Opinion

TUESDAY, APRIL 30, 2019

FOCUS ON TASK AT HAND

Archbishop of Colombo, Malcolm Ranjith

At a time when the whole country has been affected by a major catastrophe, politicians should stop finding fault with each other. Instead they must have broad discussion on what steps need to be taken to solve this and take this country out of this crisis

From cows to cane, a mix of bad and weak policies

If Modi's policies on the cow were bad, those on sugar were a continuation of the past; both can cost him dearly in UP

EVEN BEFORE THE first vote was cast in the 2019 elections, it was always obvious that Uttar Pradesh held the key to whether or not prime minister Narendra Modi comes back to power. Other scenarios, by the pro-BJP camp, like the BJP/NDA making up what it loses in UP by wins in Odisha, West Bengal and the North East, are essentially variants of the same theme of the centrality of UP. With the BSP and the SP tying up, it was always going to be tougher for the BJP, though there are some who argue that caste is no longer as central to the elections as it once was; if it was, the argument goes, India's caste-warriors would never have lost as badly as they have on various occasions in the past. It is also argued that, while caste has not lost its centrality, it is not going to be easy to get the SP supporters to vote BSP and vice versa.

While we have to wait another few weeks to know what actually happened, if Modi does badly in Uttar Pradesh, a big factor will be the government's policies on cows and cane; even if the BJP manages to hold on to its seats, the fact that it has been given a scare is due to these two factors. The policy on cows began with candidate Modi's running down the 'pink' revolution—export of beef—in companion to the 'green' and 'white' revolutions of the past and, later, the fact that the UP government never acted firmly on the illegal actions of *gaurakshaks* even after incidents of lynching undoubtedly encouraged them. If those cultivating crops were hit by their poor prices, those who earned their livelihood from the dairy sector were hit by not getting money for their old cattle—this included even buffaloes—and, more important, were left paying the bill for their feed. Since 13-15 million cattle and buffaloes are slaughtered every year, assuming the business ground to a complete halt due to the *gaurakshak* terror, farmers would end up with a ₹30,000 crore additional food bill across the country in just the first year, assuming a feed cost of ₹60 per day. And, with the menace of stray cattle, another issue came up, of them destroying crops; so, farmers had to either pay for fencing their land or had to stay up at night to guard their crops against the stray cattle.

In the case of sugarcane where, as many have pointed out, the dues from mills are currently around ₹10,000 crore, farmers are a disgruntled lot. The problem, in this case, is that Modi's policies were timid, aimed at maintaining the status quo for fear of alienating the powerful cane farmers. The cane prices that the government forces sugar mills to pay—and they have to buy all the cane brought to them—are much too high. As a result, there are always large cane dues and it is quite a farce to see the government, almost every year, warning sugar mills to pay their dues, then arresting mill officials for not doing so and, when none of this works, coming up with a sugar 'package' from time to time to give the mills enough money to pay their dues to farmers. This is nowhere near a solution and merely postpones the pain to another year, but no government has been able to fix this. So when analysts talk of how Modi faces the wrath of the sugarcane farmer, this is ironical since the prime minister has done his best to ensure they continue to get a largesse other farmers don't get. Unless post-Balakot nationalism prevails, the prime minister will have to bear the brunt of his cow and cane policies; in one case, he was unacceptably aggressive, in the other, he was too passive.

Taking out malaria's bite

First malarial vaccine launched could hold promise for India

MALARIA REMAINS A vexing public health problem for India. With nearly 4 lakh cases of malaria and 85 malarial deaths in 2018—these numbers are from the National Vector Borne Disease Control Programme, WHO pegged death alone at nearly 17,000 in 2017—it has one of the worst country-malaria-burden in the world. Indeed, official data is likely skimming the surface, with, as per *The Indian Express*, an estimated 60-80% of patients in urban areas treated at private establishments, most of which don't report cases to the official data-collector. What makes India's problem particularly acute is that some of its poorest and most remote regions account for the bulk of the malaria burden. Odisha, Jharkhand, Chhattisgarh, Meghalaya, Arunachal Pradesh, Mizoram and tribal areas of Maharashtra and Madhya Pradesh report 90% of the notified cases. Add to this the fact that many strains of the malarial parasite have rapidly developed resistance, and tackling malaria becomes a nightmare. Cholorquine, once the go-to drug for malaria, failed in the 1980s, artemisinin resistance was detected sometime in the late 2000s, and, in 2015, resistance to one of the partner drugs in artemisinin combination therapy (ACT) was reported. Against such a backdrop, the launch of the first malarial vaccine—RTS,S—in Africa should be manna from heaven; not just India, but most nations with a high malaria burden are either developing or poor African/South Asian nations. A vaccine is a far more economic solution in the long-run than drugs, and since it primes the immune system to fight off the pathogen, disease burden falls sharply with the threat of resistance nullified or minimised.

