Corpsec Hotline

September 26, 2007

CAPITAL ACCOUNT CONVERTIBILITY: CONVERSION AHOY!

The Reserve Bank of India (**"RBI"**) and the Government of India (**"GoI"**) have moved a step closer to fuller capital account convertibility. On September 25, 2007 the RBI introduced a number of measures to be implemented with immediate effect. Before we examine the changes introduced by the RBI in consultation with the GoI, let us understand the reason behind the acceleration of the third phase of recommendations of the Committee on Fuller Capital Account Convertibility (**"CFCAC"**). It may be noted that the CFCAC had originally agreed to implement the third phase of recommendations in 2009-2010. What then motivated the RBI to accelerate the implementation of phase three?

India's Foreign Exchange Reserves

Over the last quarter FII inflows coupled by the appreciating rupee, the rupee has appreciated over 11% since the beginning of this year and touched a nine-year high of 39.72 against the dollar, has increased the Indian forex reserves. The further liberalization of the Forex Rules appears to be an attempt by the RBI to encourage capital outflow from India. It remains to be seen the extent to which the recent relaxation encourages capital outflow.

The New Measures

The September 25, 2007 measures can be broadly summarized as below:

1. The existing limit for investments overseas by Indian individuals under Liberalized Remittance Scheme ("LRS") being enhanced from USD 100,000 to USD 200,000 per financial year.
2. Investment in overseas Joint Ventures (JV) / Wholly Owned Subsidiaries (WOS) by Indian companies will now be permitted up to 400 per cent of the net worth of the Indian company under the Automatic Route. The enhanced limit will also be available to registered partnership firms.
3. In order to provide greater opportunities to listed Indian companies for portfolio investment abroad, the existing limit of 35 per cent of the net worth for portfolio investments by listed Indian companies is being increased to 50 per cent of the net worth.
   Further, the requirement of 10 per cent reciprocal share holding in the listed Indian companies by overseas companies for the purpose of portfolio investment outside India by Indian listed companies has been dispensed with.
4. The existing limit for prepayment of External Commercial borrowings (ECBs) without the Reserve Bank approval is being increased from USD 400 million to USD 500 million, subject to compliance with the minimum average maturity period as applicable to the loan.
5. The aggregate ceiling for overseas investments by mutual funds, registered with SEBI is being increased from USD 4 billion to USD 5 billion. In addition, the existing facility of investing up to USD 1 billion in overseas Exchange Traded Funds, as may be permitted by SEBI by a limited number of qualified Indian mutual funds would continue.

Analysis of the New Measures

Under the LRS, Indian individuals may now remit twice as much as they were earlier allowed to remit overseas. This amount has been for the time being capped at USD 200,000 per financial year, up from USD 100,000. While the erstwhile limit of USD 100,000 was not being fully utilized, nevertheless, the revised limits do enable an individual to invest more money to create a portfolio of global blue-chip shares. However, with the Indian markets offering substantially high returns, it is questionable whether individuals would be tempted to diversify their portfolios.

A second possible benefit of the enhanced limit for families is that a family can club each member's individual limits to invest in real estate overseas. For instance, a family of four can collectively remit USD 800,000 which can be used to buy a second home in most countries (except the ones restricted under LRS), subject of course to the property laws of the country in which the property is being bought.

Further, the aggregate ceiling for overseas investments by mutual funds, registered with SEBI is being increased from USD 4 billion to USD 5 billion. At first sight, this appears to be a welcome change for funds and investors seeking to diversify their portfolios and investments in other markets. However, it remains to be seen whether funds

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actually decide to increase investments into other markets.

Additionally, enhancement of the existing limit for prepayment of External Commercial Borrowings (ECBs) will now allow corporates to retire external debt faster and with relatively more ease.

Significantly, Indian listed companies benefit from the removal of the requirement of 10 per cent reciprocal share holding in the listed Indian companies by overseas companies for the purpose of portfolio investment outside India. The removal of this requirement would now allow Indian listed companies to make investments in a wider range of overseas companies.

The RBI has attempted to encourage outward remittance of capital from India, yet it remains to be seen just how effective these recent measures are in tackling the burgeoning of the already vast foreign reserves of India. The intention of the RBI appears well placed, however considering the booming Indian economy and the high returns offered by Indian markets, combined with the soaring rupee, the effect of the fast forwarded capital account convertibility transition will really be felt over a period of time.

Source: The Press Release No. 2007-2008/420 issued by the RBI

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