

# **INDIA'S INVESTMENT AND FINANCIAL REGULATIONS: POLICY DILEMMAS AND A POSSIBLE WAY FORWARD**

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**PRI-NCAER VIDEO DIALOGUE**

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# OUTLINE

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- I. Macroeconomic Background**
- II. Regulations and Policy Dilemmas**
- III. Japan-India Financial Cooperation**
- IV. Conclusions**

# I. MACROECONOMIC BACKGROUND

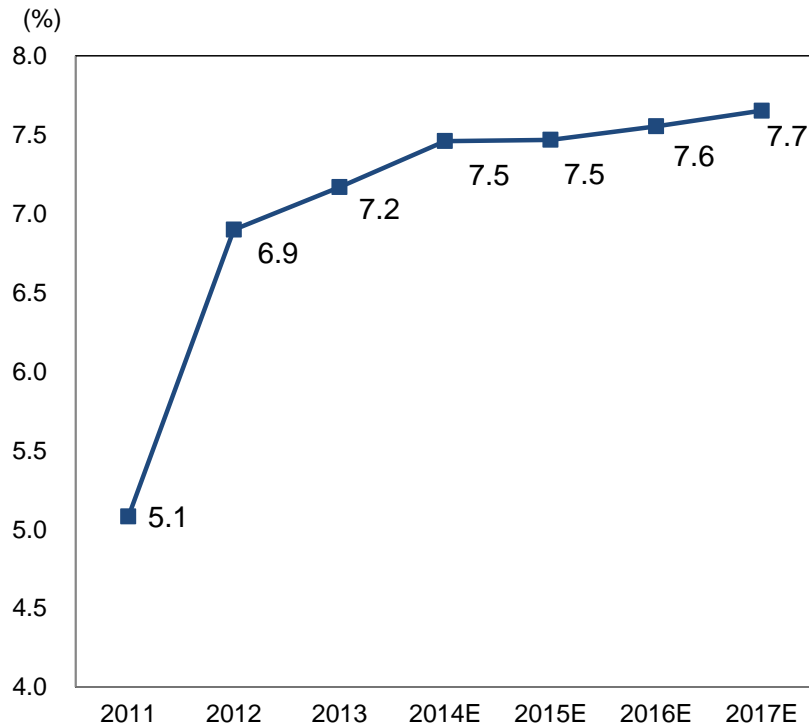
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**Why should we discuss investment and financial regulations?**

# MACROECONOMIC BACKGROUND

India is now seeing a pick-up in growth momentum...

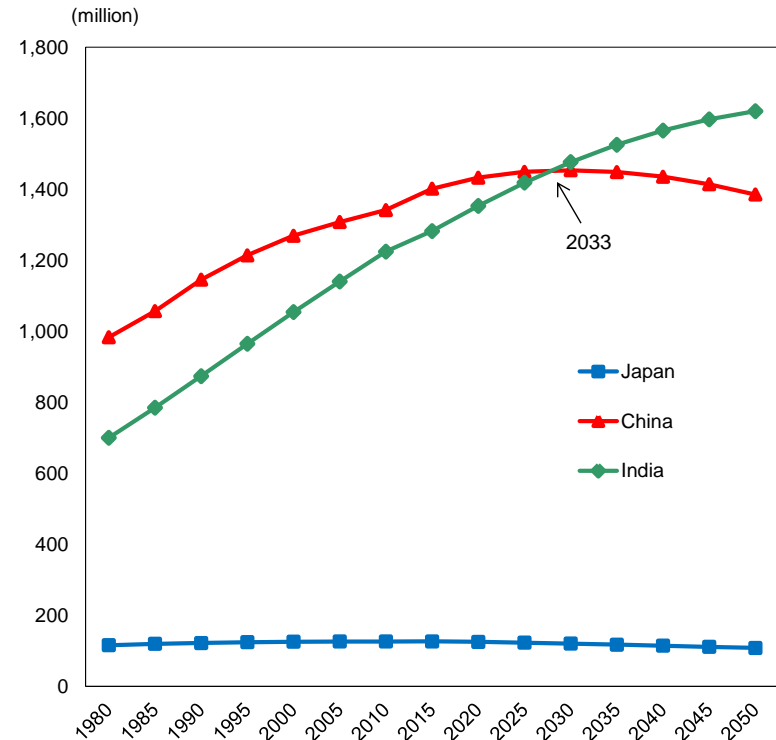
## Real Growth Rate (%)



Source: IMF World Economic Outlook, April 2015

...and it will reap its demographic dividend in the medium-term.

## Working Age Population



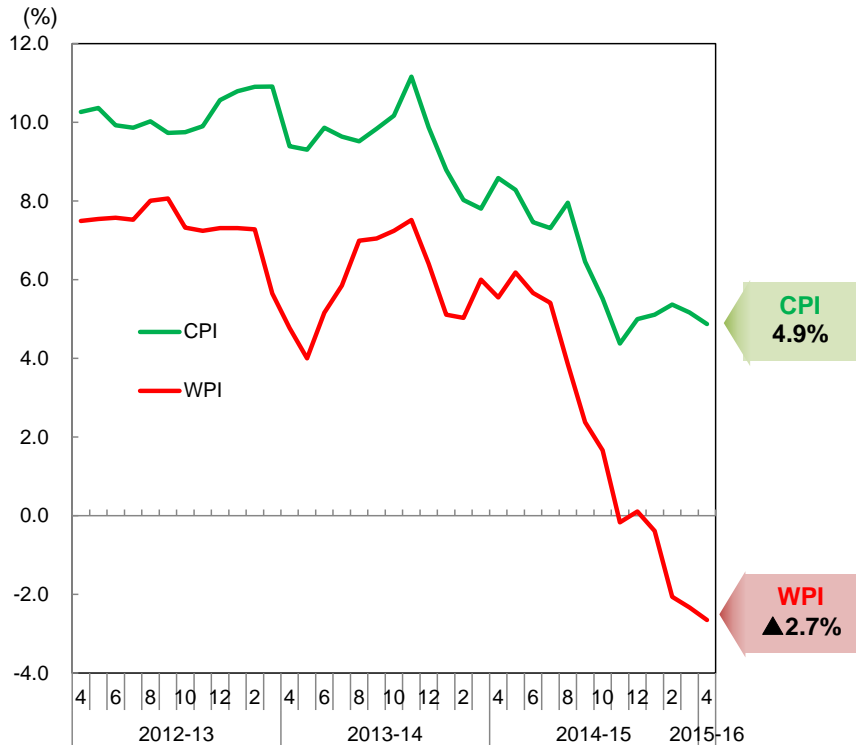
Source: UN World Population Prospects: The 2012 Revision.

# MACROECONOMIC BACKGROUND

Inflation has been contained since Dr. Rajan entered the RBI office...

...while infrastructure bottlenecks still remain.

