25 October 2007 | 7 pages

India Equity Strategy

Final P-note Measures: A Near-Term Negative For Flows

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- **SEBI's final p-note measures** — No further issuance of p-notes for derivatives and through sub-accounts. Current positions in these categories to be unwound over 18 months. New p-note issuance permitted only to FIIs where it is less than 40% of their assets under custody as on 30th Sep. Measures to come into effect after 25th Oct.

- **Some relaxation in FII registration norms** — Broad-based criteria modified to include entities having at least 20 investors, with no single investor holding more than 49% (vs. 10% earlier). Track record of individual fund manager to be considered for the purpose of ascertaining the track record of a new fund. P-note issuance to be limited to 'regulated', and not 'registered' entities.

- **Potentially negative for near-term FII Flows** — Given the limited headroom available due to the 40% limit, as well as the time it might take for the entities to get the FII registration, the measures may significantly reduce near-term flows.

- **Long term: Improved transparency positive for market health** — As noted earlier, if these measures are followed by rapid FII registration, it would improve disclosure and transparency in the market, which would be welcome.

- **Economic implications** – The measures are in sync with other recent moves to control capital flows and currency appreciation. We maintain our rupee and other macro forecasts.

See Appendix A-1 for Analyst Certification and important disclosures.

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Final P-note Measures: A Near-term Negative for Flows

The Securities and Exchange Board of India (SEBI) had proposed a series of new regulations on issuance of participatory notes (p-notes) and Offshore Derivative Instruments (ODIs) on the 16th Oct. These proposals had suggested no further issuance of p-notes for derivatives and through sub-accounts. Current positions in these categories to be unwound over 18 months. New p-note issuance permitted only to FIIs where it is less than 40% of their assets under custody. For more details, please see our note https://www.citigroupgeo.com/pdf/SAP10152.pdf.

In a board meeting on 25th Oct, the regulator provided final measures on p-notes and FII registration, which were mostly in line with the proposals in the discussion paper, while giving some further details on relaxation on FII registration norms.

New p-note norms

Issuance of p-notes with derivatives as underlying by FIIs and their sub-accounts is to be discontinued with immediate effect from the 25th Oct. Existing positions are to be unwound over the next 18 months. Renewals of these derivatives are to be limited to these 18 months.

Those FIIs with notional value of PNs outstanding (excluding derivatives) as a percentage of their AUC in India of more than 40% to issue PNs only against cancellation / redemption / closing out of the existing PNs of at least equivalent amount. P-note issuance by an FII below the 40% limit is allowed up to 5% each year until the 40% limit is reached, and thereafter only on cancellation or redemption of existing contracts.

Some relaxation in FII registration norms

The definition for 'Broad-based' Funds is now relaxed to include funds that have at least 20 investors, with no single investor having more than 49% (vs. 10% limit earlier).

Track record of individual fund manager will also be considered for the purpose of ascertaining one-year track record of a newly setup fund.

FII and sub-account registrations will be perpetual, subject to payment of fees (vs. periodic renewals earlier).

P-note issuance to be restricted to only 'regulated' entities, and not ‘registered’ entities. For more details on what constitutes 'regulated entities' here, please see an earlier SEBI note http://www.sebi.gov.in/circulars/2004/fiicir132004.html.

Pension Funds, Foundations, Endowments, University Funds and Charitable Trusts and Societies can be registered as FIIs without imposing the requirement of their being regulated.

Actual vs. proposals

The 30th Sep date for AUC calculation and return to 'regulated' entities requirement (vs. 'registered' entities allowed earlier) may come as a negative surprise for the market vs. the proposals. Relaxation in definition of broad-based funds and track record requirement for FII registration would be a positive surprise.

Potentially negative for near-term FII flows

Given the limited headroom available due to the 40% limit, return to 'regulated' entities rule, and the time it might take for the entities to get FII registration, the measures overall may significantly reduce near-term foreign flows.

As noted earlier, if these measures are followed by rapid large-scale FII registration of entities currently using p-notes, it would improve disclosure and transparency in the market, which would be welcome.

