

Volumes crash as tax googly stumps foreign investors

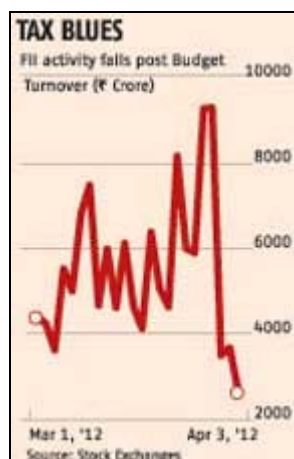
Rajesh Bhayani & B G Shirsat / Mumbai April 7, 2012, 0:56 IST

Foreign institutional investors' (FIIs) interest in Indian equities seems to be waning as the uncertainties surrounding the Budget proposals begin to clear. The first impact was on investments through Participatory Notes (P-Notes) and later on the overall investment climate, which got muddled. As the finance minister and ministry officials started clarifying, FIIs started distancing themselves from the market, leading to a nearly 50 per cent fall in their cash segment volumes.

The daily cash market volumes of FIIs were in the range of Rs 6,000-7,000 crore, which has fallen to below Rs 3,000 crore in the last few days, as most preferred to wait and watch before taking fresh positions. Even their overall exposure in the derivatives segment has taken a hit after the expiry of last month's contract on March 29. Rollovers and open positions have also come down.

In the first week after the February 2012 contract expiry, average daily volume in derivatives were Rs 95,000 crore, of which FIIs' share was 40 per cent. After the expiry of March derivatives contracts, volumes have come down to Rs 77,500 crore, with FIIs' share down to about 33 per cent. As regards domestic investors staying away, experts say it is largely due to holidays and not the uncertainty over tax proposals.

"FII positions in the derivatives segment have fallen recently on tax concerns. However, the good thing is that lower FII positions suggest that technically the market is not heavy in terms of leveraging. Hence, in case of any untoward development, huge unwinding of positions may also not come," said Vibhav Kapoor, group chief investment officer, IL&FS.



Even FIIs that have been issuing P-Notes have drastically reduced writing fresh contracts despite several rounds of clarifications by the government that tax authorities will only track FIIs and not P-Note holders for tax purposes.

Richie Sancheti of Nishith Desai Associates, in a note, says, "Most FIIs have constricted their P-Note issuances till the Budget is approved and clarity is obtained. And this trend is likely to continue until some resolution is obtained."

According to the procedure, by early May the President's approval is given to the Finance Bill and then it becomes law. In this backdrop, the

rules clarifying GAAR and its implications could be expected by the middle of next month.

"Till then, no big action, especially buying, can be expected from them (FIIs)," said Kapoor. However, FIIs may sell if there is any big negative event on the global front.

FII exposure to stock markets through P-Notes is currently \$36 billion, which is 16.4 per cent of their total investments (P-Notes, for derivatives are 30 per cent of total P-Note issuances). FIIs' total assets under custody in Indian equity market are \$219 billion or about 17 per cent of the India's total market capitalisation. FIIs, meanwhile, have already represented to the finance minister, stating "the provisions relating to taxation of indirect transfers of assets, as well as the General Anti-Avoidance Rule (GAAR), are too broadly worded and could be interpreted to tax investments by FIIs in the Indian listed

equity markets”.

In fact, the Asia Securities Industry & Financial Markets Association, a body representing a majority of FIIs, had warned of liquidation from the Indian market if the issues were not resolved. The association said, “If these tax uncertainties are not resolved quickly, we fear FIIs will decide the tax risks are unacceptable. These investors may then proceed to liquidate their India investments and such a disorderly dissolution of large positions held by these overseas investors could seriously disrupt the Indian capital markets” said.

While finance secretary R S Gujral told FIIs on Wednesday (April 4) that the proposed GAAR would not hurt genuine investors and will be invoked only in case of impermissible arrangements, the confidence hasn't returned as FII activity remains muted.