India's Investment Environment – August 2008

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I. Introduction

India is ranked the second best country after China for business investment by *Winning Strategies in Economic Development Marketing* survey which is based on the opinion of American corporate executives. It is also supported by the fact that India is fast catching up with China in foreign direct investment (FDI) flow as capital inflows through FDI has crossed US$10bn in the first quarter of this fiscal. The FDI flow shot up to US$22bn in 2006-07 and US$32bn in 2007-08 and is expected to reach US$40bn this fiscal. The reasons for this spurt are strong corporate incentives to invest, namely high domestic demand and high capacity utilisation rates amidst improved profitability in the last few years.

The overseas investors are also seeking out Indian partners for advice as the Indian market has certain peculiarities which domestic advisory firms can deal best with. It is a new Knowledge Process Outsourcing (KPO) format – one that entails outsourcing of investment decision inputs by global funds to Indian investment managers. The Government also plans to set up at least 20 foreign investment facilitation centres abroad in a bid to attract more FDI. Initially, 10 investment promotion centres would be established in the US, Japan, Taiwan, Germany, Singapore, South Korea, France, the UK, Switzerland, and Italy.

II. Expected Changes in FDI Rules

Following changes in FDI rules are expected in the near future:

i FDI cap in cable and DTH may rise to 74 percent

The Government is expected to raise the FDI cap to 74 percent from the present level of 49 percent in cable and direct-to-home (DTH) telecast services. The Telecom Regulatory Authority of India (TRAI) is asking for a complete and holistic review of FDI policy to hike the FDI cap in all forms of broadcast signal distribution to 74 percent, i.e. in Cable TV, Head-end-in-the-Sky (HITS), DTH, Internet Protocol TV (IPTV) and mobile TV. TRAI has also recommended hike in the foreign investment limit for news and current affairs television channels to 49 percent from the present level of 26 percent. For FM radio, the FDI cap could be raised to 26 percent in the case of news and current affairs channels, and 49 percent for non-news channels.

At present, there is a wide variation in FDI caps across different sub-sectors in telecommunications and broadcasting. The current policy also does not specify the FDI limit for HITS. The inconsistency in the policy is best illustrated by the example: delivery of television signals through satellite based technology (DTH) has an FDI cap of 20 percent, but distribution of the same content attracts an FDI cap of 49 percent through cable and 74 percent if offered by an Internet Service Provider (ISP) or telco on the IPTV platform.

ii FDI cap in insurance to be raised to 49 percent

The group of ministers on insurance has given the green signal to raise FDI cap in the insurance sector to 49 percent from the existing 26 percent. The panel has also recommended revising the Insurance Laws (Amendment) Bill, which contained the FDI hike proposal, since some new provisions have been included in the amendment.

iii FDI in sensitive sectors may go off automatic route

Flow of FDI into sensitive infrastructure sectors, such as airports and ports may be taken off the automatic route. The Government is considering the clearance of sensitive projects only after thorough verification under the proposed National Security Exception Act. The proposed law would work on the lines of the Exxon-Florio rule in the US, which enable authorities to stall foreign firms from buying assets in the US if it compromises national security. However, the Finance Ministry and Department of Industrial Policy & Promotion (DIPP) has been against such legislation.

The policy makers have now begun a review of their stand in view of increasing security apprehensions. The concern about these sectors is not so much related to the building of infrastructure but about its operation as also inflow of capital from tax heavens like Cyprus, Mauritius, and Cayman island.

iv. Joint venture companies with foreign equity will need fresh approval

The Government is planning to rework the FDI policy for holding companies. Joint venture companies with foreign equity will need to seek fresh approval from the FIPB within 90 days while investing in down stream companies like subsidiaries. The Foreign Investment Promotion Board (FIPB) clearance will be mandatory to avoid imposition of penalty by the Reserve Bank of India (RBI).

The Government is also going to decide whether issue of equity shares by an Indian company to PIOs and NRIs would be allowed through the automatic route. The liberalised procedures for governing the conversion of lump sum fee for technological transfer; royalty, and import of capital goods into equity are also expected. Once these norms come into place, companies can convert even interest payments into equity much faster.

v. The Press Note 9 of 1999 is expected to come around to haunt FDI investors

The Press Note 9 of 1999 is expected to come around to haunt FDI investors as FIPB is interpreting the Note differently. The Note was a step taken by the regulatory authorities to liberalise the investment regime for foreign companies and enable foreign owned Indian holding companies to make down line investments under the automatic route subject to the condition that the company in which the investments are to be made should qualify to be under the automatic route in the current FDI policy.

