India's Investment Environment – January 2009

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I. Introduction

Even as the world comes to grips with the ongoing recession, India is expected to witness record inward remittances for the second year in a row with early indicators suggesting remittances of more than $40 billion in the calendar year 2008. This is way ahead of World Bank's projection of $30 billion for the year. The remittances from NRIs also touched a record high during the July-September quarter at $14.2 billion, up 57 percent over the same period a year ago. Unlike FII flows, NRI remittances are considered to be extremely sticky as money sent on a monthly basis by overseas based Indians is used largely for household consumption. This will help government offset the effect of liquidation of FII investments as well as reduce dependence on it and similar hot money. Similarly, a slowdown in India does not seem to have weighed heavily so far on the entry of international brands, which are mostly from advanced countries in the grip of recession. This indicates the country's solid economic fundamentals and undiminished growth opportunities.

India is also projected as one of the top 10 countries with an optimistic economic outlook for year 2009.

II. Expected changes in FDI rules

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

(i) Major reforms expected in FDI policy

Major expected changes in FDI policy include a) scrapping automatic approval for FDI in sectors that have FDI limits and in which ownership or control is shifting to a foreign company and b) a new definition for calculating indirect foreign equity. Current policy allows automatic approval for companies in sectors with FDI limits to bring in foreign equity. It is also proposed that all sectors with FDI limits will have the remaining equity owned by Indians.

A proposal has also been made for making ownership and control by Indian shareholders mandatory in the case of companies associated with sectors having FDI limits lower than 49 percent. The primary objective of these guidelines is to ensure that ownership of Indian companies in sensitive sectors is not transferred to foreign companies. The method of calculating indirect foreign equity in a company also might be reworked to make it simple and homogeneous across all sectors.

The government may also liberalise FDI norms further after making a beginning by exempting PepsiCo from divesting 49 percent stake in its Indian bottling arm. The government is planning to free certain sectors from archaic laws that often create hindrance to foreign investment flows. The issues include removing the compulsory divestment clause in the chemicals sector, doing away with the mandatory Cabinet Committee on Economic Affairs (CCEA) approval for FDI proposals involving amounts above Rs 600 crores (approx. $120 million) and scrapping of Press Note-1 (PN-1) for sectors such as advertising. PN-1 makes it mandatory for a foreign investor to take a no objection certificate (NOC) from its existing Indian joint venture partner before tying up with another Indian company in the similar business. The government is also considering the liberalisation of FDI norms in defence and retail sectors.

(ii) 100 percent FDI allowed in fax editions of foreign newspapers

The government has allowed 100 percent FDI in fax editions of foreign magazines and newspapers. The decision would allow international media houses to open subsidiaries and market and distribute facsimile editions of their magazines and newspapers in India. A facsimile or fax edition of a magazine or newspaper is a 100 percent replica of that publication.

(iii) Separate foreign investment caps may be scrapped

The government is considering doing away with the ceiling on portfolio investments by foreign institutional investors and instead prescribing a composite foreign investment cap. It is being considered that foreign investment in a company can be made through any route - FII or FDI, as long as it is within the composite ceiling. At present, total holding by FIIs in an Indian company cannot exceed 24 percent of its paid-up capital. The new rules will allow FIIs to raise their stake beyond 24 percent till it reaches the FDI cap. The new policy will be critical for sectors where there are individual caps for FII and FDI. These sectors include aviation, stock exchanges, commodity exchanges, credit information companies and DTH broadcasters. However, the company will have to be owned and controlled by resident Indians with management control in sectors where the foreign investment limit is limited to 49 percent.

(iv) FDI up to 25 percent may be allowed in airlines

The government is considering a proposal to permit foreign airlines to pick up stake up to 25 percent in domestic carriers. This is being considered to help the Indian aviation industry overcome the financial crunch. However, the influence of foreign airlines would be limited to their roles on boards and in the management. The government is of the view that allowing the much larger foreign airlines to own stakes in fledging Indian carriers could cause grave harm to the domestic aviation sector.

Cash rich carriers such as Singapore Airlines have in the past shown interest in owning stakes in local airlines but have been prevented by foreign investment rules.

(v) FDI limit for cable TV sector expected to rise to 74 percent

The government is considering increasing the FDI limit for multi-system operators (MSOs) in the cable TV sector to 74 percent from the existing 49 percent. This is being done to align it with the proposal for raising the FDI cap for other distribution mediums like DTH, HITS, and mobile TV. The FDI ceiling for local cable operators (LCOs) is expected to remain unchanged at 49 percent. Earlier the cable sector was excluded by the government on the pretext that raising the FDI limit might result in the management control passing from Indian hands to foreign investors. The Government has considered this sector sensitive as cable TV still remains the predominant mode of distribution for broadcast channels in India.

The MSOs are distributors who could either deliver TV content directly or route it through LCOs. At present cable TV services are being provided by 6000 MSOs and over 60000 LCOs.