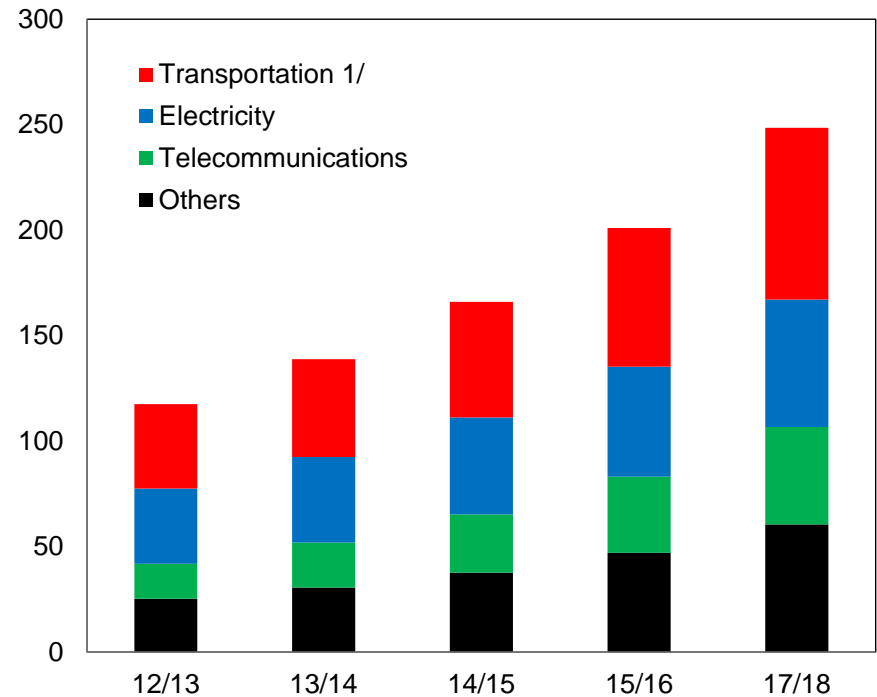
## Inflation Rate (%)



Sources: RBI and MOSPI.

## Infrastructure Needs

(in millions of US\$)



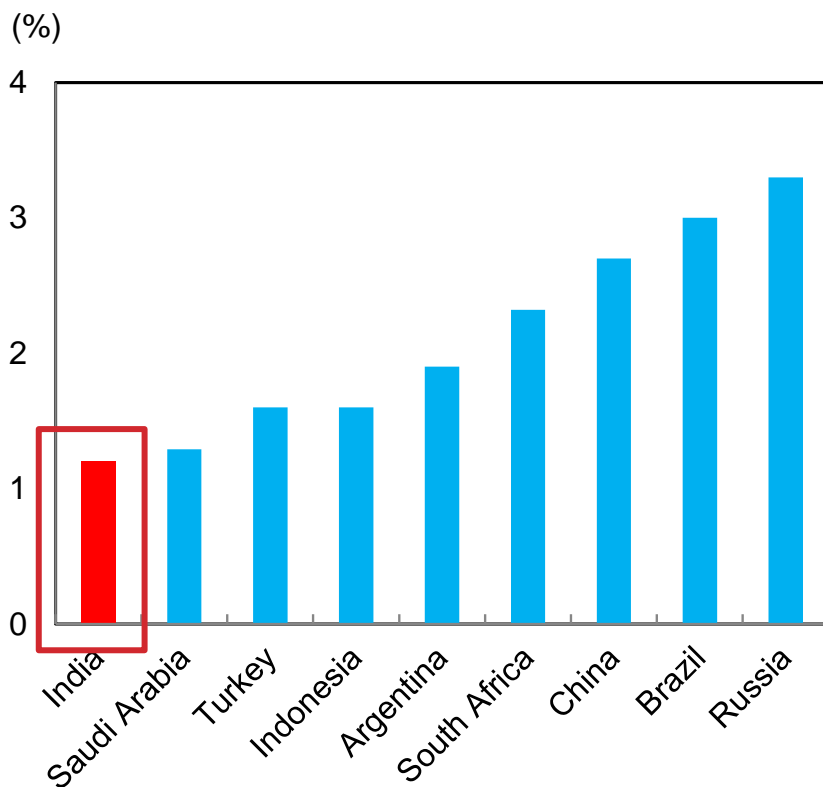
Source: Planning Commission.

1/ Transportation comprises of "Roads and Bridges", "Railways", "MRTS", "Ports", and "Airports"

# STRUCTURAL REFORMS NEEDED

FDI inflow to India still lags behind its peers...

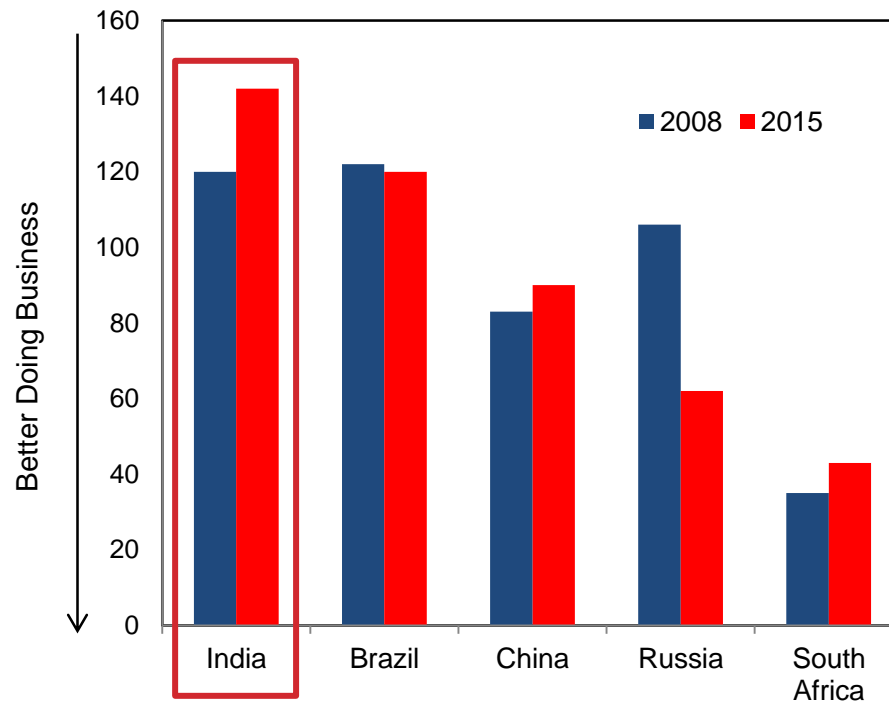
## FDI Inflows in GDP terms (2013)



Sources: IMF Article IV Staff reports, UNCTAD, and Bank of Russia.

...due partly to underdeveloped business and investment climate.

