India's Investment Environment – February 2009

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I. Introduction

While other nations are reeling under the strain of the global meltdown, FDI inflows into India are still going strong. India ranks as one of the most favoured destinations for foreign investors because of its growing economy, an emerging middle class with high purchasing power and success in almost every sector of the industry. Despite the global meltdown, FDI inflows into India have not weakened much. India is expected to receive $30 billion in FDI in the current year, which is however still short of the official target ($35 billion) by about 14 percent. The government has taken various measures including liberalisation of FDI policy to make India an attractive investment destination.

II. Expected changes in FDI rules

The following changes in FDI rules are expected in the near future:

(i) Norms for indirect FDI eased
As part of its effort to rejuvenate declining capital inflows, the government, through Press Notes 2 and 3 of 2009 (http://siadipp.nic.in/policy/changes/pn2_2009.pdf, and http://siadipp.nic.in/policy/changes/pn3_2009.pdf) has rationalised indirect FDI norms. The move would enable foreign entities to hold higher stakes, with possible FDI components, in joint ventures with firms owned and controlled by Indians.

With the changed FDI norms, the government has decided to adopt a more liberal classification of foreign investment types for calculating foreign investment in downstream companies. Now only direct investments by a non-resident company into an Indian company will be counted as foreign investment. However, if the foreign investment is through an Indian investing company that is owned and controlled by resident Indians, it will not be considered as foreign investment. A company will also be considered as Indian owned if more than 50 percent of the equity is beneficially owned by resident Indians and Indian owned and controlled companies

The crux of the new policy is that ownership and control would determine whether or not a foreign holding in a company is to be treated as foreign investment. The primary objective of the policy is to ensure that ownership of Indian companies in sensitive sectors is not transferred to foreign companies. Now it will also become mandatory for the Indian company to take FIPB approval for transferring ownership or control to a foreign company in restricted sectors such as telecom, air transport services, broadcasting and defence

production. Till now, the transfer of equity from resident to non-resident entities, including acquisition of shares in an existing company, was on automatic route, subject to the sectoral policy.

However, to clarify things, the government has issued a set of guidelines through Press Note 4 of 2009 (http://siadipp.nic.in/policy/changes/pn4_2009.pdf).

(ii) FDI in mortgage guarantee companies brought down to 49 percent

As discussed in the earlier FDI update, the government has brought down the FDI limit in mortgage guarantee companies (MGCs) from 100 percent to 49 percent. The recent guidelines of the Reserve Bank of India (RBI) prohibit the holding of equity stake in a MGC by a foreign investor in excess of 49 percent. Mortgage guarantee is an insurance tool that helps an individual to buy a house with minimum down payment.

(iii) Realtors may be allowed to divert surplus FDI to other projects

The government is expected to waive end-use restriction and allow realty developers to divert surplus FDI to real estate projects. As per the existing norms, FDI is allowed only in projects which cover a minimum area of 10 hectares and involve a certain minimum level of investment - 10 million in the case of wholly owned subsidiaries and $5 million for joint ventures.

With the revised condition, a real estate company which has brought in FDI into a project meeting the mandated conditions can now use surplus funds in another project which may not meet the prescribed conditions. While the new norms will do away with the end-use restrictions, it may also nullify the various mandatory norms pertaining to FDI use. This is being deliberated by the government in view of the difficulties being faced by the cash strapped real estate sector.

(iv) Foreign investment via partly-paid shares allowed

The FIPB has removed ambiguities in the rules regarding partly paid equities. Now, Indian companies can issue partly paid up equity shares to foreign firms provided these are converted into fully paid up shares within 18 months.

While the Foreign Exchange Management Act (FEMA) does not allow issue of partly paid up shares to non residents, the Companies Act permits it. The FDI policy was so far silent on this instrument and FDI through this route was allowed only on a case-to-case basis.

III. News & Views

(i) With revised FDI norms, Indian companies may now be in breach of sectoral caps

It is being argued that revised FDI norms certainly widens the scope for additional foreign investment and will be beneficial for companies under partial Indian ownership that are constrained by existing FDI ceilings. Sectoral caps and prohibition might not apply for such companies even in previously protected sensitive sectors such as telecom, media, defence, banking and aviation.

But concerns are being raised that revised norms may result in several foreign investment compliant (under old norms) Indian companies breaching sectoral caps as the total foreign

investment in an Indian operating company would now be calculated as the sum of direct and indirect foreign investment. For example, in the telecom sector, where foreign investment is capped at 74 percent, consider a scenario under which an Indian operating company gets 37 percent FDI from foreign company A and 49 percent indirect investment from an Indian investing company which in turn has 75 percent foreign equity from foreign company B. Under the earlier norms the foreign investment would have been 37% + 75% of 49% (36.75%) amounting to 73.75 percent which is compliant with the sectoral cap. With the revised norms the total foreign investment will be 37% + 49%, amounting to 76 percent, thus breaching the sectoral cap of 74 percent.

(ii) Which way the policy will swing is not clear

It is being argued that the flip-flops in the recent FDI guidelines and confusion created by Press Notes 2 and 3 of 2009 have resulted in much uncertainty about the future course of FDI policy. The Press Notes display the discomfort of Indian regulators in dealing with offshore multi-layered investments with demons of drug money, tax evasion and round tripping lurking in all corners.

(iii) Increased FDI with opaque corporate structures and round about policy rules will not help

It is being debated that instead of opacity on the policy front, the requirement is for clear-cut rules, transparency and institutional capacity to smoothly coagulate funds on the ground in reasonable time. The changed norms are meant to incentivise FDI and cross border funds flow, against the backdrop of the resource crunch that domestic promoters are currently facing.

But what has happened to the FDI that has already come to India? Several investment projects have been shelved and indefinitely delayed. The fact remains that FDI does shore up growth, complete with attendant spillovers for technology, managerial skills and operational know-how in the domestic economy. It is being argued that India is possibly not capitalising on these potential benefits to the fullest extent because of its rather opaque corporate structures and convoluted rules. The focus should be on transparently easing the flow of foreign investments rather than creating loopholes or new hurdles.

(iv) New FDI norms will make foreign companies hawkish on profit sharing

Whether foreign investment will actually flow into sectors without corresponding surrender of control to foreign companies is a matter which is being debated. Even if that is the case, there is also every chance that indirect control by foreign companies may continue and these may extract large amounts of profit by using an array of methods. This will be possible because the new FDI norms are clear about equity sharing but have little to say on profit sharing. Even under the existing norms, foreign investors have been able to exercise effective control through various methods despite a minority share. The revised policy undermining the FDI ceiling would further this process.

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