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Australia-India Comprehensive Economic Cooperation Agreement
Free Trade Agreement Division
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INDIA-AUSTRALIA COMPREHENSIVE ECONOMIC COOPERATION AGREEMENT

The Financial Services Council (FSC) welcomes the agreement by the Indian and Australian Governments to commence negotiations on a bilateral free trade agreement (Comprehensive Economic Cooperation Agreement) and appreciates the opportunity to comment on issues pertaining to Australian (or Australia based) life insurance companies and funds management companies currently operating in or looking to expand into India.

The FSC represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, trustee companies and public trustees. The FSC has over 125 members who are responsible for investing more than $2.3 trillion on behalf of 11 million Australians. This submission covers life insurance and funds management.

LIFE INSURANCE

Background

In FY 2013-14, Indian life insurance premiums totaled AUD $65 billion (USD $51 billion), or 2.7 per cent of Indian GDP[1]. Despite this India remains underinsured. According to the World Economic Forum, India ranks 52 out of 62 surveyed nations in insurance penetration[2]. In FY 2013-14 the life insurance penetration rate was a mere 3.1 percent. This provides headroom for greater involvement by foreign insurers India must allow more Foreign Direct Investment which will deliver more funds and ensure the size of the market grows.

[1] The World Bank, GDP Current ($USD), 2014
[2] World Economic Forum, the Financial Development Report 2012, 147

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Until recently, the share of foreign investment in the Indian life insurance and general insurance markets has been capped at 26 percent[3]. Wholly foreign-owned branches are also prohibited, so foreign insurers must enter into joint ventures with Indian firms to access the market.

Reinsurers are similarly prohibited from operating branch offices in India, and the government-owned General Insurance Corporation (GIC Re) remains the sole reinsurer in India[4]. At the same time, the government-owned Life Insurance Corporation (LIC) maintains a domestic market share over 75 percent, according to the Insurance Regulatory and Development Authority of India (IRDAI) 2012 annual report[5].

In 2008, legislation was introduced that proposed to raise the foreign equity limit in the insurance industry to 49 percent and to permit foreign reinsurers to open independent branches. More recently, the Indian government has considered different types of liberalisation in the sector[6] and in December 2014 Prime Minister Modi issued an executive order which increased the FDI cap to 49 percent in a bid to end years of inaction by the Indian Parliament.

The following submission provides further explanation of the key barriers to establishing business in India as experienced by the FSC's Life Insurance members:

1. **Foreign Direct Investment Cap**

   The most significant barrier for Australian insurers has been the cap on foreign direct investment in insurance companies in India. Recently the cap, which stood at 26 percent for the last decade, was changed when Prime Minister Modi issued an executive order in December 2014 increasing FDI by foreign entities to a 49 percent stake. This issue also relates to other Australian businesses.

   Despite this, for most insurers there is still a view that India is too risky on the basis that Modi's executive order must still be ratified by the Indian Parliament. The executive order is also unclear about 'branch status' and Section 45 of the ordinances that stipulates that insurers must pay claims irrespective of circumstances if the policy has been held for a period of three years. This is especially pertinent given the degree of insurance fraud relevant to India.

   Even with FDI increased to 49 percent, the Indian insurance market is still one of the most protectionist in the Asia region. Banks, for example, can be 74 percent foreign owned and asset management companies can be wholly foreign owned. In contrast, China, Korea and Taiwan permit 100 percent ownership of insurance companies and Malaysia and the Philippines permit more than 50 percent ownership.

3 Government of India, IRDAI, "History of Insurance in India," December 2007
4 Simchak, written testimony to the USITC, Washington, DC, February 2, 2014
5 IRDAI, "Annual Report 2012-13," October 2013, 21
6 Simchak, written testimony to the USITC, February 25, 2014, 6–7

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Recommendation:

Negotiations with India should focus on the need for the Indian Parliament to ratify the Prime Minister's executive order on FDI.

2. Regulatory consistency and predictability

It is important that Indian regulators approach their prudential obligations with the understanding that while liberalisation of the insurance market is necessary, achieving a balance between consumer protection and industry sustainability is vital.

One area where life insurers have had a poor experience with the Indian regulatory process is in the Unit Linked Insurance Product (ULIP) market, which made up 85 per cent of life insurance sales. In this case the Indian Ministry of Finance reauthorised the Insurance Regulatory and Development Authority to regulate these products and in the process mandated far reaching changes to the structure of ULIPs and the way in which agents could be compensated.

While the changes were necessary in order to protect consumers, the very limited nature of consultation with the life insurance industry, including inadequate notice and comment period and no regulatory impact assessment, caused overnight changes including widespread cancellation of policies. ULIPs now make up just 12 percent of total premium.

Life insurance premiums have been detrimentally impacted by this episode which has caused year-on-year premium decreases and a substantial drop in life insurance premiums as a component of Indian GDP.

Recommendation:

The Indian Ministry of Finance must adopt more rigorous processes for assessing the impacts of regulatory change. This must include meaningful consultation with industry and transparent regulatory impact assessment.