## Doing Business, 2008 and 2015

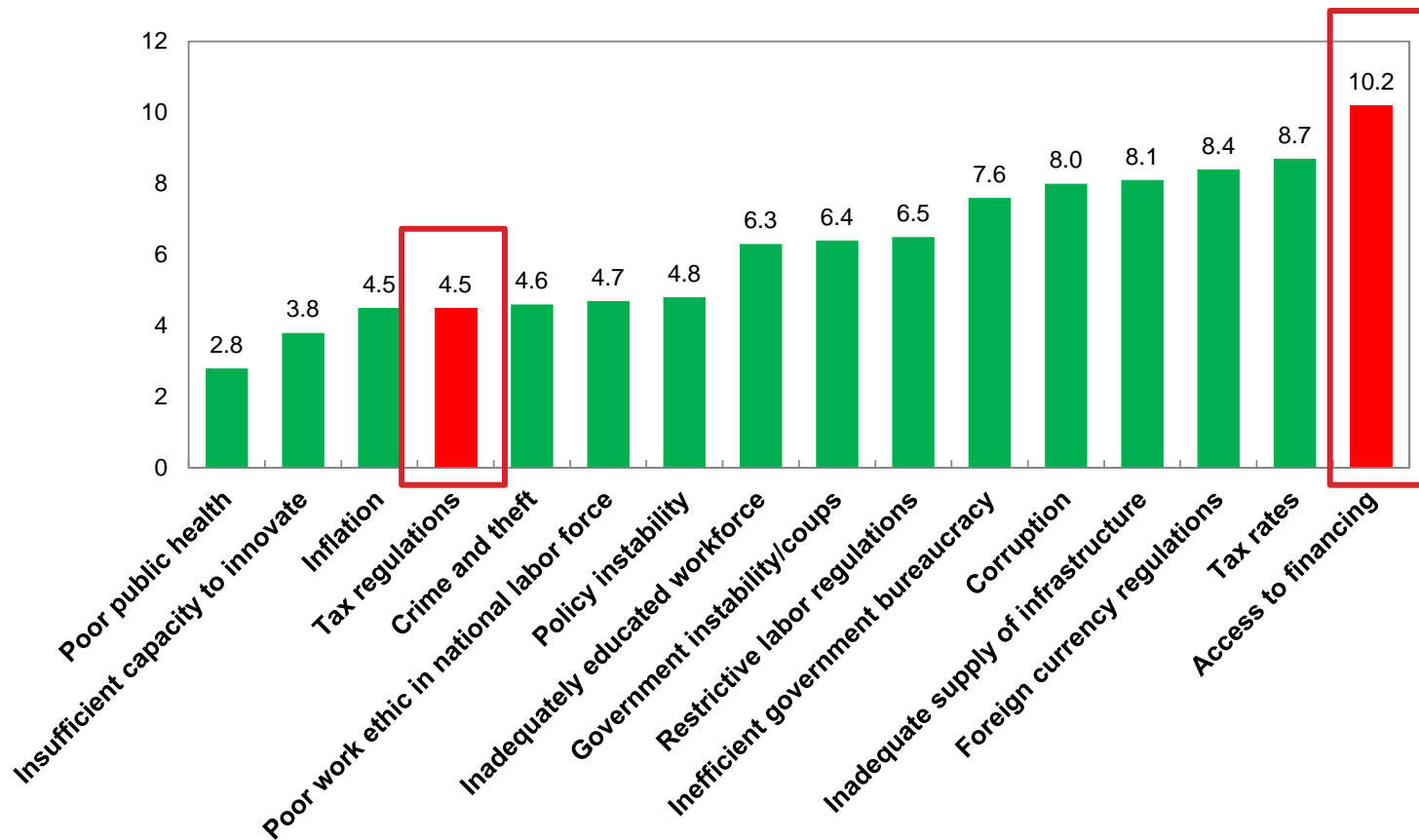


Source: World Bank, Doing Business Reports (2015 and 2008)

# ACCESS TO FINANCING IS A KEY FACTOR

In order to bring the growth momentum onto firm footing, addressing financial regulation issues is essential.

## India: Most Problematic Factors for Doing Business, 2015



Source: World Economic Forum, The Global Competitiveness Report 2014–2015.

## **II. REGULATIONS AND POLICY DILEMMAS**

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**How should policymakers address policy dilemmas, in the context of investment and financial regulations?**



# REGULATIONS AND POLICY DILEMMAS

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*Foreign Direct Investment Restrictions:*

**Economic Security or Growth Money?**

*Foreign Portfolio Investment Restrictions:*

**Prudence or Catalyst?**

*Priority Sector Lending (PSL):*

**Inclusion or Efficiency?**

*Insurance Regulations:*

**Penetration or Competition?**

# FOREIGN DIRECT INVESTMENT

## Dilemma: Economic Security or Growth Money?

### *Economic Security:*

FDI restrictions are often justified based on national security and/or protection of strategic industries.

### *Growth Money:*

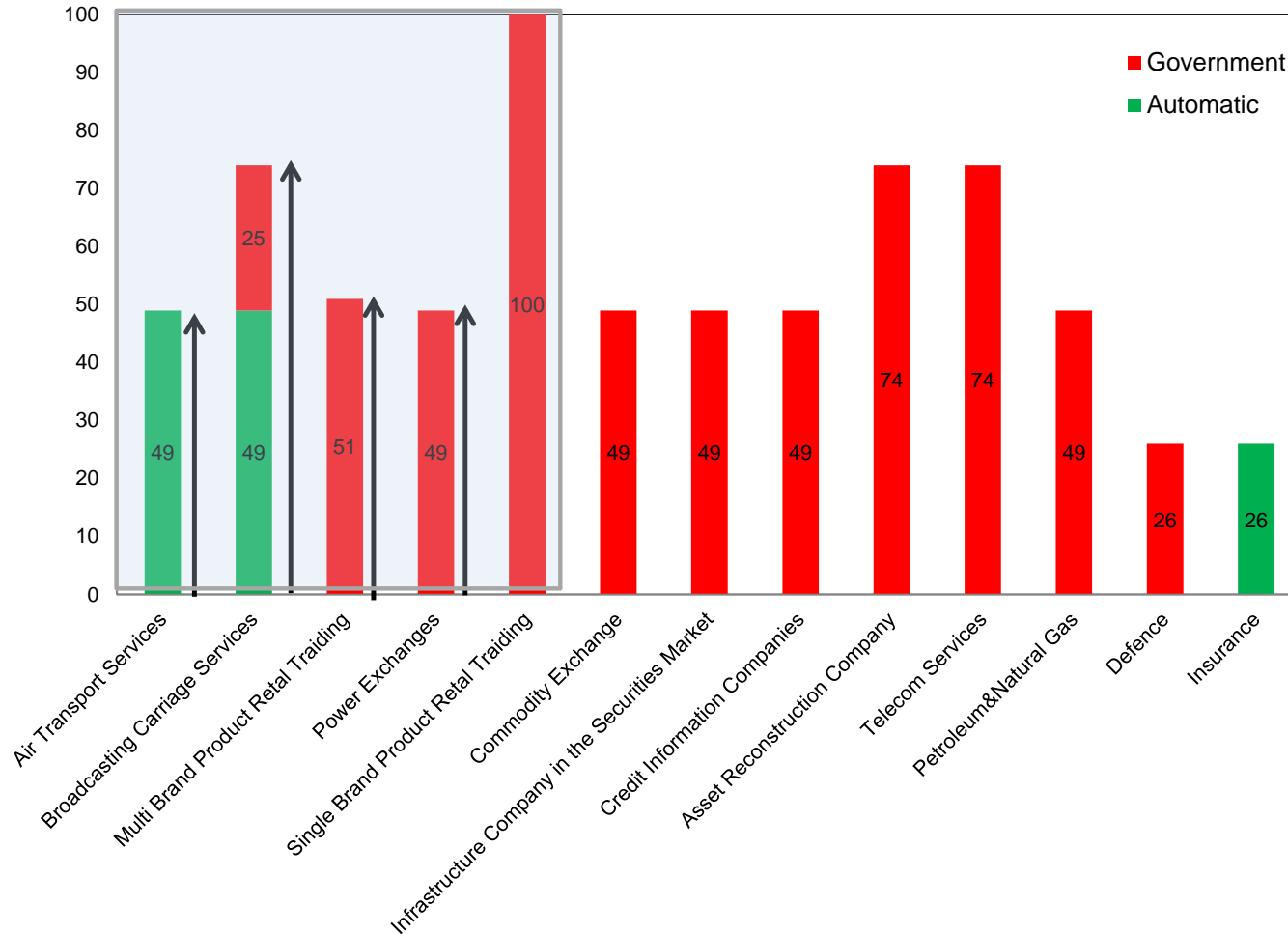
FDI brings stable and long-term funds to finance the current account deficit and thus support the healthy growth. Moreover, it often has positive externalities, including skill and knowledge transfers.

