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Industries at risk due to economic crimes: Aerospace & Defence

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Key Messages

Key characteristics of the A&D industry makes it vulnerable to economic crimes



Globally, economic crime in the Aerospace and Defence sector is one of the least reported in comparison to other sectors

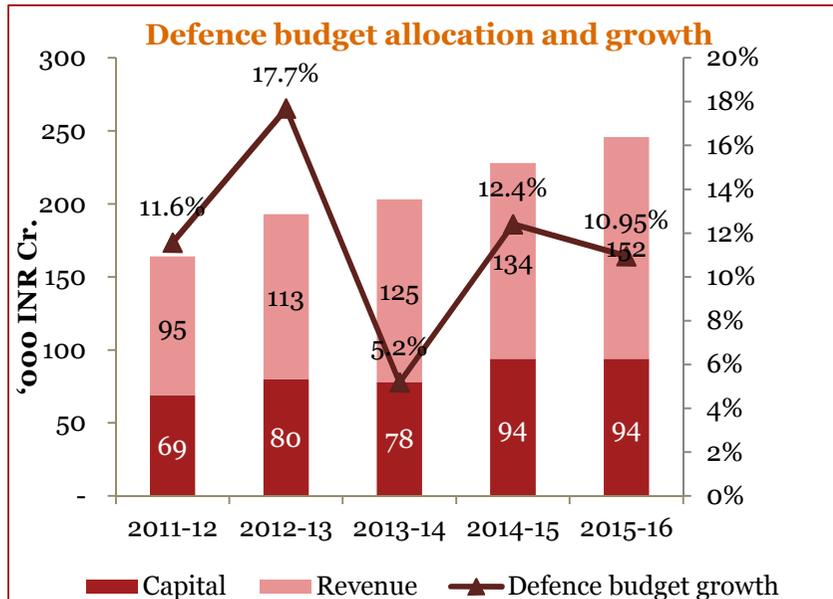


Government has continuously focussed on making procurement transparent, but challenges remain

Indian A&D sector – An overview

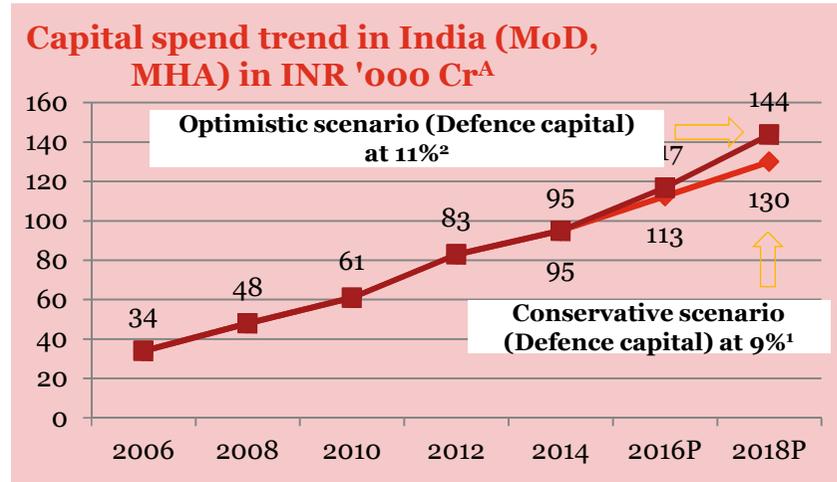
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India's defence budget has grown to INR 246 k Cr, with 40% of it being capital spends, expected to grow to INR 130-144k Cr by 2018

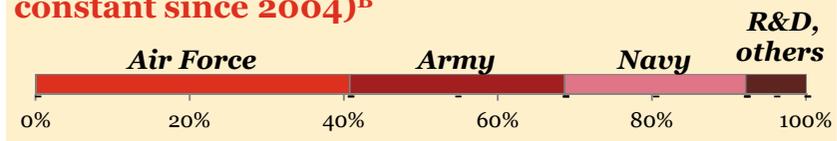


Key Insights:

- The Indian government typically spends around 2% of GDP on defence related expenditure (~40% is capital outlay)
- The nominal defence budget allocation is **increasing YOY by around 10%**
- India ranks among the top 10 countries in the world in terms of military expenditure yet imports 70% of defence equipment