A two-year pilot vaccination project has kicked off in Malawi, and 3,60,000, children in three African nations—Malawi, Ghana and Kenya—will be inoculated each year. Pharma giant GSK that developed RTS,S will donate 10 million doses for the project. The vaccine was first reported by GSK in 1987, and, only in 2014, did it clear phase III clinical trials. RTS,S prompts the immune system to interfere in the first stages of the *Plasmodium falciparum* (the most lethal as well as the most prevalent malarial parasite species) life-cycle in the human body by preventing its entry into the human host's liver from the latter's bloodstream following a mosquito bite. Children in Africa who were part of the phase III trials received four doses of RTS,S, and the vaccine was shown to prevent 4 in 10 cases of malaria, 3 in 10 cases of severe malaria, 6 in 10 cases of severe malarial anaemia, the leading cause of malaria-related deaths in young children.

Once the pilot is completed in Africa, WHO will be reviewing the results, and based on the results, the vaccine could likely become part of the anti-malaria protocol. For India, if the vaccine is found effective, the key question then will be the cost to public health, especially if the vaccine is made part of the universal immunisation programme. But, given India aims to eliminate the disease by 2030 and high-burden states like Odisha have shown exceptional commitment, cost shouldn't weigh too heavy if adoption is considered.

VeiledThreat

Sri Lanka is banning face-veiling, typical of Islam, in the aftermath of the Easter bombings

IN THE AFTERMATH of the horrific Easter attacks on churches and hotels in Sri Lanka by ISIS-affiliated terrorists, the island nation's president, Maithripala Sirisena, said he was using an emergency law to ban face coverings in public. Any piece of cloth or garment that covers the face of the wearer and "hinders identification" is outlawed, the leader's office said, in a move that is apparently being carried out for security reasons after Islamic militants carried out the vicious and relentless terror attacks that killed at least 250 people and injured scores more. Although the official press release from the president's team did not contain the words, '*niqab*' or '*burqa*'—face-covering veils traditionally worn by Muslim women—critics are already pinning it to the state deliberately impinging on the religious freedom of Muslims. While the two poles in the larger debate on *burqa* ban are, respectively, that veiling is a choice and that it is a symbol of oppression, in the Sri Lanka instance, with reports of intelligence from various sources warning of more attacks where the terrorists may be clad in military uniform or face-veils typical of the *burqa*, there is little reason to read too much into the ban.

Limitations on wearing face veils in public have already been enacted in France, Belgium, the Netherlands, Bulgaria, Austria and Denmark. Critics of the Muslim veiling tradition argue that women do not wear the veil by choice, and they are often forced to cover their heads and bodies. The opposing camp holds that, for some, the veil symbolises devotion, piety and identity. To them it is a question of religious identity and self-expression. The bans have, in some instances, led to harsher violence against Muslim women. Surveys of attitudes toward French Muslims post the country's ban showed that there was a strong correlation between the highly publicised legislation banning headscarves in 2004 and an increase in anti-Muslim sentiment. Banning face veils prescribed by Islam for national security reasons is tricky terrain, since it encroaches upon personal freedoms, but it is a necessary evil. At the same time, it could be liberating for some women who are actually facing injustice and oppression—the dreaded culture police in some Islamic nations that enforce veiling has its parallels within the Muslim community even in progressive nations. The issue at the heart of terrorism and security concerns though is rising marginalisation of Islam and the extremism that emanates from this.