**What has been done? Could India do more?**

# FOREIGN DIRECT INVESTMENT

## Dilemma: Economic Security or Growth Money?

### FDI caps ( September 2012)

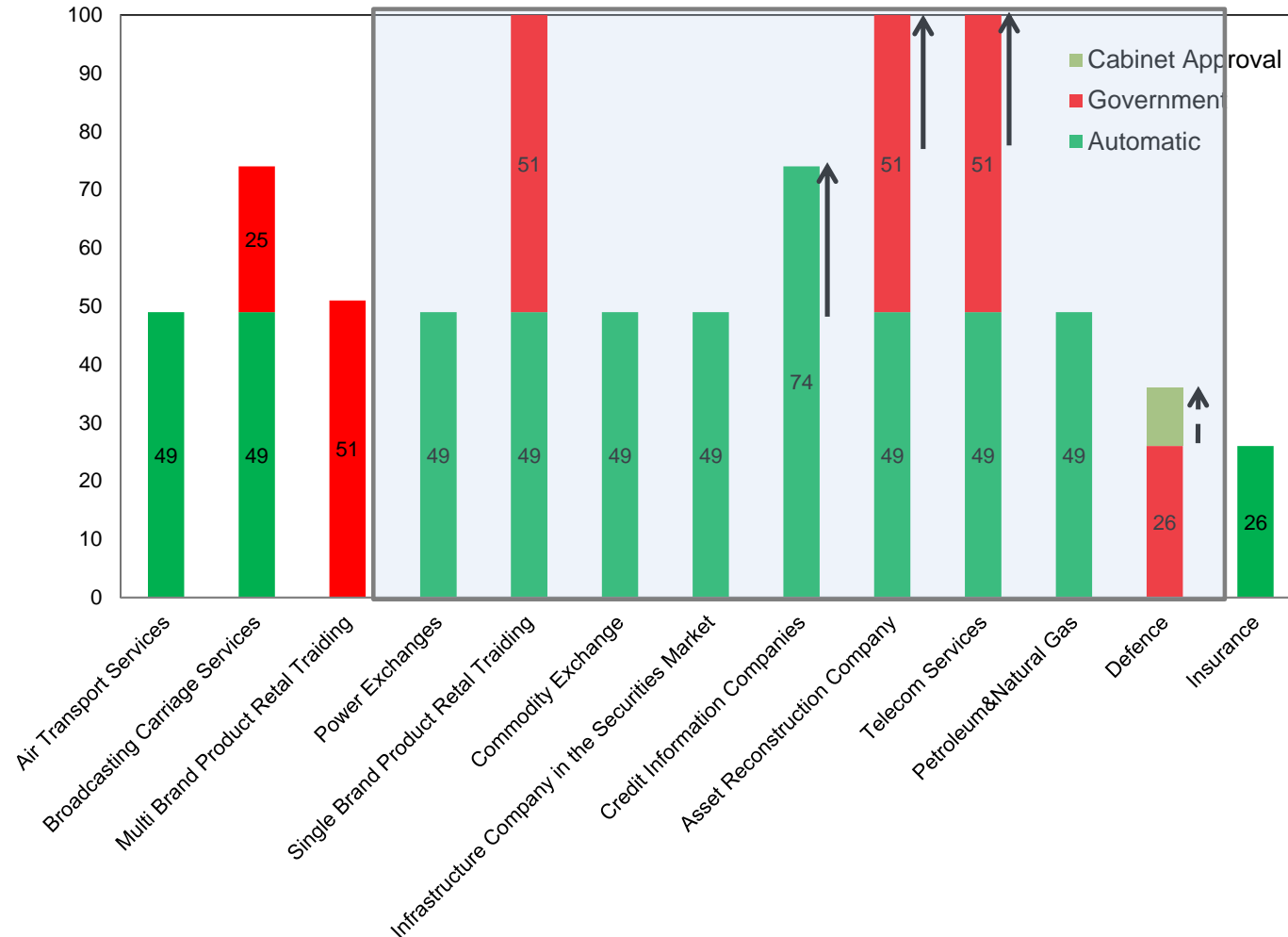


Sources: Department of Industrial Policy and Promotion and the author.