3. Level playing field for reinsurers

Reinsurance in India is effectively monopolised by the state-owned General Insurance Corporation. Mandatory concessions and its right of first refusal privilege prevent primary insurers in India diversifying risk.

The presence of international reinsurers will be a vital element by making additional capital available and relieving Indian insurers of partial or entire risks that are too large

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for their own capital base. It will also transfer international know-how to the local market and provide Indian insurers with proven international expertise in assessing complex risks and handling large, complex claims.

Recommendation:

Permit branch offices of reinsurers to be established in India to write Indian reinsurance risks and permit such reinsurance risks to be written freely by foreign reinsurers on a cross-border basis.

i. Ability to perform reinsurance retrocession

Retrocession occurs when one reinsurance company has another reinsurance company partially underwrite some of its reinsurance risk. This essentially diversifies its risk portfolio and limits its potential losses as a result of a catastrophe. This is standard practice for reinsurers in developed markets globally.

The current restrictions applied in the Indian reinsurance regime make it difficult for this practice to occur because of the Indian Government reinsurer's right to accept any business that requires reinsurance above 20 percent mandatory cessions and the requirement under the applicable insurance law to exhaust local reinsurance capacity before using a foreign reinsurer.

ii. Ability to write quota-share treaty agreements

In quota-share reinsurance agreements a reinsurer agrees to cede to the quota-share reinsurer a percentage of all premiums arising from a book of business in exchange for the reinsurer bearing the same percentage liability for losses.

Quota Share treaty arrangement are generally not permissible in the Indian market except the obligatory cession where every Insurance Company is expected to cede 10% of each and every risk to GIC which is the national reinsurer.

Recommendation:

Allow reinsurance risks to be written freely by foreign reinsurers on a cross-border basis.

4. Capital and Solvency

For foreign insurers, regulations stipulate companies must have a capital base of at least US $20 million. Reinsurers are required to hold capital reserves of US $45 million.

Indian regulations prescribe the Gross Premium method for policy reserves and a standard formula approach for the capital requirement. The Indian insurance regulator is

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currently considering whether a different approach (more closely aligned to what is used in Australia) should be considered in India as it helps to set capital having regard to the particular issues within each company.

Some of the limitations with the current capital and solvency requirements in India include:

- Formula approach for solvency does not vary between companies
- Does not differentiate between different mix of business
- Little differentiation between insurers with good and bad investments
- No reflection of the specific risks that each company is exposed to

Recommendation:

A revised approach to calculating capital and solvency ratios should be considered in India to ensure capital is set relative to the particular issues within each company.

FUNDS MANAGEMENT

Background

Funds management remains a small sector in India but has the potential to grow significantly. Assets under management in India stand at US$166 billion managed by 45 asset management companies as at 31 December 2014. The mutual fund industry is small compared to global benchmarks – AUM to GDP ratio is 7-8% compared to a global average of 37%. Australia's ratio is over 100%.

Australia has a large amount of expertise in funds management which would benefit the Indian industry if market access was improved. Likewise, India has untapped potential of benefit to Australian managers wanting to expand into new markets and gain exposure to new assets.

FSC members have experienced great difficulties doing business in India due to a large amount of red tape and bureaucracy. This needs to be addressed if Australian businesses are to benefit from the Free Trade Agreement.

The Indian Government has implemented some regulatory changes and improvements of investment restrictions in recent times. Likewise, initiatives by the Securities and Exchange Board of India (SEBI) have been undertaken. However it is still very difficult to access the market.

Ultimately, Australia requires mutual recognition of licensing arrangements (regulatory equivalence) between regulators so Australian licences can be recognised in the Indian market without the need for additional approvals.

The following submission provides further explanation of the key barriers to establishing business in India as experienced by the FSC's funds management members.

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1. General market access in financial services

Obtaining market access in India is a lengthy and complex process. FSC members have experienced 6 – 12 month waiting times in setting up accounts in India. This compares to around 4 weeks or less in other markets.

The process is hindered by lengthy documentation, identification and visa requests and unclear processes within SEBI and Government agencies. FSC members have noted they have been required to deal with multiple agencies to get approvals. The process is very expensive, bureaucratic and uncertain compared to other (more advanced) markets.

Local representatives and local tax agents are also required for foreign businesses, which adds to the complexity and expense in setting up accounts in India.

The penalty laws are also very punitive compared to other markets. The laws mean that there is the potential for an appointed compliance manager in Australia to be subject to jail time if breaches by any manager under the licence occurred. This considerably heightens the risk of doing business in India.

The unpredictable process in gaining approvals as well as punitive breach penalties for compliance managers has deterred Australian fund managers (as well as Australian Responsible Entities (RE) managing offshore managers) from doing business or investing in India. The issues also exist for offshore managers acting on behalf of Australian entities.

Recommendation:

A clear, non-discriminatory and streamlined process for Australian business to access the market in India should be negotiated. This should include improved business visa processes, reduced penalties for breaches, condensed documentation requirements and reduced waiting periods to open accounts.

2. Licensing and mutual recognition

FSC members have experienced lengthy delays in trying to obtain a financial licence to do business or invest in India. There have been recent changes to the licensing process for foreign companies which are expected to reduce waiting times. However new processes and new documentation mean this is unlikely to benefit Australian businesses in the short term.