LIQUIDITY CRUNCH

GOVERNMENT FAVOUR CAN HELP PRIVATE COMPANIES SWELL TO GARGANTUAN SIZE QUICKLY, BUT THOSE DEBTS WILL EVENTUALLY HAVE TO BE PAID

How private giants fall in China

SHULI REN
Bloomberg

CHINA LIKES TO tout the virtues of its private sector, whose firms are the source of most new jobs and most economic growth in the country. Not all private companies are created equal, however. Those perceived to have the state's backing can grow disturbingly fast and crash to earth just as quickly.

Behemoth China Minsheng Investment Group Corp. is only the latest example. The company was founded in May 2014 to act as a private-sector version of a sovereign wealth fund, one that would supposedly be better at investing than its state-run counterparts. Its founding investors included 59 different private companies, who pooled together some 40 billion yuan ($5.9 billion) in registered capital. As of last September, the most recent financial data available, the group was carrying 232 billion yuan in debt, 63% of it due within a year. As with other fast-growing private conglomerates such as HNA Group Co. and energy trader CEFC China Energy Co., those obligations have started to unravel. CMIG has tested bondholders' nerves repeatedly this year with late repayments, the latest of which spread offshore and triggered cross-default clauses on dollar bonds that had been worth $800 million.

CMIG's stunning growth has inevitably created the impression that the firm has political backing. It openly describes itself as the brainchild of premier Li Keqiang. In a 2016 bond prospectus, the group noted it was "the only private enterprise approved by the State Council to use 'China' in its name" and that it regarded "serving [China's] national strategy as its mission". The group pledged to spend $5 billion developing an industrial park in Indonesia as part of president Xi Jinping's signature Belt and Road infrastructure-building programme, and talked up investing in Vietnam and Cambodia.

Within two years of its founding, the company had won credit lines with policy banks such as China Development Bank and Export-Import Bank of China, the latter now mired in an asset-disposal dispute with the firm. CMIG enjoyed about $10 billion in loan facilities from the two policy banks and China's big four commercial banks—an unusually large amount for such a young private company.

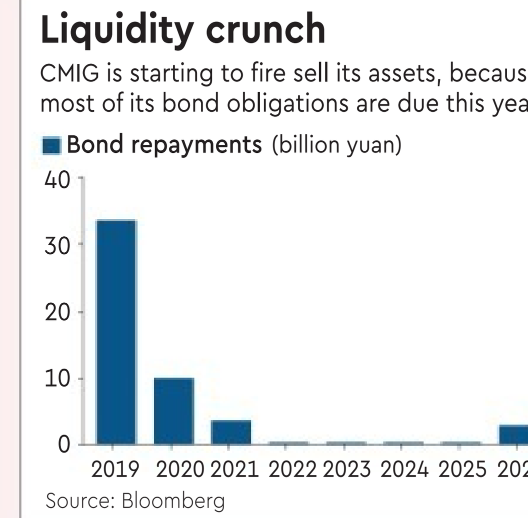
There is nothing inherently wrong with relatively easy credit. But it can breed overconfidence, leading firms to take on riskier long-term projects. When that tap closes all of a sudden, as it frequently can in China, companies such as CMIG can be stuck with illiquid projects desperate for cash injections.

For instance, shortly after its founding, CMIG spent 25 billion yuan, or roughly two-thirds of its capital raise, on a prime plot of land in Shanghai. This could have been its best investment—Shanghai's property price has soared since—but the deal didn't work out: CMIG had promised to develop the plot by 2020, which meant it required the kind of cash the now-distressed company no longer has. The property was sold under pressure to state-owned developer Greenland Holdings Group Co. Ltd. to honour a February bond repayment.

CMIG could face similar problems elsewhere in its portfolio. In late 2016, in a $2.6 billion deal, CMIG took control of Yida China Holdings Ltd., which specialises in property developments in lower-tier cities such as Dalian. China's smaller cities have a notorious oversupply issue, and sure enough, sales at Yida have been stagnant in the last three years, while those of its larger competitors have rebounded.