# FOREIGN DIRECT INVESTMENT

## Dilemma: Economic Security or Growth Money?

### FDI caps (August 2013)

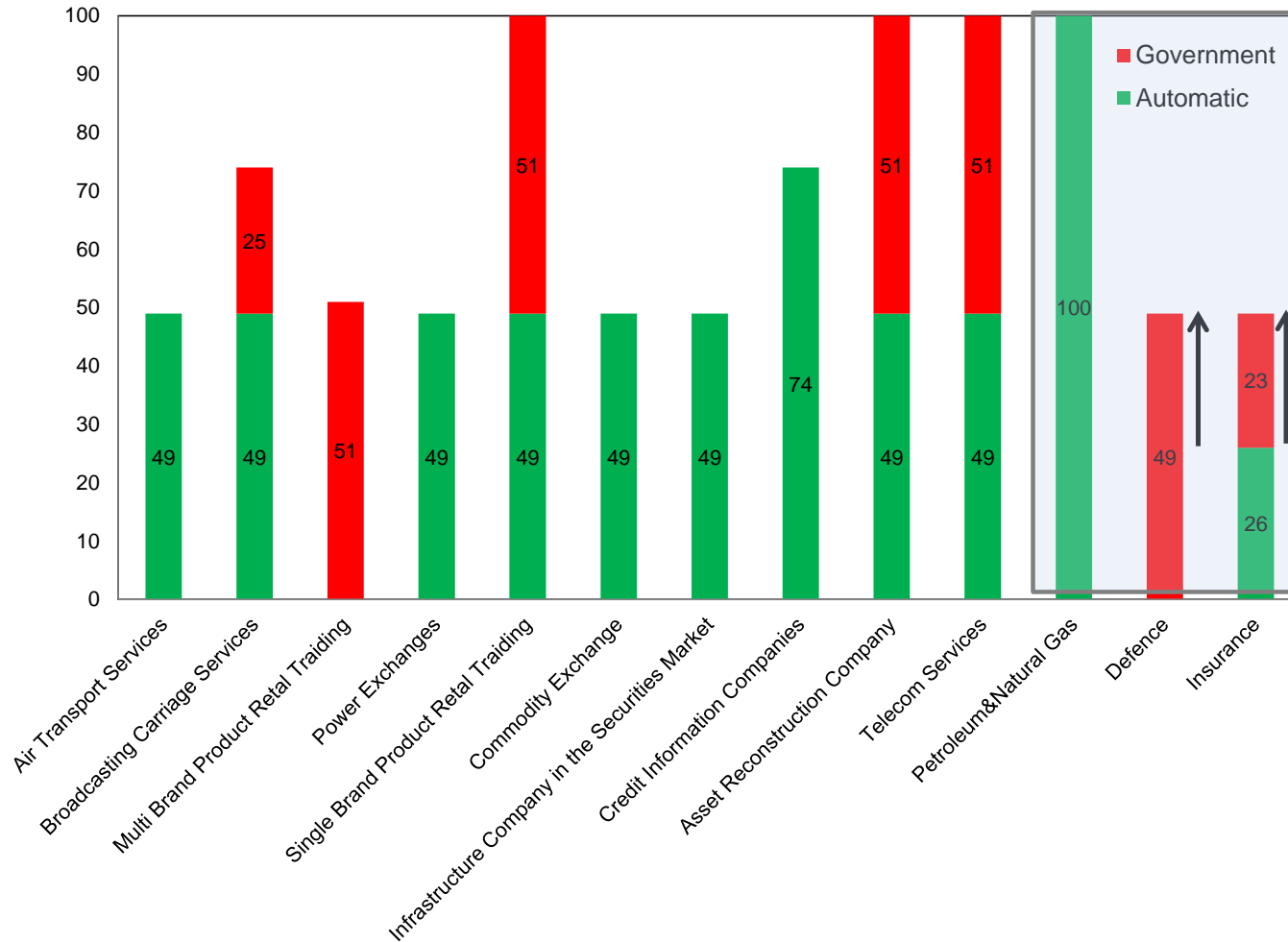


Sources: Department of Industrial Policy and Promotion and the author.

# FOREIGN DIRECT INVESTMENT

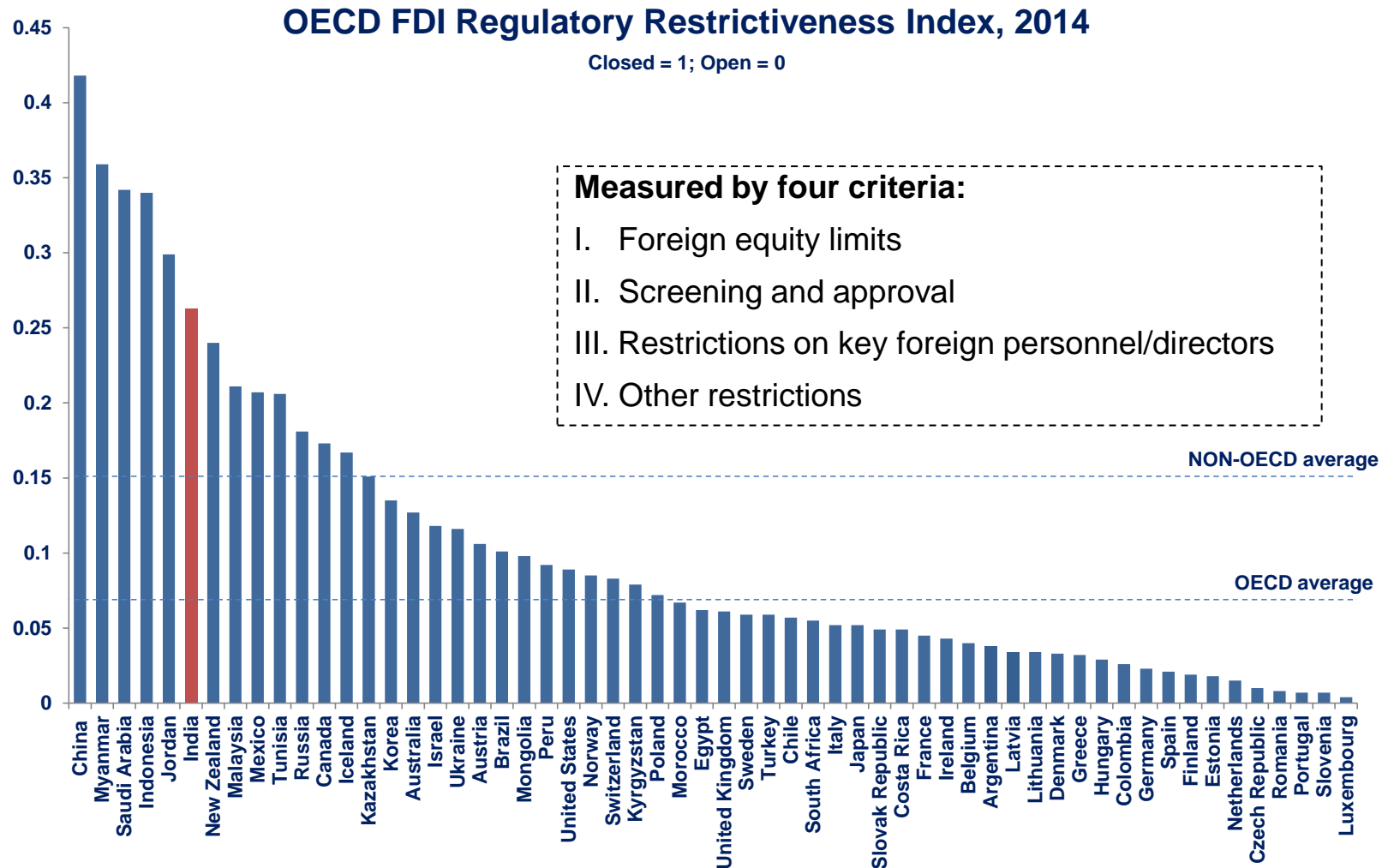
## Dilemma: Economic Security or Growth Money?

### FDI caps (2014- )



# FOREIGN DIRECT INVESTMENT

## Dilemma: Economic Security or Growth Money?



Source: OECD.