We understand previously the trustee would obtain one licence which covered all beneficial owner trusts which would set up sub-accounts under this licence. Under the new rules, each beneficial owner trust obtains a licence in addition to the trustee. It is unclear at this stage how this will impact doing business in India.

Ultimately, the Australian Government (through relevant securities regulators) should negotiate mutual recognition of licensing arrangements with India for financial services licences. This will ensure Australian fund managers can ensure that their approved Australian Financial Services Licence will be recognised by Indian authorities and significantly reduce time, expense and uncertainty.

While mutual recognition will be required to be implemented by regulators following the FTA, full market access and licence recognition should be committed to in the FTA. Important areas to cover for India (such as the Japan and Korea FTAs) are non-discrimination against Australian providers, market access for investment and services and no requirement to establish a commercial presence.

Recommendation:

Negotiate full market access and recognition of Australian Financial Services Licenses in India with a view to implement mutual recognition between securities regulators.

3. Investment restrictions

Several investment restrictions exist in India which limit the amount of business Australian managers can undertake. FSC members have noted these restrictions are much tighter than is experienced in other markets. The limits are also subject to the trustee as a whole so need to be managed across all managers.

Equity funds are subject to a restriction which limits the proportion of a company foreigners can invest in (currently 10%). This limit is at the licence level rather than the manager level which proves very problematic in practice. This limit should be removed, increased or imposed at the manager level.

Debt funds also face a host of issues namely, (i) restrictions from the central bank about size, terms, tenure and (ii) no access to a long term currency hedging market.

Recommendation:

Remove or streamline investment restrictions to improve investment conditions for Australian fund managers in India.

TAX ISSUES

Although not within the remit of the FTA, there are many tax issues in India which would need to be addressed to provide certainty for Australian businesses.

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India's complex tax system creates a productivity drag for Australian insurers and fund managers due to the need to deploy considerable resources for compliance and resolving adverse tax outcomes.

This problem is compounded by the unique accounting standards used in India. For example, Australian insurers operating in India must operate two sets of books, one using the unique Indian standards and the other using international standards. This is a huge cost impost for foreign insurers.

Australia's double tax treaty with India needs to be updated and has several issues currently. For example, our current treaty with India is poor from a non-resident Capital Gains Tax perspective for non-real estate assets. Also, currently there are no tax reclaim or tax relief procedures.

Australian companies operating in India are also subject to a higher rate of withholding tax, roughly five percent higher than similar economies. Although, standard withholding tax rate can vary depending on the nature of the income.

The registration process to remit the withholding tax is time consuming (both in effort and how long the process takes). It effectively has to be completed well before the transaction is done. Interest penalties are significant for late payments. Our members have also had significant issues making tax withholding payments via the Indian banking system and their custodians.

The rules require the purchaser to withhold from the purchase price. Where the purchase price is not Indian Rupees (likely due to indirect transfers), the purchaser effectively bears the FX risk between withholding at payment date and fixing of the FX conversion rate for Indian tax purposes (which is only known after the event).

The Indian rules are not well developed for common investment fund type transactions. For instance, it seems that the cost base of the investment could be the nominal value of the shares rather than the amount paid up on the shares. The applicable tax rate depends on classifications like "marketable" and "security" – getting a firm view of these concepts is difficult.

Tax lodgement systems are poor – Australian businesses must lodge electronically, and are charged to lodge tax returns by the tax agent. It was noted that the electronic tax lodgement generally fails and businesses have to pay to re-lodge the returns. It is also a very lengthy process for income tax refunds.

Another major issue for our members is a Permanent Establishment tax risk – at a minimum level this risk could potentially expose the income of all the investors into Australian funds in India to taxation in India due to presence in India and at an extreme level, it could expose entire income of the Australian parent company to taxation in India.

There are also new tax issues arising from the 2015 Indian Budget. Firstly, India's residency test will be changed from "control and management wholly in India" to "place of effective management ("POEM"), at any time in that year, is in India". POEM is the place where key management and commercial decisions that are necessary for the conduct of the business of an

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entity as a whole are in substance made. This change will make it even more crucial to differentiate between asset management and asset advisory services.

Secondly, a safe harbour for fund managers in India has been introduced such that a ‘business connection’ is not made for non-resident funds. However one condition is that the manager cannot be connected to the fund. Global fund managers as a rule need to show the market that they have some ‘skin in the game’ when launching new product and it is very common to see some sponsor capital be invested in such funds. Our concern is whether or not such an investment will ‘connect’ the manager (generally an Indian subsidiary of the corporate group) to the fund.

Recommendation:

> Reassess taxation barriers as part of the Australia-India double taxation agreement which should be reviewed in conjunction with the FTA negotiations.

We would be pleased to meet with you at your earliest convenience to provide a comprehensive briefing on this issue well ahead of negotiations with India.

Please contact me directly on 02 8235 2513. Alternatively, your staff can contact William de Haer in my office on wdehaer@fsc.org.au or 0434 566 764 or Sara Dix on sdix@fsc.org.au or (02) 8235 2514.

Yours sincerely

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