Liquidity crunch

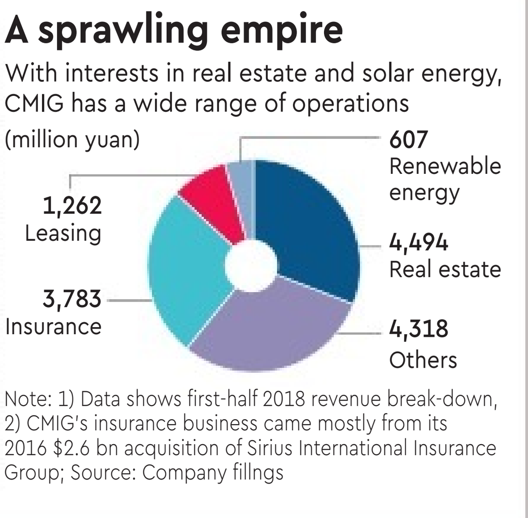
CMIG is starting to fire sell its assets, because most of its bond obligations are due this year



Source: Bloomberg

A sprawling empire

With interests in real estate and solar energy, CMIG has a wide range of operations



Note: 1) Data shows first-half 2018 revenue break-down, 2) CMIG's insurance business came mostly from its 2016 $2.6 bn acquisition of Sirius International Insurance Group; Source: Company fillngs

And then there's CMIG's unfortunate venture into solar energy, which followed the meteoric rise of Hanergy Thin Film Power Group Ltd. In 2015, CMIG sought to build the world's largest solar park. By last June, it had plowed over 10 billion yuan into solar projects, which are notorious for their long investment cycles. (CMIG's biggest project, in Ningxia province, won't break even for nearly a decade, even using the company's own aggressive assumptions).

Meanwhile, the policy tide is turning. Tired of hefty subsidy bills, Beijing now only welcomes solar players to supply to its grids if they don't require government aid. While CMIG continues to tout the potential of Belt and Road investments, prospects are dwindling there, too, in part because of a backlash among recipient countries. Its construction work at Country Garden Holdings Co.'s $100 billion Forest City project in Malaysia has stalled ever since prime minister Mahathir Mohamad balked at foreigners buying property there. Its Indonesian industrial park has gone nowhere.

The Belt and Road label does have one key advantage: CMIG can be kept alive longer if it can show it owns strategic assets. Nearly a year since it first defaulted, energy trader CEFC has yet to be put into a bankruptcy process in China, *Debtwire* has reported, because Beijing wants the company to offload its minority stake in an Abu Dhabi oil concession—a strategically important asset—before its other assets fall into creditors' hands.

CMIG hasn't grown big enough to pose a systemic financial risk. Still, China should be wary of allowing such private-sector giants to swell largely on perceptions of political support. Sooner or later, those bills will come due.

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Medical devices need their own law

Policymakers need to view devices and drugs differently in order to make them safe and consider regulating devices under the ministry of health

RAJIV NATH
Forum coordinator of Association of Indian Medical Device Industry (AiMeD

THIRTY YEARS HAVE gone by since the 1st medical device was regulated as a drug but a comprehensive regulatory framework still remains elusive. India imports 70-90% of its medical devices of which the vast majority are unregulated for quality and safety. While many of these products may have regulatory certifications in other countries, the reality is that a considerable number of them are being exported from countries that do not regulate their exports.

Our policymakers are surprisingly undecided and seem to be in no urgency to usher in a "Patient Safety Medical Devices Law" to protect patients, even after the recent ICIJ implant files or J&J incident, or the most recent ban on Trans-vaginal Pelvic Mesh by US FDA.

Devices do need to be regulated but, once again, the DTAB (Drugs Technical Advisory Board) has suggested forcibly notifying all medical devices that are engineering products as 'medicines' under the Drugs & Cosmetics Act and the road-map being defined by it does not entail migrating these to a separate 'Medical Devices Act' in due course. At present, only 23 out of over 5,000 medical devices are regulated by being notified as 'drugs'. Additionally, the health ministry has recently cherrypicked and notified 12 other products as 'drugs'. The medical devices market in India is over $10 billion (₹70,000 crore) and projected to grow to $50 billion by 2025 and is the fourth-largest in Asia.

Devices, not drugs

It's imperative to have a separate law as devices are engineering items and not medicines—an X-ray machine by no stretch of the imagination can be called a drug, and, so, continued attempts to regulate devices as drugs is illogical and incorrect unless assured that it is a temporary measure. A beginning was made to correct the anomalous situation with the introduction of the Medical Device Rules in 2018. These Rules have risk-proportionate controls correlating to the risk classification of devices. Similarly, the law and penal provisions need to be risk-proportional as you can't have the same penalty for a manufacturing failure of a pair of spectacles as for a contact lens or for an intra-ocular lens. Patient safety is more complex with devices where the same are 'a shared responsibility of the manufacturer, medical practitioners, product user and the regulator'. The Drugs Act itself needs reforms as it does not uniformly and equitably regulate quality from state-to-state in the absence of a national singular regulatory authority and there is no point of replicating this limitation for devices too.