## Dilemma: Prudence or Catalyst?

### *Prudence:*

**An increased foreign presence could result in greater volatility in local bond markets.**

### *Catalyst:*

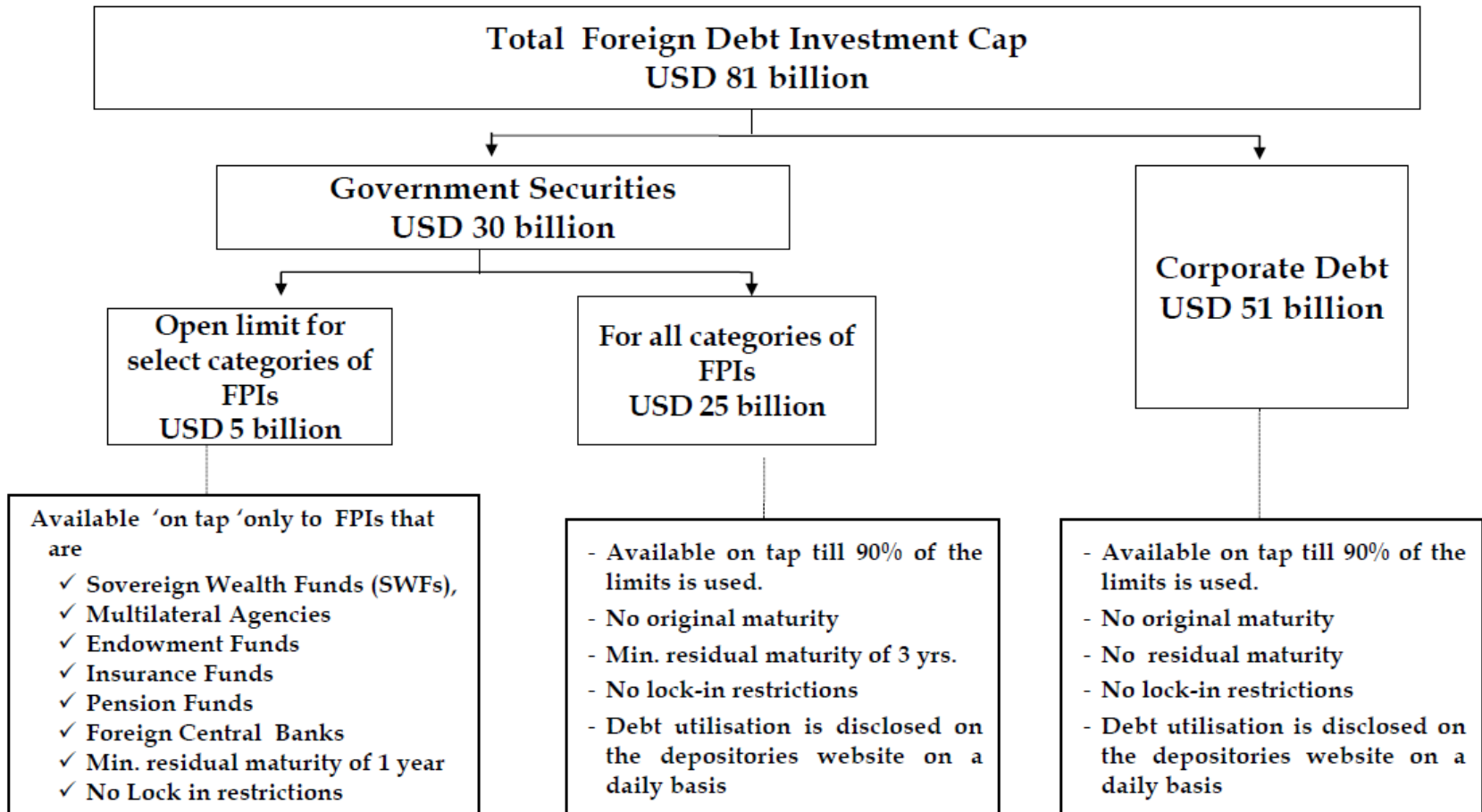
**Foreign investors could act as catalysts for the development of local bond markets, particularly by diversifying the institutional investor base and creating greater demand for local EM debt securities.**

***Where does India stand between these two competing priorities?***

# FOREIGN PORTFOLIO INVESTMENT

## Dilemma: Prudence or Catalyst?

### Policy Developments for Foreign Investments in Debt





# FOREIGN PORTFOLIO INVESTMENT

## Dilemma: Prudence or Catalyst?

### Debt Utilisation Status, as on January 13, 2015

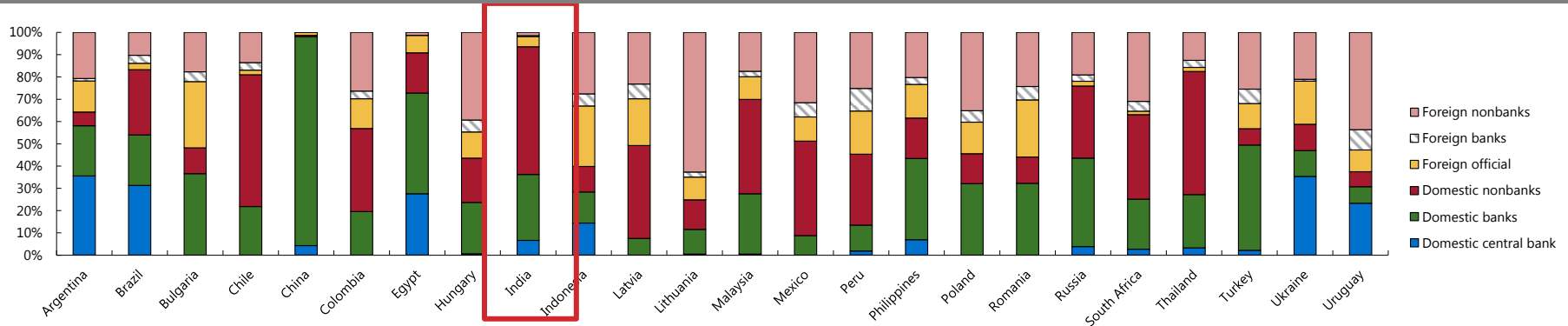
S.No	Type of Instrument	Upper Cap (USD bn)	Upper Cap (INR Cr.)	Investment as reported by Custodians (INR Cr.)	Unutilised Limit available with the entity acquiring limits (INR Cr.)	Total Investments including limits acquired by the entity (INR Cr.)	% of limits exhausted	Free Limit (INR cr)
		(A)	(B)	(C)	(D) = (B) + (C)	(E) = (D)/(A)	(F) = (A)- (D)	
1	Government Debt (auction)	25	124,432	123,434	997	124,431	100	1
	Government Debt (on tap)	5	29,137	29,129	N/A	29,129	99.97	8
1(a)	Treasury Bills	5.5	25416	1,558	-	1,558	6.13	23,858
2	Corporate Debt	51	244,323	150,657	N/A	150,657	61.66	93,666
2(a)	Commercial Papers	2	9,978	9,828	125	9,953	99.75	25
2(b)	Credit Enhanced Bonds	5	23,953	-	-	0	0	23,953
	<b>Grand Total</b>	<b>81</b>	<b>397,892</b>	<b>303,220</b>	<b>1,122</b>	<b>304,217</b>	<b>76.46</b>	<b>93,675</b>

Source: SEBI.

# FOREIGN PORTFOLIO INVESTMENT

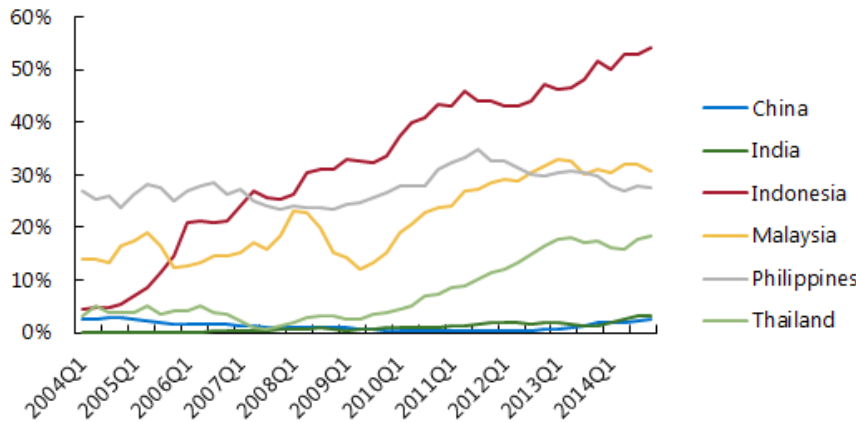
## Dilemma: Prudence or Catalyst?

