BASILSTONE
CONSULTING PRIVATE LIMITED

atharv

May 2022

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Basilstone Consulting is pleased to present to you the **May 2022** issue of atharv, covering regulatory insights as well as discussion papers. This issue covers the following areas:

1. Regulatory updates & its expected impact

1.1. Securities & Exchange Board of India

1.1.1. System & Network Audit of Market Infrastructure Institutions (MII's)

MII's are required to conduct System & Network Audit as per the framework and Terms of Reference prescribed. MIIs are also required to submit information with regard to exceptional major Non-Compliances (NCs)/ minor NCs observed in the System and Network audit.

1.1.2. Circular on Development of Passive Funds

SEBI has allowed Mutual Funds to launch ELSS as passively managed funds. ELSS schemes to be based on an index that comprises the top 250 companies in terms of market capitalisation. A mutual fund can have either an actively-managed ELSS scheme or a passively-managed one, but not both. Further, SEBI laid down norms on how debt passive funds – ETF's and index funds – should be managed. Transactions that are above Rs 25 crore can be done directly with the asset management company (AMC), where the investor place an order for creation or redemption of ETFs units with the AMC. To ensure liquidity of the ETFs on the stock exchanges, the mutual funds would be required to appoint at least two market makers, who are members of the stock exchanges.

If there are any incentives to be given to the market makers, it should be charged to the scheme within the stipulated limit of total expense ratios (TERs). SEBI wants mutual funds to have a transparent incentive structure in place for market makers. These incentives will be linked to the performance of market markets in terms of generating liquidity for the ETFs. The charges applicable for investor education and awareness initiatives on ETFs and Index funds have been reduced to 1 basis points and fund of funds (FoFs) investing more than 80 percent of their NAV in underlying domestic passive funds, will not be required to set aside funds for investor awareness. New fund offers for Debt ETFs and Debt Index Funds have been made easier.

Impact:
This will help increase liquidity for ETFs on the exchanges and more investors will trade on exchanges, rather than directly trade with the asset management company. Further, ELSS Funds with their tax benefit and long-term approach offer investors a tax efficient investment tool for wealth accumulation towards meeting their financial goals and being passively managed, it is available at relatively lower cost and can be an added benefit to help achieve the goals.

1.2. Reserve Bank of India

1.2.1. Minimum Investment grade Credit Rating for NBFC's

The regulator prescribes the minimum Credit Rating of BBB- by Credit Rating Agency for acceptance of new deposits by Deposit Taking NBFC's as well as with intent to update the existing master directions.

1.2.2. Interoperable Card-less Cash Withdrawal (ICCW) at ATMs

The regulator has prescribed that all banks, ATM networks and White-Label ATM Operators (WLAOs) may provide the option of ICCW at their ATMs, facilitated by Unified Payments Interface (UPI) integration with all banks and ATM networks.

While UPI would be used for customer authorisation in such transactions, settlement would be through the National Financial Switch (NFS) / ATM networks. The on-us / off-us ICCW transactions will be processed without levy of any charges other than those prescribed under the circular on Interchange Fee and Customer Charges.

RBI has also prescribed that the withdrawal limits for ICCW transactions will be in-line with the limits for regular on-us / off-us ATM withdrawals.

Impact:
The said circular paves way for the next revolution in Cash Withdrawals, which over-time is expected to make Debit Cards redundant. A product innovation on similar lines also holds the potential to disrupt the Credit Card market, as well as break the hegemony of the three payment processing giants.

1.2.3. Import of gold by Qualified Jewellers as notified by IFSCA

RBI has enabled the import of gold under certain codes through the India International Bullion Exchange IFSC Ltd (IIBX) subject to FEMA compliance, overseen by Authorized Dealers, which are:

- Advance for 11 days of import has been allowed
- The advance remittance shall be commensurate with the value of gold and quantity for the value determined
- Bill of entry shall be submitted to AD remitting the amount
- Payment to be made through approved IFSCA mechanism

AD bank shall also ensure compliance with FEMA, 1999, FTDR Act 1992, Foreign Trade Policy and regulations of IFSCA and shall be required to report to RBI as laid down in the notification

1.2.4. Variation Margin Directions, 2022 (Draft Directions released on 07th September 2020)

The Directions provide a structured framework for counter-parties (CPs) engaging in Non-centrally cleared derivatives (NCCD's) which are derivative contracts not having an intermediary for settlement.

The regulation identifies Covered Entities, which can be further distinguished as domestic and foreign, based on the criteria laid down therewith to whom the said directions are applicable. Covered entity shall not be settled physically and does not include CPs such as Banks, Government, etc.