Can a competent builder from Mumbai, experienced enough to make a 90-storey building, risk starting the construction of a 70-storey one in Gurgaon if the building by-laws there don't permit construction of over 36 floors only under hearsay that said by-laws are under amendment or will he wait?

At present, only 23 out of over 5,000 medical devices are regulated by being notified as 'drugs'.

Similarly, medical devices manufacturers need to know the legal requirements, penalties, rules and roles that every stakeholder in the system needs to follow, in a predictable manner. This will attract overseas and Indian investments. Presently, investors shy away from an unpredictable, incomplete and incorrect regulatory environment. In the absence of regulations, domestic manufacturing suffers as a surgeon is unsure of trying an unregulated device from a start-up on a live patient.

Road-map for a robust Medical Devices Law

Policymakers need to view devices and drugs differently in order to make them safe and consider regulating devices under the ministry of health as done for food. Food is not regulated under the Drugs Act or under DCGI, or the CDSCO, but has a FSSAI with a chairman and CEO.

The government should stick to its earlier assurance given to the industry by the MOH&FW in 2016 of four steps—starting with the Medical Devices Rules (MDR), initially experimenting with a few electronic devices under the MDR, the MDR to be amended as per experience gained after 6 months of introduction and the simultaneous drafting of a Medical Device Patient Safety Bill to be reviewed and passed by Parliament and the MDR to accordingly be tweaked in order for it to migrate to an eventual Medical Devices Law.

The National Accreditation Board of Certification Bodies is already accrediting certification bodies for voluntary quality assurance (the Indian Certification for Medical Devices (ICMED) scheme) under the QCI (Quality Council of India). Incentivizing ICMED certification by the QCI will help manufacturers in capacity building for voluntary compliance to quality standards, thereby ensuring global competitiveness and enabling the smooth transition to mandatory compliance under a Patient Safety Medical Devices Law. A strong and fair regulatory environment will help the Make in India campaign by encouraging the growth of this industry.

If we are serious about placing India as a top global medical devices manufacturing hub, then one needs to understand that piecemeal reforms will not work. Right from trade margin rationalisation to ensuring a separate set of legislations and regulatory frameworks to govern the medical device sector and everything in between needs to be looked at afresh to galvanise domestic manufacturing.

LETTERS TO THE EDITOR

A crude strategy

As crude prices continue to fluctuate, it is important to remove entry barriers, reduce dependence on OPEC's production policies and expedite the development of viable and alternative fuels in the economy, to increase long-term competitiveness and benefit consumers. Amid a relatively weaker currency valuation and rigid tax structure, defensive measures such as counting on limited sources to meet fuel needs, expecting increased production every time a price hike occurs and the cutting of imports are not only non-viable to implement but also largely insufficient to control the retail cost of fuel in the long-term. To serve the larger interest, it is prudent to overcome the oligopolistic and monopolistic practices. A uniform, tax-friendly, transparent, robust and conducive framework is thus required to mitigate uncertainties in the longer-run, wherein the potential impact on account of the daily revision would be overcome by means of efficient pricing

— Girish Lalwani, Delhi

Sword still in scabbard

Choosing not to stand from Varanasi, Priyanka has kicked her own and the party's feet. With this decision, and stating it as assistance to the Mahagathbandhan in UP, the Congress has scored a self-goal in the remaining rounds of voting, especially in the final UP rounds, which could well decide who will win in 2019. Priyanka, if she had contested, could have brought down Modi's victory margin. She would have lived up to her description as the Congress's Brahmastra, bestowed by her party. However, the weapon never left the docking area. In such a scenario, when the Congress party is not on a very strong footing, it makes all the more sense for the party to act humble before allies and try to get its desired results

— Mayank Khatri, Ujjain

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ILLUSTRATION: SHYAM KUMAR PRASAD