INVESTOR BASE OF EM GENERAL GOVERNMENT DEBT AT END-2014 (% OF TOTAL)



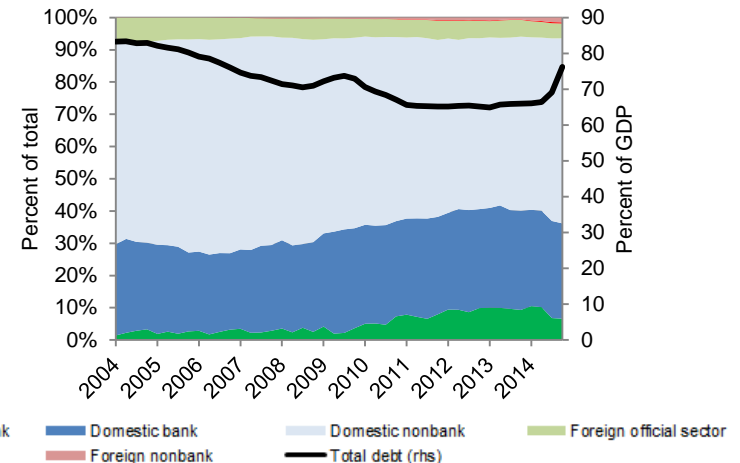
FOREIGN HOLDINGS OF ASIAN EM GOVERNMENT DEBT SECURITIES

(% of total)



HOLDERS OF INDIAN GOVERNMENT DEBT, 2004-14

India



Source: Sovereign investor base estimates by Serkan Arslanalp and Takahiro Tsuda (2014) "Tracking Global Demand for Emerging Market Sovereign Debt", IMF Working Paper WP/14/39, Washington, DC.

## Dilemma: Prudence or Catalyst?

...Several studies show that an increase in the share of foreign investors or real money investors in the investor base is typically associated with lower sovereign bond yields (Andritzky, 2012; Arslanalp and Poghosyan, 2014; Jaramillo and Zhang, 2013; Warnock and Warnock, 2009).

- *Serkan Arslanalp and Takahiro Tsuda (2014) "Tracking Global Demand for Emerging Market Sovereign Debt", IMF Working Paper WP/14/39, Washington, DC.*

....The results of a panel data analysis of 10 emerging markets show that greater foreign participation in the domestic government bond market tends to significantly reduce long-term government yields. Moreover, greater foreign participation does not necessarily result in increased volatility in bond yields in emerging markets and, in fact, could even dampen volatility in some instances.

- *Peiris, S. (2010), Foreign Participation in Emerging Markets' Local Currency Bond Markets, IMF Working Paper 10/88, (Washington: International Monetary Fund).*

# PRIORITY SECTOR LENDING

## Dilemma: Inclusion or Efficiency?

### *Inclusion:*

PSL forces commercial banks to provide financings to SMEs, agricultural sector, in order to achieve inclusive growth.

### *Efficiency:*

PSL could distort optimal financial resource allocation, thus preventing from achieving a full growth potential.

**How can we strike the best balance?**

# PRIORITY SECTOR LENDING

## Dilemma: Inclusion or Efficiency?

### Summary of Recent PSL Amendment (April 23, 2015)

#### Categories under priority sector

##### Before Amendment

- (i) Agriculture
- (ii) Micro and Small Enterprises
- (iii) Education
- (iv) Housing
- (v) Export Credit
- (vi) Others

##### After Amendment

- (i) Agriculture **1/**
- (ii) Micro, Small, and **Medium Enterprises**
- (iii) Export Credit **2/**
- (iv) Education
- (v) Housing
- (vi) **Social Infrastructure 3/**
- (vii) **Renewable Energy 4/**
- (viii) Others

1/ Within Agriculture category, "Farm Credit", "Agricultural Infrastructure" and "Ancillary Activities" were newly classified.

2/ Capped at 2% of total (For Foreign banks with less than 20 branches, 32%).

3/ Capped at 50 million Rupees.

4/ Capped at 150 million Rupees.

Source: RBI and the author.

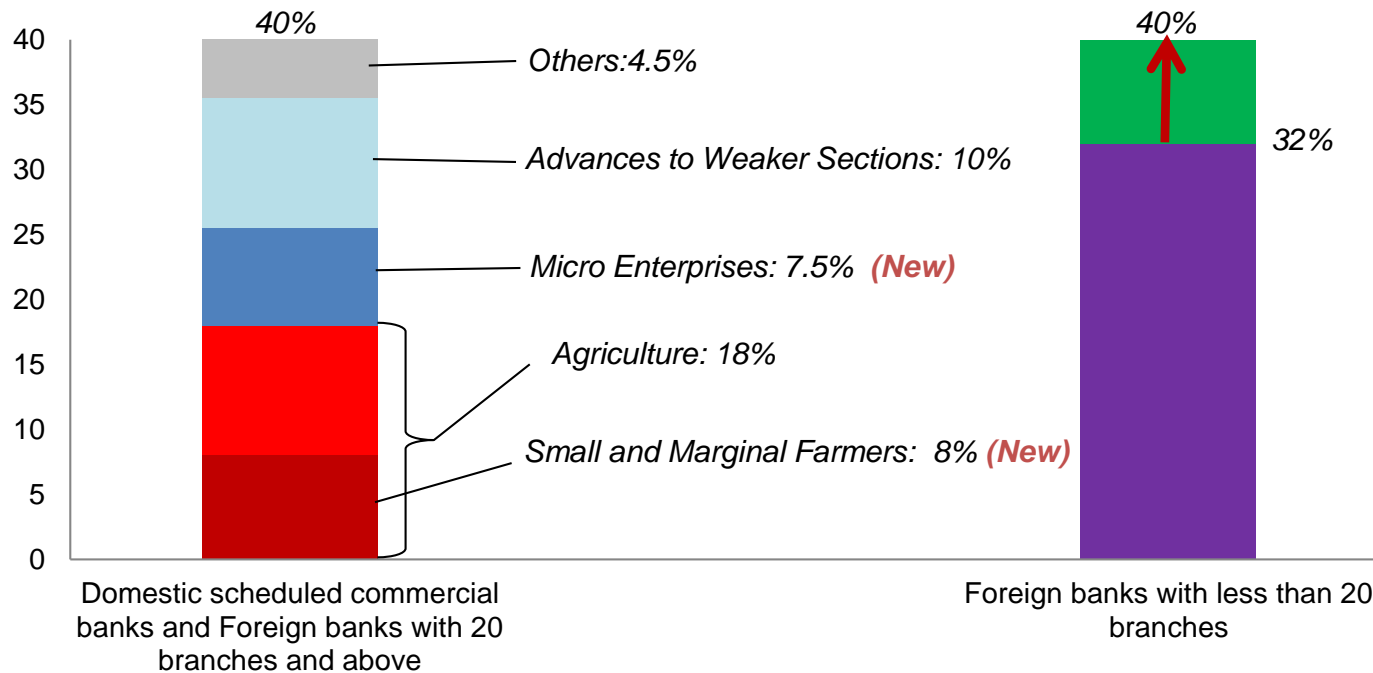
# PRIORITY SECTOR LENDING

## Dilemma: Inclusion or Efficiency?

### Summary of Recent PSL Amendment (April 23, 2015)

#### PSL Total-target and Sub-targets

(in percent of Adjusted Net Bank Credit or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher)



Note: The total priority sector target of 40 percent for foreign banks with less than 20 branches has to be achieved in a phased manner during 2015/16 – 2019/2020. Various phased adjustments are also applicable to sub-targets for domestic banks and foreign banks with 20 branches and above.