Domestic Covered Entities can exchange margin with other Domestic and Foreign Covered entities, and the Foreign Covered shall only be allowed to exchange margin with a Domestic Covered Entities.

Directions lays down the following for Domestic and Foreign Covered Transactions:

- the methodology for Computation of Variation Margin
- Eligible Collateral-Indian Currency, FCCB, Debt securities of Govt., Rupee Bond, etc. (Securities issued by CPs shall not be eligible Collateral)
- Haircuts based on risk of eligible Collateral,
- Collateral Treatment,
- Dispute Resolution between CPs, etc.

Margin Requirements for cross-border transactions shall be subject to review of margin requirements of foreign jurisdiction. Domestic entity shall assess that foreign jurisdiction:

- is a member of the BCBS-IOSCO Working Group
- has implemented in line with the policy framework
- legally enforceable netting framework

Impact:
The Notification puts forth a formalized mechanism for determination of margins in the absence of an intermediary and provide more functional and structured option to the international and domestic counterparties to enter into formalized derivative arrangement besides their primary arrangement.

1.2.5. Provisioning for Standard assets by Non-Banking Financial Company – Upper Layer

The RBI has charted out, for the Upper Layer NBFC's, the provision/provision floor (for Ind AS) to be maintained against different exposures identified as Standard assets as per below:

Category of Assets	Rate of Provision
Individual housing loans and loans to Small and Micro Enterprises (SMEs)	0.25 per cent
Housing loans extended at teaser rates	2.00 per cent, which will decrease to 0.40 per cent after 1 year from the date on which the rates are reset at higher rates (if the accounts remain 'standard')
Advances to Commercial Real Estate – Residential Housing (CRE - RH) Sector	0.75 per cent
Advances to Commercial Real Estate (CRE) Sector (other than CRE-RH)	1.00 per cent
Restructured advances	As stipulated in the applicable prudential norms for restructuring of advances
All other loans and advances not included above, including loans to Medium Enterprises	0.40 per cent

The said provisioning norms shall be applicable only to Upper Layer entities as had been introduced in September 2021 by RBI. The provision required is perceived based on the risk posed by each sector as against the earlier provision whereby all standard asset provisioning was to be maintained at 0.40%

Impact:
The Notification shall mandate the companies to classify its standard assets based on the nature of exposure and maintain higher provision for certain exposures as stated by RBI. This shall affect the capital ratio and higher blocking of the working capital due to higher provisioning.

1.3. International Financial Services Centre Authority

1.3.1. Framework for Aircraft Lease

The IFSCA has prescribed a detailed framework for Aircraft Leasing, encompassing the following activities for a Finance Company to undertake aircraft leasing operations with a minimum owned fund of USD 200,000 or its equivalent in freely convertible foreign currency, maintained at all times by the entity:

- Operating lease for an aircraft lease arrangement including sale and lease back, purchase, novation, transfer, assignment, and such other similar transactions in relation to aircraft lease;
- Operating lease for an aircraft ground support equipment;

- Asset Management Support Services for assets owned or leased out by the entity or by its wholly-owned subsidiary(ies) set up in IFSCs in India;

For undertaking following activities in addition to above, minimum owned fund of USD 3 million or its equivalent in freely convertible foreign currency, is to be maintained at all times by the entity:

- Financial lease or a hybrid of financial and operating lease for an aircraft lease arrangement including sale and lease back, purchase, novation, transfer, assignment, and such other similar transactions in relation to aircraft lease;
- Financial lease or any hybrid of financial and operating lease for an aircraft ground support equipment;

Impact:
The said circular establishes a detailed framework for undertaking Aircraft Leasing activities in India in an effort to on-shore the activities undertaken by Indian Aviation Industry at foreign jurisdictions, apart from making IFSC a hub for Aircraft Leasing operations.

2. Discussion Papers

2.1. Active v/s Passive Management – Who Wins?

Getting Familiar with Active v/s Passive Management
Active Management as the name implies takes a hands-on approach and requires someone to act in the role of Fund Manager. The fund manager seeks to pick stocks with the aim of beating the benchmark and generating alpha. A fund manager cannot possibly invest in the same stocks as he has to take a call on picking stocks outside the index or keeping the exposure of sectors different from the index.

A fund is considered to be Passively managed if the fund manager replicates the index with exactly the same stocks and in the same proportion. Here the fund manager tries to replicate the index performance with as little tracking error as possible. Since the fund manager has to mimic the index, he will have very little cash and that too, only to meet redemption proceeds. Index funds and ETFs are one of the most common examples of passively managed funds.