AMITENDU PALIT

The author is senior research fellow and research lead (Trade & Economic Policy) at the Institute of South Asian Studies in the National University of Singapore. Views are personal
amitendu@gmail.com
Twitter @Amitendu1

Protecting privacy without choking data

It appears the Supreme Court's judgment on Right to Privacy has provided the framework for RBI and DIPP to push hard on data nationalisation. These agencies now can fall back upon the judicial intent of safeguarding civil liberties for defending their policies on local data storage, restricting cross-border transfer, and even refraining from participating in global trade negotiations. This is unfortunate

INDIA'S SEARCH FOR a data protection framework began from the Supreme Court judgment on the Right to Privacy delivered on August 24, 2017. The judgment, which overturned the Court's earlier contrary judgments on the subject, highlighted the judicial intention of protecting personal information of individuals with the greater objective of protecting civil liberties.

Since then, much has happened in the sphere of data protection.

While the Srikrishna Committee has submitted its report on a national data protection framework and the ministry of electronics and information technology (MeitY) has circulated the Personal Data Protection Bill, 2018, the Reserve Bank of India (RBI) has issued rules for local storage of payments data. The RBI rules followed the circulation of the draft Digital Information Security in Healthcare Act (DISHA) that seeks to empower the health regulator to localise data. And finally, the RBI rules were followed by the issue of the draft National e-Commerce Policy by the Department of Industrial Policy and Promotion (DIPP) earlier this year, which forcefully restricts sharing of Indian data abroad.

The series of developments since the Supreme Court judgment conveys a couple of distinct impressions. The first is that of the Supreme Court judgment inspiring regulatory activism. This is particularly visible in a situation where India is yet to create an umbrella authority for regulating data. And the second impression is that of a judicial judgment delivered for protecting civil liberties being used by regulators and government agencies to justify protective economic policies.

Some analysts have argued that the Personal Data Protection Bill, 2018, proposes the template for data localisation in India. This is debatable. However, given that the Bill is premised on the core objective of safeguarding personal information and preventing breach of such data, it is not surprising that it proposes certain categories of sensitive data, defined as 'critical' personal data, needs to be stored *exclusively* in a server or data centre located in India. For non-sensitive personal data, the Bill needs processors to 'mirror' or store at least one copy of the data in an Indian server. The latter is transferable outside India, including to specific countries and sectors in these countries, if so decided by the central government and the Data Protection Authority that the Bill proposes to establish. These countries, obviously, need to be jurisdictions providing 'adequate' level of data protection, which could have been the influence of the European Union's General Data Protection Regulation (GDPR).

The larger point to note though is that the Bill provides for cross-border transfer of even sensitive 'critical' personal data 'to a particular country, or to a particular international organisation that has been prescribed under clause (b) of sub-section (1), where the central government is satisfied that such transfer or class transfers is necessary for any class of data fiduciaries or data principals and does not hamper the effective enforcement of this Act' [Section 41(3)(b)]. In effect, this clearly implies that, under specific conditions, the government can certainly allow transfer of sensitive personal data, including financial data, health data and data protected by passwords.

The flexibility on data transfer allowed in the Personal Data Protection Bill of 2018, however, is missing from the rules that RBI has announced for local data storage. Except for mentioning that only data for the foreign leg of the transaction, if any, can be stored overseas, the RBI rules insist on storage of end-to-end payments transaction data only in India. Financial data is defined sensitive by the Data Protection Bill. But while the latter mentions conditions under which such data can be transferred abroad, the RBI rules are completely silent in such possibilities.

> The flexibility on data transfer allowed in the Personal Data Protection Bill of 2018 is missing from the rules that RBI has announced for local data storage

There are two implications of the silence. First, RBI takes a much more strict, overarching and restrictive position on data transfers than the Personal Data Protection Bill, 2018, does. Second, it raises questions on which authority will have the final call on deciding circumstances over transfer of sensitive data. On payments data, for example, would it be RBI's prerogative or that of the Data Protection Authority and the central government?

The overarching and strict posturing is also evident from the draft National e-Commerce Policy prepared by the DIPP. The policy not only prescribes localisation for all data generated by the Internet of Things (IoT) in public space, but also suggests narrow and limited grounds under which cross-border data transfers can happen. Furthermore, in going where no other rules and policies have gone, the policy insists on businesses storing Indian user data abroad to give immediate access to such data by central government agencies if they wish such access.