Breakup of capital spend (almost constant since 2004)^B



Assumptions:

1. Conservative scenario (Defence capital spend - Scenario 1: Assuming IMF projections for India's GDP, 2004-11 average %age GDP spend on defence (2.1%) as well as 2004-11 average %age capital spend (43%))
2. Optimistic scenario (Defence capital spend - Scenario 2: Assuming 10.9% Y-o-Y growth in Capex (CAGR 2004-11)

Source: PwC report, Stockholm International Peace Research Institute (SIPRI), MoD, IMF's India GDP projections, MHA Annual Reports, News reports;

*A. Excluding spend on R&D, others – 9% of total defence outlay; the capital spend estimates are supported by the visibility of programs as on date, B. Budget for 2015-16 has outlined a similar mix of capital spend

Indian Defence industry supply side segmentation

DEFENCE PUBLIC SECTOR UNDERTAKINGS (DPSUs)

Grown tremendously through protection
Responsible for strategic requirements of armed forces
Have developed and acquired new technologies
Large backlog of orders

OEMs & LARGE/MID SIZED INDIAN COMPANIES

OEMs and Tier-1s looking towards lower cost destinations - India in the scheme of things for all majors

Aggressive capability building by big houses like Tata, L&T, M&M; Reliance new entrant

Mid sized and small players like Dynamatic, Aequus Technologies, Maini Group, TAAL building capabilities/diversifying products to cater to a larger value chain

IT/ENGINEERING COMPANIES

Active in the field of avionics
Big players have separate aerospace vertical: Wipro, Infosys, HCL
Offer complete solutions ranging from Product Design and Development, Embedded Systems and Avionics to Product Lifecycle Management services
Have capability to undertake, sustenance and verification activities in several aircraft subsystems

MSMEs

~ 6000 MSMEs – Fragmented; mainly catering to DPSUs, offsets. Increasing # of success stories – Centum, Alpha Design Technologies, Coreel, etc
Have potential but require further support from Government & large private players
Key pain points – access and cost of capital, building capability, accreditation

The present government is working to build a facilitative environment for private investment

Market Attractiveness

- Fastest growing civil aviation market
- Vast talent pool of engineering
- Obsolescence of military equipment
- High defence & commercial aircraft demand
- Strong domestic manufacturing base
- Cost advantages
- Well-educated talent pool
- Abundant low cost skilled workforce
- IT competitiveness
- Growing R&D and design base