Key Differences between Active and Passive Management

Sr. No.	Particulars	Active Management	Passive Management
1.	Expense Ratio	Higher Expense Ratio, as an actively managed fund will have a team of analysts and fund managers who will study the various parameters of the economy and take calls on sectors and stocks in order to generate higher returns.	Lower expense ratio, as these funds need less management, given that they simply have to mimic the index.
2.	Turnover Ratio	High Turnover Ratio because a lot of active stock calls are taken continuously in active management.	Lower Turnover ratio, as the churn is only when there is a change in a stock in the index or when the fund has huge inflows and the same needs to be deployed in the index stocks.
3	Performance & Volatility	In actively managed funds, the fund manager aims to create alpha. There is also a possibility that the fund may underperform if its calls go wrong. Active management also at times lead to higher volatility in returns compared with benchmark.	Since a passively managed fund mirrors its benchmark in every aspect, the possibility that the fund may underperform its index by a huge margin is Low. At best the return differential could arise as a result of tracking error

4	Flexibility & Diversification	In active funds you can choose funds from different market cap segments or funds using different strategies (such as growth or value). You can also choose funds with a combination of equity and debt or those that invest based on market valuations.	Passively managed funds offer little choice in the Indian context. There are very less funds that will invest in a combination of asset classes
5	Managing Liquidity	In case of a scenario of market crash, actively managed funds can sell the stocks in the fund and move the money to cash or money market funds to prevent further erosion of investment.	In case of a scenario of passively managed funds such as index funds and ETFs, it will not be able to move the money to liquid instruments.

Birth of Passive Management

Introduction to Passive Management worldwide goes back to 1975 when the celebrated American investor John Bogle, founder of The Vanguard Group, created the first index fund. It was his hope that small investors would find it simpler and cheaper to gauge market performance by tracking this index fund, instead of engaging expensive pros at mutual funds. The concept gave birth to passive investment and since then the active vs passive investing debate has seen a renewed vigour.

With the Indian mutual fund industry dynamics steadily transforming, there is a recent reduction in alpha for active mutual funds and, almost parallelly, a sharp surge in the AUM of passive mutual funds, making the debate intriguing. Globally, it has been often seen that in the lesser mature mutual fund investing markets like India, the active fund management style plays out more than passive. But as the market develops, inevitably, the passive style of investing becomes increasingly prominent. [1]While in 2010, only 14% of the assets of open-ended mutual funds worldwide were constituted by passive funds, in 2020, it grew to 31%.

In India too, the share of passive funds has seen an exponential rise in the last 5 years, although over a much lower base. [2]Data from Association of Mutual Funds of India (AMFI) reveals that investors have started putting in big money in passive schemes, including index funds and ETFs. Index funds saw net inflows of Rs 6,061.86 crore in April and ETFs other than gold received a whopping Rs 8,662.80 crore.

This shows that passive funds have made a place for themselves in the investor portfolios, but it is said that there is a lot of alpha to be made in the Indian market, so passive funds can't replace active funds yet, they are here to stay. In fact, the rise of passive has pushed active managers in the right direction, it is only changing its form with new themes like smart beta, ESG, etc.

Without a doubt, it can be witnessed that markets face considerable uncertainty with regards to the direction of economies and inflation pressures. In this backdrop, there is an argument that passive

[1] Crisil Views and Commentaries 28 September 2021
[2] Economic Times Survey

funds may find it hard to outperform against the best active funds, which have more flexibility to take advantage during volatile times.

The debate for active v/s passive management may not have a final conclusion and one right answer to it, but a best of both the worlds can help the investor sail through uncertain markets.

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About Basilstone

Basilstone Consulting Private Limited (‘Basilstone”) has been promoted to partner with the society and its businesses to achieve their true potential and help realize their vision. We work closely with our clients and enrich their growth by offering them solution driven consultancy services in the areas of strategic planning, incubation, impact analysis, idea validation, product validation, feasibility study, synergy evaluations, fund raising, restructuring, transaction advisory, representation – guiding on regulatory / non-regulatory meetings, succession planning, Inbound and outbound investment, due diligence, dealing with regulatory / statutory authorities, etc.

We, at Basilstone aim to position ourselves as the ‘Go to Consultants’ for **Simple Solutions & Value Creation** recognised by our clients for delivering ultimate desired results.

The Purpose of Basilstone is to provide simple solutions and create value backed by:

Strong Processes

In-Depth Knowledge

Invaluable Experience

Deep-Rooted Values

We clearly resonate ourselves with the ever-growing Basil, inspiring us to imbibe the quality of being natural and pure while we adapt to changing conditions and innovation. The rock-solid Stone is representative of our endurance, stability, permanence and our determination, paving the path of value creation for our clients and our firm allegiance to our principles.

Basilstone is the quintessential blend of traditional values and modern thoughts which are echoed in the experience, enthusiasm and energy of its people and translated in the services rendered to its clients.

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