What is perhaps becoming increasingly clear is that the Supreme Court's judgment has provided the framework for RBI and the DIPP to push hard on data nationalisation. These agencies now can fall back upon the judicial intent of safeguarding civil liberties for defending their policies on local data storage, restricting cross-border transfer, and even refraining from participating in global trade negotiations like informal e-commerce talks. This is truly unfortunate.

The implications of draft PE attribution rules

ASHWIN VISHWANATHAN

The author is tax partner, EY India. Views are personal

The proposals seek to create an artificial distinction between arm's length price and arm's length profit

ATTRIBUTION OF PROFITS to a permanent establishment (PE) has been a confounding issue of taxation. The government's intent to bring clarity, consistency and predictability to this is a welcome step. Releasing the recommendations for public consultation is even more laudable as it encourages key stakeholders to collaborate and co-develop a fair framework. The recommendations in their current form have far-reaching ramifications for all businesses and, thus, require reconsideration of several aspects.

Implications for business: Discarding the arm's length principle in favour of a mechanical fractional apportionment may be ambiguous. It is likely that this may create differences with international principles, double taxation and lead to disagreements across borders as other countries may not necessarily subscribe to the same methodology.

The proposals seek to create an artificial distinction between arm's length price and arm's length profit, even though the latter is universally used to infer the former. General economic principles under rational behaviour and, consequently, the arm's length standard expect entities to earn a return commensurate to their functions and risks, and what similarly placed independent parties in the market would earn irrespective of their corporate form. By creating this artificial distinction, a taxpayer group may end up being differently taxed depending on the legal entity form chosen to operate in India. A subsidiary will be held to a differential benchmark compared to a PE (i.e. a branch office or a project office). This appears to contradict Indian tax law itself, which enshrines the arm's length principle applying equally to PEs. The form of presence in a country for a multinational group is a decision contingent on a variety of commercial, regulatory and legal factors, and this sort of PE taxation regime could be a disincentive for foreign investment in India.

The need for a new profit attribution methodology is premised on the argument that the transfer pricing principles using the functional, asset & risk (FAR) analysis only address the supply side of the economy, while profits are a function of both supply and demand. Profits of an enterprise are driven by the market in which it operates and factors influencing the industry therein, and will reflect demand and supply conditions. To separately build in additional compensation for a market jurisdiction through the three-factor method based on equal weight to sales (representing demand) and manpower and assets (representing supply including marketing) seems difficult to understand and justify. A deeming profit margin of 2% in cases where the global profit is either negative or less than 2% further weakens the underlying premise of this methodology since the demand factor is presumed to impact profit but not loss. It is also unclear how global profit would be identified in situations where a group has multiple business segments or activities and only one or a few of them are conducted in India.

The three factors are also debatable in the current environment where business models are rapidly evolving and supply chains are transforming radically, given the digital wave. The weights assigned to these factors may further vary across businesses and impose a straitjacket on computing taxability without taking into account economic reality.

Digital businesses commonly characterised by scale without mass, reliance on intangibles, and data and user participation will face a fourth factor, i.e. 'users' in determining profit attribution subject to the significant economic presence criterion. Users would carry a 10-20% weight depending on the user intensity of the business. User intensity itself is a subjective concept and will require greater elucidation and clarity before it can be applied in any formula.

The next steps: Companies need to review and monitor their business models for implications of these proposals even though they are not final. The public consultation process is a good opportunity for taxpayers to submit their thoughts and ideas to the government, and explain their reservations on some of the recommendations and alternative policy formulations to be considered.

This is a question with multiple dimensions requiring a carefully crafted solution. Half measures or hasty implementation will defeat the stated aim of clarity and predictability on this issue.

IND AS 109

Does it make life easier for hedgers?

Ind AS 109 is the harbinger of commodity risk management culture

MUZAMMIL PATEL & RUCHI SHUKLA

Patel is MD, Acies Consulting, Shukla is AVP, Research, MCX. Views are personal

THE TRANSITION TO Indian Accounting Standards (Ind AS) has been a landmark change for Indian industry, bringing about a paradigm shift in accounting and reporting practices. The new standards are increasingly principle-based and enable alignment of accounting with an entity's risk management practices. By reducing the emphasis on statistical hedge effectiveness testing, Ind AS 109 allows for hedging instruments to qualify as effective hedges based on their economic relationship with the underlying exposure. Removal of the bright line (i.e. the 80:125 rule) puts the focus on actual economic offset as opposed to a theoretical statistical offset between hedges and underlying exposures. The standard also recognised that an entity may choose to hedge only part of its price risk (for example, the pricing benchmark portion) and allows for effectiveness to be assessed only against this component of the entire exposure.