Government Initiatives

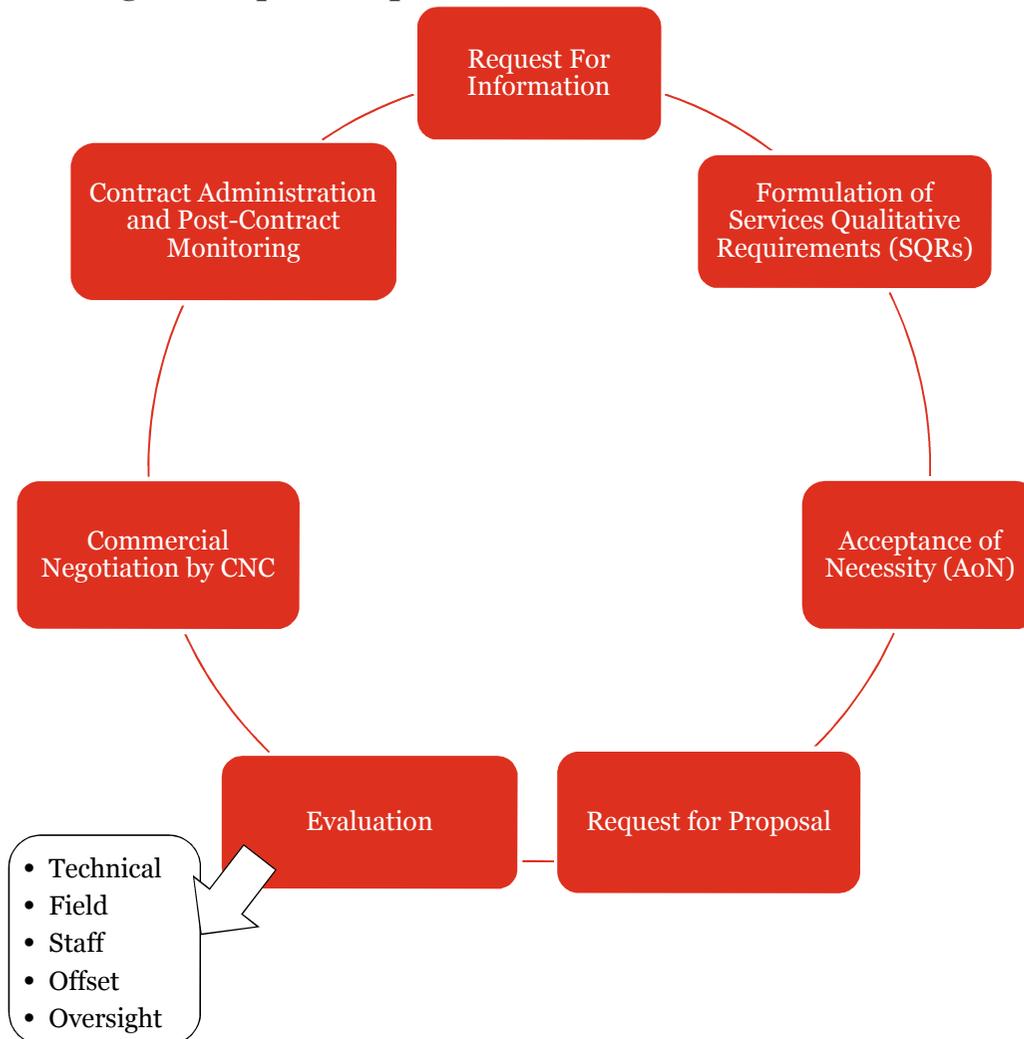
- Make in India campaign
- Push for private participation
- Increase in FDI cap to 49%
- Streamlining of licensing regulations
- Initial validity of IL extended to 15 years, further extendable up to 18 years
- Security Manual Issued
- Revamping of offset policy and DPP in progress
- Flexibility in relation to nomination or change in offset partners post signing of contract
- Level playing field- ERV benefit extended to private sector
- Smaller defence deals brought under the ambit of "integrity pact"
- List of military stores requiring NOC of DoDP notified by DGFT
- End User Certifications now required only from the immediate buyer
- Strategy for export of defence products notified
- National Policy on Electronics includes Avionics

Procurement Procedure in India

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Defence Procurement Procedure – A glimpse

Stages in acquisition process



DPP – First formulated in 2002. 6 revisions thereafter

Scope

Cover all capital acquisitions undertaken by MoD

Objective

- Expeditious procurement
- Development of indigenous defence sector
- Conformity to highest standards of transparency, probity and public accountability
- Fair competition

Provisions in DPP to promote transparency

Relevant Issues

- **Integrity Pact:**

- An 'Integrity Pact' is signed between government department and the bidders for all procurement schemes over INR 20 crore – not to accept/ offer bribes during the procurement process
- As per Article 22 of Standard Contract document, *“giving or offering of any gift, bribe or inducement or any attempt at any such act on behalf of the SELLER towards any officer/employee of the BUYER or to any other person in a position to influence any officer/employee of the BUYER for showing any favor in relation to this or any other contract, shall render the SELLER to such liability/ penalty as the BUYER may deem proper, including but not limited to termination of the contract, imposition of penal damages, forfeiture of the Bank Guarantee and refund of the amounts paid by the BUYER.”*
- Violation of the above provisions – Cancellation of the contract (all or any other contracts with the seller) and recovery of the amount of any loss arising from such cancellation.