Now the regulatory stance is that if an operating company with existing FDI makes a further down line investment or acquisition, the character of the company changes from an operating to an operating-cum-holding company as envisaged under the Press Note 3 of 1997 and Press Note 9 of 1999. Since the investment company is not covered under the approved activities of a Non-banking Financial Company (NBFC) in the current FDI policy, therefore, whenever such an operating company makes a down line investment, the character of the company changes from operating to holding company. Thus, for making a down line investment, the company shall require the prior permission of the FIPB.

vi. Investment cap in stock exchanges may not be raised

The Securities and Exchange Board of India (SEBI) is expected to discuss the proposal to raise the investment limit for single investors-individual or institutional – in stock exchanges from the present 5 percent level to 15-20 percent. But the Government is unlikely to raise the limit. The concern is to what extent profit-oriented corporates could be allowed to take over public investment platforms. At present, there is a cap of 49 percent foreign investment in stock exchanges. Within that limit, total FDI in exchanges could go up to 26 percent while total Foreign Institutional Investor (FII) could not go beyond 23 percent. And any single investor cannot have a stake of more than 5 percent in the exchange.

vii. Participatory Note review on anvil

The SEBI is expected to review restrictions, imposed in October 2007, on the issue of participatory notes by FIIs. It is also expected to review the Securities Lending and Borrowing (SLB) scheme in order to make it market friendly. The scheme was reintroduced in 2008 after a gap of 11 years.

viii. Restrictions on foreign venture capital investments likely

The Government is planning to prevent foreign investors from manipulating foreign investment norms by taking the venture capital route. With real estate in mind, the Government is planning that foreign venture capital investments (FVCIs) be restricted to nine sectors identified as eligible for the benefit of tax pass-through in Central Budget of 2007-08. The investment in other sectors should be treated as FDI. The new restrictions of FVCIs would help the Government ward off concerns like low capital base, circumvention of take over guidelines and round tripping of investments while evaluating FVCI proposals.

Foreign investment coming in as venture capital is accorded special concessions not available for normal FDI. These include exemption from entry and exit pricing norms, exemption from the SEBI take over code for sale of shares by FVCIs to company insiders after listing, exemption from the one year lock-in period for sale after an initial public offering and exemption from sectoral FDI caps for investments in domestic venture capital funds. The FVCI route was accorded a preferential status presumably in view of the need for an affirmative policy action to encourage development of entrepreneual capabilities in high risk, technology intensive ventures and in greenfield projects.

ix. Lock-in condition for FDI in realty projects likely to stay

It is expected that FDI in real estate would not be exempted from the mandatory three year lock-in period in the case of mixed projects that include hotel and tourism activities. There were efforts within the Government to exempt real estate projects from Press Note 2 of 2005 if they included hotel and tourism components. The Press Note makes minimum capitalisation, minimum area of development and three year lock-in mandatory for flow of FDI in real estate.

The view emerging within the Government is that exemption from minimum capitalisation and minimum area of development can be provided for FDI in projects including hotel and tourism activities. This will be subject to 50 percent of the total built-up area in such projects being reserved for tourism activities and 20 percent of the total built up area being reserved for hotel rooms. This means at least 30 percent of the total built up area should be allocated for tourism activities other than hotel rooms. The purpose of the exemption is to provide a FDI boost to tourism infrastructure.

x. Foreign portfolio investment guidelines are to be reviewed

The Government is expected to carry out a comprehensive review of the existing policy regime on portfolio investment as the policy on foreign portfolio investment has undergone several changes after India opened the doors for entry into the secondary markets in 1992.

xi. The Associated Chambers of Commerce & Industry of India (ASSOCHAM) wants ceiling for overseas developers raised

The ASSOCHAM is asking for a rise in ceiling for overseas developers for undertaking construction activity. It feels that with real estate in India emerging as a hot market, foreign institutional investors are looking at India for parking their surpluses as returns on such investments will be the highest in the near future. It is asking for enhancing the existing ceiling of 50,000 square feet to 200,000 square feet in the next 10 years in a gradual manner.

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