So, how does Ind AS 109 make life easier for hedgers? One major change introduced by Ind AS 109 over earlier standards is with respect to time value of options. Risk managers widely recognise that, for an initial outlay, options can be a very effective risk management instrument in terms of flexibility, cost and no commitment to giving up upside in a hedging transaction. The price for an option contract is the option premium, i.e. the price that the option buyer pays, and the option seller receives for the rights granted under the option. This option premium has two components: intrinsic value and time value. Intrinsic value is determined in terms of the difference between the strike price and the current market price of the underlying, while the remaining value of the option is time value that reflects the volatility of the price of the underlying, interest rates and the time remaining to maturity. From an accounting perspective, however, time value of options, whether on plain vanilla options or option structure, had the propensity of introducing volatility to earnings. This is because earlier hedge accounting standards required time value to be reassessed at each reporting date. Change in time value was required to either be recognised in the earnings statement or treated as part of statistical hedge effectiveness testing depending on whether time value was split or not at the time of hedge designation.

Where time value was not split, volatility in time value could impact adherence to the bright line, thereby causing far greater volatility to earnings. Hedging is supposed to reduce earnings volatility and this asymmetric accounting treatment, at times, deterred risk managers from engaging in option transactions, thereby taking away a significant instrument from the risk management toolbox.

Under Ind AS 109, where hedge accounting is applied, option premium can be either amortised over the life of the hedged item (i.e. underlying exposure) or can be included in the carrying value of the hedged item depending on the nature of the hedged item. Both these accounting treatments allow for reduction in earnings volatility and a more accurate depiction of the risk management strategy of the organisation.

In the first scenario, an entity can amortise time value (i.e. cost of hedging) over the life of the hedged item where the intention of the hedging transaction is to obtain protection over a period. Where an entity holds inventory whose value may fluctuate and impact earnings, such an entity may buy an option with the intention to protect earnings statement from volatility in inventory revaluation. In such cases, it is possible for the entity to amortise time value of options in a systematic manner. This allows for greater stability and predictability in reported earnings.

In the second scenario, an entity can carry the change in the fair value of the time value component in 'other comprehensive income (OCI)', i.e. as part of equity. When the hedged item is recognised in the books, the amount is recycled from the OCI to the carrying value of the hedged item in case of non-financial hedged items. In case of financial hedged items, the amount is recycled to the earnings statement at such time where the hedged item impacts the earnings statement. This removes any interim volatility in earnings and recognises time value of options as a cost that can be adjusted in the carrying value of a hedged item. Where an entity hedges the forecast purchase of gold using options whose intrinsic value is zero (i.e. strike price is equal to market price) and time value is ₹1,00,000, the entire ₹1,00,000 and any subsequent changes in the value of ₹1,00,000 can be carried in the OCI. Once the physical gold is actually procured, the amount carried in the OCI will be added to the value of the gold procured. This treatment enables elimination of earnings volatility. More importantly, it allows for accounting to align with the risk management intention, i.e. pay for protection against rise in future prices at a predetermined cost, thereby effectively procuring in the future at a price adjusted for time value of options.

In both the scenarios, however, it is important for organisations to consider aligned time value, i.e. time value should only relate to the hedged item in such a way that it aligns all critical terms of the hedged item and hedging instrument.

The accounting treatment for option contracts permitted by Ind AS 109 represents a significant enhancement from earlier standards. It also allows risk managers to execute their hedging strategy without worrying about asymmetrical accounting treatment as per earlier standards. Where organisations are ready to incur an initial outlay to ensure downside protection without giving up upside, Ind AS 109 removes accounting vagaries associated with option transactions. In a nutshell, Ind AS 109 provides for delivering the value of commodity risk management appropriately on the balance sheet and to make risk management a culture amongst commodity ecosystem stakeholders.