Increase in outstanding P-notes

Why in news?

P-notes (Participatory notes) hit a 31-month high in November 2020, with the value of outstanding P-notes reaching Rs. 83,114 crore.

What are P-notes?

- Foreign portfolio investment (FPI) is a common way to invest in overseas economies.
- It includes securities and financial assets held by investors in another country.
- P-notes are issued by foreign portfolio investors (FPIs) registered with SEBI to overseas investors who are not registered as FPIs in India.
- In this, the final owner can be concealed from regulators.
- This anonymity provided by P-notes had led to entities using this route to round-trip funds.

What are the recent developments?

- P-notes have gained notoriety on account of their rampant misuse prior to 2008.
- The value of outstanding P-notes had exceeded 50% of FPI assets in late 2007.
- This led to SEBI clamping down on the issuances of, and disclosure and trading in, these instruments.
- Outstanding P-notes have reduced sharply since then.

Is increase in outstanding P-notes a problem?

- There is no real cause for alarm in the value of outstanding P-notes increasing.
- These instruments account for only 2% of FPI assets currently.
- The increase in value of outstanding P-notes can be explained by two factors:
    1. the rally in stock prices has resulted in inflating the value of existing P-note holdings
    2. there has been a great surge in FPI inflows this fiscal, with investments so far exceeding Rs. 2,42,000 crore
- So, increase in outstanding P-notes implies higher overseas demand for

Indian stocks.
- Despite the impact of the pandemic on the economy, foreign investors have preferred Indian equities.
- This is due to the country's demographic advantage and its consumption-led growth.
- Foreign investors already registered with SEBI can easily increase their investments into the Indian market at such times.
- But, those yet to obtain registration may prefer the P-note route for its speed and lower compliance requirements.
- It further needs to be noted that there are no P-notes issued on derivatives outstanding now.
    - Derivatives are securities that derive their value from an underlying asset or benchmark.
    - P-notes on derivatives are the riskiest.
    - This is because they are used by hedge funds and large traders in the international market who tend to move in and out of stocks very rapidly.
    - This may cause great volatility in stock prices.
- Since no P-notes issued on derivatives outstanding now, SEBI need not worry about scrutinising the P-note inflows or tightening the rules governing these instruments.
- However, this cannot be said about rules governing FPIs.

What are the reforms in this regard?

- SEBI has, of late, been trying to simplify rules governing FPIs which can dilute the existing checks against money laundering through this route.
- E.g. the re-categorisation of FPIs in 2018, wherein more institutional investors and funds were categorised as Category I FPIs needing lower compliance and KYC checks
- Similarly, SEBI simplified the registration of multiple investment managers.
- It also did away with the broad based eligibility criteria for institutional foreign investors.
- But these reforms could possibly lead to trouble.
    - Funds from overseas are necessary for increasing liquidity and better price discovery.
    - But the regulator cannot let down its guard on the kind of money that is entering India in the garb of FPIs.

Source: BusinessLines