Tweaking of QFI scheme may lead to more takers

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In recent years, captivated by the Indian growth story, the global investor community has been keen to participate in the Indian capital markets. However, until recently, access to investment opportunities in India was by and large limited to foreign institutional investors (FIIs) and foreign venture capital investors (FVCIs).

Invitation widened

In recent times, the government has recognized that the economy would be better served by enabling foreign investors, provided they meet certain eligibility criteria, to directly invest in Indian securities. Besides reducing volatility and increasing inflows, it was hoped that the move to attract a more diversified investor base would ultimately lead to the deepening of the Indian capital markets.

Pursuant to an announcement in the Union Budget of 2011-12, eligible foreign investors, referred to as qualified foreign investors (QFIs), were permitted to directly purchase mutual fund schemes without prior registration with the Securities and Exchange Board of India (SEBI). Since early this year, the QFI framework has been expanded to include investment in equity as well.

Subsequent to a press release of the Ministry of Finance, the Reserve Bank of India (RBI) and SEBI issued a series of circulars in July to allow eligible QFIs to invest in the corporate bond market for the first time. Concurrently, the RBI and SEBI have also eased certain norms pertaining to the QFI mechanism, key aspects of which are highlighted below.

Except for minor modifications, the July circulars have retained the expanded definition of the term QFI adopted by SEBI in June. Earlier, a person that was not a resident of India, a SEBI-registered FII, a sub-account of such an FII, or an FVCI could be a QFI, provided it fulfilled the twofold eligibility criteria of being resident in a country which was compliant with the Financial Action Task Force (FATF) standards and was also a signatory to the International Organization of Securities Commissions' Multilateral Memorandum of Understanding.

However, this has been relaxed to include residents from countries which are members of the European Commission and the Gulf Cooperation Council, which themselves are members of the FATF, thereby greatly expanding the number of investors that could enjoy the benefits of this route.

Debt investments

QFIs are now permitted to invest on a repatriation basis and without any lock-in or residual maturity clause in eligible debt instruments such as listed non-convertible debentures, listed units of mutual fund debt schemes, and listed and "to be listed" corporate bonds (if listing will occur within 15 days from the date of making such an investment).

QFI investment in eligible debt instruments is subject to a maximum of US$1 billion, which is distinct from the pre-existing ceiling of US$20 billion applicable to FII investment in corporate debt. Further, a relaxation permitting investment of up to US$3 billion has been granted in the case of infrastructure-oriented mutual fund debt schemes (i.e. a scheme holding at least 25% of its assets in the infrastructure sector).

Devil in the details

The government has also used the latest circulars to address certain drawbacks of the previous QFI mechanism. Chief among the changes has been the widely lauded move to permit QFIs to open a bank account in India, for the purpose of providing funds to be used by the QFI's SEBI-registered depository participant (DP) in India to purchase securities as instructed by its client.

The permission to open a bank account in the QFI's own name will ease several operational headaches faced by DPs, which previously were asked to hold fund inflows (by way of remittances from clients) as well as outflows (by way of dividends or sale proceeds of securities) of all their QFI clients in a single rupee pool. This also eliminates the high processing costs associated with the cumbersome requirement that DPs refund inward remittances back to the QFI within five days in case of failure to purchase securities.

Past tense, future perfect?

Thus far, the QFI route has proved to be a non-starter, with investors demonstrating a marked lack of enthusiasm for the scheme. The onerous requirements associated with complying with "know-your-customer" norms and the prevailing confusion over the specifics of tax liability and withholding requirements applicable to QFIs have proved to be a dampener.

With the release of the long overdue clarification on tax-related issues pertaining to the QFI mechanism expected imminently, the tweaking of the QFI framework to suit investor sentiments may provide a much needed fillip to India's dwindling foreign funds inflows.

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