# PRIORITY SECTOR LENDING

## Dilemma: Inclusion or Efficiency?

### Private Sector Reaction

*...But bankers say the segment-wise limit ignores the expertise all the 11 members of a cricket team to bat, bowl, and keep wickets...*

*- Economic Times, April 7, 2015*

**Isn't there any way to utilize bankers' expertise and allow certain specialization?**

**What are comparative advantages of public and private sector banks? Or domestic and foreign banks?**

# INSURANCE REGULATIONS

## Dilemma: Penetration or Competition?

### *Penetration:*

**More corporate agents can boost India's insurance penetration, which is merely 3.9 % (Cf. World Av. 6.3%)**

### *Competition:*

***Exclusive corporate agent arrangements are often based on existing JV contracts in line with established business customs.***

**Dose the recently-published draft norms on corporate agents make sense?**



# INSURANCE REGULATIONS

## Dilemma: Penetration or Competition?

### Japan's Commitments to Indian Insurance Market

#### Life Insurance

Company	Japanese Company	Indian Partner (s)	Rank
Max Life Insurance	Mitsui Sumitomo (26%)	Max India (74%)	5
Reliance Life Insurance	Nippon Life (26%)	Reliance Capital (74%)	7
Star Union Daiichi Life Insurance	Daiichi Life (26%)	Bank of India (74%)	15
Edelweiss Tokio Life Insurance	Tokyo Marine & Nichido Fire (26%)	Edelwiss Financial Group (74%)	23

#### Nonlife Insurance

Company	Japanese Company	Indian Partner (s)	Rank
IFFICO-TOKIO General Insurance	Tokyo Marine & Nichido Fire (26%)	Indian Farmers Fertilizer Cooperative Limited (74%)	7
Cholamandalam MS General Insurance	Mitsui Sumitomo (26%)	Murugappa Group (74%)	11
Universal Sompo General Insurance	Sompo Japan Nippon Koa (26%)	Allahanbad Bank (30%), Indian Overseas Bank (19%), Karnataka Bank (15%), Dabur (10%)	17

Note: Rank is based on the 2012/13 Revenue.

# INSURANCE REGULATIONS

## Dilemma: Penetration or Competition?

### IRDA Registration of Corporate Agent Regulations, 2015

#### 3. Scope and applicability of these Regulations:

These regulations shall cover Registration of Corporate Agents for the purpose of soliciting, procuring and servicing of Insurance Products of life insurers, general insurers and health insurers during the validity of certificate of registration as per the following.

- (a) that in the case of Corporate Agent(Life), the applicant ~~shall~~ **may** have arrangements with a maximum of three life insurers to solicit, procure and service their insurance products
- (b) that in the case of Corporate Agent (General), the applicant ~~shall~~ **may** have arrangements with a maximum of three general insurers to solicit, procure and service their insurance products [...]
- (c) that in the case of Corporate Agent(Health), the applicant ~~shall~~ **may** have arrangements with a maximum of three health insurers to solicit, procure and service their insurance products.

### **III. JAPAN-INDIA FINANCIAL COOPERATION**

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**What collaboration channels have been established between India and Japan?**

# THREE CHANNELS

## Three Working-level Communication Channels

1. Japan Fast Track (“Consultative Mechanism”)
2. Japan Plus
3. India-Japan Dialogue on Financial Markets

## Japan-India Joint Statement: Intensifying the Strategic and Global Partnership

January 25, 2014

The two Prime Ministers reaffirmed the importance of investment for driving economic growth and job creation in their economies and ways to create enabling environments to mobilize investment and give a fillip to economic relations. They agreed to continue working towards a greater understanding of all financial and taxation related issues including **Indian rupee denominated finance by JBIC** and **establishing a consultative mechanism between the two countries.**

## Press Release

On October 8, 2014

The Ministry of Commerce and Industry of India announced that it has established a special team named “Japan Plus,” based on the agreement concluded at the Japan-India summit meeting in September 2014.

The team consists of four officials from the Indian government and two officials from the Ministry of Economy, Trade and Industry (METI), **and it will play the roles of providing support for Japanese enterprises in overcoming the challenges they are facing in India as well as facilitating Japan’s investment in India through a fast-track approach.**

## Tokyo Declaration for Japan-India Special Strategic and Global Partnership

September 1, 2014

24. (e) Prime Minister Modi underlined his determination to further improve the business environment in India including through tax, administrative and financial regulations in order to boost investment. **The two Prime Ministers decided to further deepen bilateral economic and financial cooperation.** Prime Minister Abe welcomed the approval to establish the Mizuho Bank's Ahmedabad branch.

## The Financial Cooperation Discussion between Japan and India

November 17, 2014

1. **On November 17, 2014, the financial cooperation discussion between Japan and India was held in Delhi, India.** This discussion was undertaken as one of the ongoing efforts to realize the agreement in the Tokyo Declaration for Japan-India Special Strategic and Global Partnership, [...].
2. The Japanese delegation included representatives from Ministry of Finance, Financial Services Agency, Bank of Japan, JBIC, and financial institutions. From Indian side, representatives from Ministry of Finance, Security and Exchange Board of India, Reserve Bank of India, and financial institutions participated in the discussion.



## The Financial Cooperation Discussion between Japan and India (cont.)

November 17, 2014

3. The participants exchanged their views and had candid discussion on the following issues, with a view to developing financial markets of the both countries:

- Development of the Indian local currency bond market: lessons learnt from Asian Bond Markets Initiative of ASEAN+3;
- Cross-border collaboration to expand the role of capital markets financing in India;
- Promotion of cross-border portfolio investment by jointly establishing equity and bond funds;
- Enhancing contribution to Indian economy in collaboration with Japanese and Indian banks;
- Financing for infrastructure development in India by Japanese and Indian banks; and
- Enabling environment for SME finance, including development of credit risk database (CRD).

4. **The participants determined to continue their discussion** to further promote the bilateral financial cooperation, focusing on the above-mentioned issues as well as other emerging priorities. [...].

## IV. CONCLUSIONS

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1. India needs to update its investment and financial regulations, in order to achieve full growth potential.
2. No clear answer to address dilemmas among various competing priorities. Policymakers face the need for continuous rethinking and reengineering.
3. India could emphasize more on efficient resource allocation, when designing its investment and financial regulations.
4. Japanese government is closely collaborating with the Indian authorities, including through a newly-established “India-Japan Dialogue on Financial Markets”.

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# Thank you very much!

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