for custody and still be profitable!

While Custodian Banks are prohibited from paying interest to FPIs, there is no bar on their ability to invest these balances in short term instruments that bear interest. Interest earned on these balances form income of the custodian Bank. Given short term to midterm instruments may bear interest rates of 3%-6%, this can be a substantial revenue for Custodian Banks, when they invest core balances out of this float. Thus, they are in a position to quote near Zero Custody pricing (Transaction/ Safe Keeping)! A rare phenomenon in the Worldwide Custody Industry.

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There are over 9800 FPIs registered with SEBI; on any given moment 2500 are active. The total Float could be in the region of over $ 2- 3 billion in an over performing market. Its highly profitable(as these balances can be placed at interest rates between 3-6%) for Custodian Banks. However Non-Bank Custodians(SHCIL, Edelweiss, Orbis, SBI-SG) have to rely on only Transaction and Safe Keeping fees and thus are disadvantages. Its pertinent to note that India is one of the few countries that has non-Bank Custodians. Further given the RBI regulations it does not benefit FPIs. In effect while it disadvantages single Country(India Based) Custodians, and FPIs, it also lessens the attractiveness of Indian Capital Markets. This has been the scenario ever since FPIs invest in India, since early 1990s.

It can be said that India has been less competitive vs many other jurisdictions(which don't have such restriction). However, there is no reason that this anomaly peculiar to India vs other jurisdictions cannot be rectified- India's competitiveness can be increased and the large disparities between the Custodian Bank and the Non- Custodian Bank be reduced, thereby ensuring a more competitive environment.

The issue of payment of interest to Indian Institutions/Investors does not arise as they can directly remit to the clearing corp. on the same day within minutes. Thus, no Float accrues to Custodians wrt domestic Institutional segment.

Revenue pattern:
The revenue pattern of the Custodian Bank for FPIs comprise of:

1. One-time Accounting opening charges- Generally waived by Custodian Banks
2. Annual account maintenance Charges- Charged for small- Medium FPI accounts
3. Transaction Charges- Equity/ Derivatives
4. Safe Keeping Charges- Equity only
5. FX charges
6. Float Income
7. Other Ancillary services(proxy voting etc)

From the % contribution aspect- Income from deployment of Float, is the highest revenue churner with almost 75% of the revenues; this is followed by FX about 10% and the remain 15% would be the rest of the above.

The above structure has largely benefitted the Foreign Custodians as most of the business comes from Global Custodians(about 70%). The 30% direct also has a major share resting with foreign Custodians. This % is slowly changing with the changes induced by the FPI regulation of 2014 and thereafter of 2019- as more direct clients started investing in India, using the services of the Single Country Custodians.

Raising India's competitiveness:
SEBI has taken significant steps in reducing the settlement risks, introduced interoperability, promoted greater transparency, improved access to India, improved confidentiality besides other steps. These have contributed to improving the attractiveness of India and also to a large extent reduced the costs.

However, multiplicity of Intermediaries, Depositories not allowed to handle banking aspects, frequent changes, lack of capital Convertibility as well as restrictions placed on the payment of interest to FPIs(unlike in other markets) has resulted in higher costs of doing business for FPIs. No Float accrues to Custodians wrt domestic Institutional segment

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Generally, the quality of the Custodians Services in India, has been above the Global averages. However, high costs have deterred the growth of the nos of FPIs in India. FPIs have time and again remarked of the same at multiple forums.

India has to take steps to reduce the costs of doing business. There are over 50 lines of Costs for an FPI to access India.

Suggestion 1: Allow Interest to be paid to FPIs on SNRR accounts
A suggestion is to follow the Global model: of paying interest to Clients(FPIs)on the balances of FPIs maintained with the Custodian Banks, for say upto 1% interest on balances kept for 15- 30 days. This will require RBI to modify the Clause 4 of Schedule 4, wrt. SNRR account.

Some of the key benefits being:

- Being aligned to Global model
- Reduce cost to the FPIs
- Reduce the profitability spread between the Custodian Banks and non-Custodian Banks
- Increase India's competitiveness(vs only a few banks benefitting)
- Increase volumes(thus offsetting the losses) and address structural inefficiencies
- Linked to limited Banking license to custodians like StockHolding, can also result in generating income for these institutions that can assist them to provide better services and invest in Technology driven solutions
- Attract more Custodians(effect of JPM Chase), greater optics wrt India delivery and more inflows
- Improve inflows with more FPIs becoming active/ accessing India

I'm sure this will be welcomed by FPIs and Custodians, while improving the Optics wrt India attractiveness.

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