- **Agents/ Technical consultants/ Authorized vendors :**

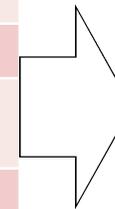
- Confirmation/ declaration that no individual or firm, has been engaged to intercede, facilitate or in any way recommend to the Government to the award of the contract to the Seller; nor has any amount been paid, promised or intended to be paid to any such individual or firm in respect of any such intercession, facilitation or recommendation.
- Required to give an undertaking to disclose all payments made in connection with the contract in question to anybody (including agents and other middlemen)

Economic crimes in A&D industry

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The defence market does not have free competition: Inherent distortions make it susceptible to economic crime

Characteristics	Impact
Highly regulated <ul style="list-style-type: none"> • Manufacture • ToT • Sales – domestic & export • Security clearance 	Large number of sanctions required Raises entry barriers – restricts number of players
Information asymmetry	Suppliers – Specifications, rue price Buyers – Long term demand
Monopsony – single buyer and L1 basis	Win-lose situation
Close knit buyer group	Fewer people to influence, scope for middlemen
Cutting edge technology – complex specs	Difficult to comprehend
Shrinking budgets	Intense competition
Limited suppliers and frequent complaints	Limit buyer options
High transaction costs	Greater risks
Large deal size	Increases stake for suppliers
Grey market – very lucrative	Increased temptation to violate laws
Lack of transparency in procurement	Greater scope
Conviction difficult	Encourages agents

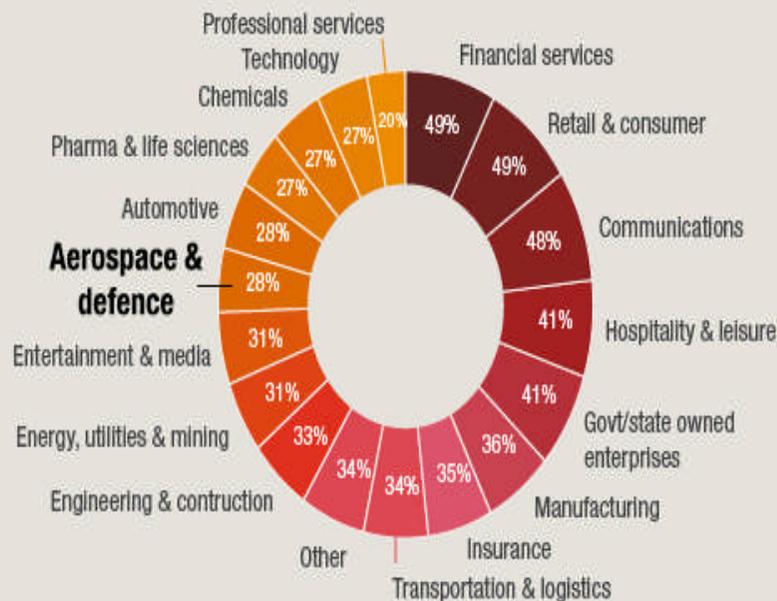


Economic Crime
<ul style="list-style-type: none"> • Bribery & Corruption • Speed money • Money laundering • Theft of intellectual property • Cyber crime • Award of non-competitive contracts • Smuggling

Globally, economic crime in the Aerospace and Defence sector is one of the least reported in comparison to other sectors

Reporting of Economic crimes (industry-wise)

By industry, economic crime is most commonly reported in the financial services, retail and consumer, and communications sectors. Nearly 50% of respondents in each said they had been crime victims.



Key insights:

- One in three organizations reports being hit by economic crime.
- The highest levels of economic crime are consistently reported by respondents in Africa (50%) and North America (41%).
- According to PwC's Global Economic Crime Survey 2014, economic crime has been reported by 28% respondents in the Aerospace and Defence sector
- According to Trace International, aerospace and defense industry members have accounted for approximately 12% of the world's anticorruption enforcement actions since 1977, second only to the extractive industries like oil and mining.
- Transparency International (TI) describes the defence sector as one of the most secretive, and one in which it is difficult to openly discuss corruption issues
- Aerospace and defence companies have unique risks due to the large scale and value of contracts, fierce competition and the complexity of the regulatory and compliance environment.