Economic Implications

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SEBI's approval of the draft circular on participatory notes comes on the back of strong trends in capital inflows and is an attempt to temper the pace of rupee appreciation. Following the 50bps cut in the Fed Funds Rate, forex reserves have risen by US$57.5bn during the fiscal year (while portfolio flows have surged by over US$15bn). As a result, the RBI has been taking a number of measures such as encouraging outflows as well as raising the limit of issuance of the market stabilisation bonds.

Curbs on capital inflows have remained top policy priority

Measures to rein in flows this year include (1) tightening the norms for external commercial borrowings, (2) encouraging dollar outflows, and (3) the P-Note proposals. Looking ahead, if the surge in dollar inflows continues and there is pressure to keep rupee appreciation in check, we could expect the government/RBI to (1) further monitor inflows coming in including those into real estate, (2) lower domestic rates to discourage inflows, and (3) propose more measures to encourage outflows.

Monetary Implications

Policy rates headed lower; but reserve requirements likely higher

From a monetary perspective, with forex reserves up US$57bn this fiscal year and the rupee already gaining 9% since April 07, liquidity management has posed a dilemma for the authorities. While the RBI has already hiked the ceiling on the issuance of the market stabilisation scheme (MSS) if the surge in dollar inflows continues, one can expect to see (1) a further hike in the MSS ceiling, (2) sell-buy swaps, and (3) a CRR hike such that the cost of sterilization is shared (a 1% hike in the CRR would result in liquidity to the tune of US$7bn being sucked out of the system).

Bottom-Line: Macro Story Unchanged

The proposed measures would temper the pace of portfolio investments coming into India. But, as we have stated earlier, even if one excludes all the portfolio flows, we estimate capital flows to be more than sufficient to finance India's current account deficit, and there will still be an accretion to reserves.

Figure 1. Trends in the Balance of Payments (US$bn)

	FY04	FY05	FY06	FY07P	FY08E
a. Trade Balance	-13.7	-33.7	-51.8	-64.9	-82.3
b. Invisibles	27.8	31.2	42.7	55.3	67.6
1. Current A/c Balance (A+B)	**14.1**	**-2.5**	**-9.2**	**-9.6**	**-14.7**
c. Loans	-4.4	10.9	6.1	21.1	13.5
d. FDI(Net)	2.4	3.7	4.7	8.4	9.4
e. Portfolio Investment	11.4	9.3	12.5	7.1	17.0
f. Banking Capital	6.0	3.9	1.4	2.1	2.0
NRI Deposits	3.6	-1.0	2.8	3.9	1.0
g. Rupee Debt Service	-0.4	-0.4	-0.6	-0.2	-0.4
h. Other Capital	1.7	0.7	-0.7	6.4	1.0
2. Capital A/c (c:h)	**16.7**	**28.0**	**23.4**	**44.9**	**42.5**
Errors and Ommissions	0.6	0.6	0.8	1.3	0.0
3. Overall Balance (1+2)	**31.4**	**26.2**	**15.1**	**36.6**	**27.8**

Source: RBI, Citi Investment Research

Currency- Near-term hiccups, but long-term story unchanged

The proposed measures will have a negative impact on temporary flows and result in near-term hiccups to currency. However, on a longer term basis, we are unlikely to see a reversal to the rupee appreciation story. Domestic factors supporting this appreciation view are (1) India's strong growth story, and (2) the size, composition and financing of its current account deficit, while rupee positive factors on the international side are (1) dollar weakness and (2) renminbi appreciation.

Overall, the phasing out of p-notes will have a short term negative impact on the markets and currency, but it is unlikely to change the macro story. We continue to expect GDP growth to come in at 9.3%, inflation to remain sub 5%, the rupee to continue its appreciating trend and the 10-year bond to trade in a narrow range.

Figure 2. Currency Forecasts (Vs US$)

	Exchange Rates(Average)				
	2007	2008	2009	2010	2011
United States	NA	NA	NA	NA	NA
Japan	116.0	114.0	109.0	100.0	94.0
Euro Area	1.35	1.43	1.44	1.45	1.45
China	7.61	7.00	6.65	6.32	6.00
India	**40.2**	**38.00**	**36.00**	**35.00**	**34.00**

Source: Citi Investment Research

Appendix A-1

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