Western nations have established strict anti corruption laws

United States	United Kingdom	Other BRIC Countries	India
<p><u>Foreign Corrupt Practices Act, 1977</u> –</p> <ul style="list-style-type: none"> • Anti bribery provisions – Prohibits offering, paying, or giving anything of value • Accounting records provision – Requires companies to maintain its accounts properly 	<p><u>UK Bribery Act, 2010</u> –</p> <ul style="list-style-type: none"> • Covers corruption in public and private sector • Does not require proof of corrupt intent • Creates new form of corporate liability for failing to prevent bribery and provides for only one defense—that an organization had “adequate procedures” in place to prevent bribery. 	<ul style="list-style-type: none"> • China amended its criminal code to make paying bribes to foreign government officials a crime. • Russia – introduced measures that imposes criminal sanctions on companies and individuals who make corrupt payments to foreign public officials. 	<p><u>Prevention of Corruption Act, 1988</u> –</p> <ul style="list-style-type: none"> • Act enacted to combat corruption in government agencies and public sector businesses in India • Applies to bribe taker, giver of bribe and any middlemen • Offence punishable with imprisonment and fine <p><u>Indian Penal Code, 1860</u></p> <ul style="list-style-type: none"> • Offence of bribery punishable with imprisonment and fine

Select example of corrupt practices in defence	
<p>Florida based defense company IAP Worldwide Services Inc paid US\$7.1 million to settle a U.S. investigation into an alleged conspiracy to bribe Kuwaiti officials to win a government contract</p>	<p>Rheinmetall Defense Electronics, a subsidiary of German defence contractor Rheinmetall, has settled a foreign bribery investigation with Bremen’s public prosecutor and agreed to pay a €37 million penalty.</p>
<p>BAE Systems paid \$2 billion in bribes to Saudi Arabian ambassador Bandar bin Sultan in a multi-billion-dollar arms deal.</p>	<p>Safran was convicted and ordered to pay 500 000 euros in penalties by a Paris court for bribes paid by Sagem to Nigerian officials.</p>

Defence deals attract controversy

Deal	Year	Deal amount (original year figure)	Allegations/ Remarks	Outcome
Bofors scandal	1986	\$ 285 mn	Receiving kickbacks from Bofors AB for winning the bid to supply India's 155 mm field howitzer	Blacklisted Bofors from doing business in India
Denel Scandal	1999	\$ 386 mn	Commission paid to a firm to swing 5 contracts signed from July 1999 onwards	Blacklisted but 8 years later, CBI closed the case as allegations could not be substantiated
Barak missile scandal	2000	INR 1150 crores	Bribe paid for swinging the deal	CBI closed the case in absence of any substantial evidence
Scorpene deal scandal	2005	INR 18,798 crores	Bribe paid to decision makers	No evidence of corruption in the deal. Scorpene submarines are now being built in India under a technology transfer agreement that was part of that contract.
VVIP chopper scandal	2010	INR 3600 crores	Bribery and corruption involving several senior officials	Cancellation of contract on grounds of breach of Pre-contract Integrity Pact and the agreement by the company – trials yet to commence in India
Tatra –BEML Scam	2012	INR 3000 crores	Embezzlement of Government funds perpetrated by BEML in collusion with MoD	CBI closed the case in absence of any substantial evidence

Source: Media reports, *International Journal*, Article by Surojit Chakraborty

Preventive measures taken by the private sector in developed countries

CEOs and Boards of Directors

- Ensuring a robust ethics and anti-corruption programme. Encouraging periodic independent review.
- Disclosing the programme fully on your company's website.
- Speak up strongly against corruption inside the company and in public fora.

Investor engagement teams, portfolio managers, and analysts

- Explaining the ethics and anti-corruption programme.
- Showing the results of independent reviews.

Procurement chiefs in arms importing countries

- Formulating effective ethics and anti-corruption programmes in place, and that they are made public.
- Explaining Ministry of Defence (MoD) regulations on the subject to all concerned

Government officials responsible for offsets

- Encouraging bidding companies to publish their detailed offset obligations.
- Encouraging publishing of annual performance assessments of their offset obligations.

Arms exporting governments

- Formulating robust ethics and anti-corruption programs

Recommendations

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Recommendations for reducing economic crime in defence sector in India

Create specialist procurement agency – multi disciplinary specialists

Encouragement / protection to honest officers

Improve and speed up prosecution

Institutionalize out of courts settlement

Blacklisting entire group companies counter productive – last resort, grave and serious offense

Conduct due diligence of supplier before engaging – working with reliable partners

Stricter corporate governance: zero tolerance policies

Whistleblower protection

Thank you

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