(vi) FDI limit in mortgaged guarantee companies may be reduced

Looking at the RBI's latest guidelines, the government may bring down FDI limit in mortgaged guarantee companies (MGCs) from the existing 100 percent to 49 percent. According to RBI's guidelines on MGCs, a foreign investor cannot hold more than 49 percent of an MGC in India or control such a company. Foreign MGCs which have received government approval for setting up 100 percent Indian subsidiary or are planning to tap the Indian mortgage market will now have to dilute at least 51 percent of their stake in favour of potential Indian joint venture partners.

Mortgage insurance products are insurance tools that help an individual buy a house with a low down payment, less than the usual average of 20 percent. These products are purchased by the lender and paid for by the borrowers. If, for any reason, the borrower stops making payments, the mortgage insurance protects the lender from the financial loss. Protection for lenders enhances the number of mortgage loans and depresses the magnitude of down payments.

(vii) No FDI in nuclear power generation

The government will not allow foreign investment in India's nuclear power generation business but would welcome participation in allied activities like construction of power plants, fuel supply and maintenance. Domestic private sector players, however, will be allowed to enter the operation business. They will be allowed to own up to 26 percent stake in power generation and distribution business. Towards that end, domestic private players have to form joint ventures with the Nuclear Power Corporation of India Limited (NPICL). When domestic players gain adequate experience the government might raise the cap on investment.

(viii) Easier FDI rules for real estate

The government is expected to do away with the minimum area and capital requirements for foreign investments in realty projects involving hotels, cineplexes, health clubs, resorts and other tourism related activities to help the country's tourism industry meet its investment requirements. Current rules allow 100 percent FDI in such a project provided it has been capitalised at $10 million or more ($5 million if it is a joint venture where funds have to be brought in within six months) and has in its possession a minimum developable area of 25 acres with a minimum built up area of 50,000 square feet.

Under the proposed policy, the government is considering exemption of such projects from the $10 million requirement, reduce the project size to 10 acres and cut the minimum built up area to 10,000 square feet. However, all FDI brought to these projects will continue to have a lock-in period of three years after the date of completion of the project. To avail the relaxation, the project must use at least 50 percent of the total built up area for hotels or facilities promoting tourism, food and culture.

(ix) Special cell for monitoring realty FDI

DIPP will soon set up a monitoring cell to track FDI inflows into real estate companies to ensure that they do not channel funds raised for FDI compliant projects to other projects where FDI clearance has not been taken, a phenomenon observed by DIPP which defeats the purpose of the FDI policy. Consequently, DIPP may ask realty companies to submit bi-yearly financial reports so that funds flow can be scrutinised.

III. News & Views

(i) Overseas M&A deals under taxmen lens after Supreme Court verdict on Vodafone

An escrow account for tax in India is likely to become an essential component of any cross-border acquisition in future that involves assets located in the country. This is the most likely impact of the recent Supreme Court (SC) judgement in the Vodafone case. Just to recall, in the Vodafone case, a 67 percent shareholding stake in an Indian company was acquired by the Vodafone group outside India from another company located in the Cayman Islands. Since the transaction was between two foreign companies wholly outside India, it was contended that there was no jurisdiction for taxing any capital gain in India.

The SC verdict has given the income tax department a right to send notices demanding tax on such deals and asked Vodafone to go back to the income tax department for settlement. The verdict will have a direct bearing on recently concluded cross border acquisitions in India. The clear message of the verdict is that tax authorities of a country have the right to claim tax on the profit made in that country irrespective of whether parties involved in the transaction are resident or non-resident.

The controversy of territorial jurisdiction is not new in India. But the Vodafone case will force foreign companies to route investment through countries such as Mauritius, Singapore and Malta which have tax treaties with India that provide protection against capital gains tax. It will become a perfect case of treaty shopping and it will be very difficult for the government to control it unless tax treaties are revised.

(ii) Government move to ban FDI in tobacco attracts global lobby

International governments and global tobacco players from Switzerland, Japan and USA have come together to lobby against a government move to ban FDI in tobacco. India currently allows 100 percent FDI in this sector but health ministry has asked for a ban on FDI in this sector. However, no FDI application has been cleared by the FIPB since 1998 owing to strong opposition from the domestic tobacco lobby and sections of the government.

The global lobby’s argument is that protectionism is the wrong answer and an ineffective tool for addressing public health objectives and will only entrench the few existing participants to the detriment of others. They are of the view that the health effects of tobacco should be addressed through regulation applied equally to domestic and imported products.

(iii) Foreign investors can not use share options for bringing FDI

As per RBI guidelines, foreign investors cannot use share options to invest in Indian companies through the FDI route. The share options give investors the right to engage in a future transaction in shares of a firm at a pre-determined price and time, without the obligation to buy those shares. RBI's view is that only those instruments that are fully and mandatorily convertible into equity within a specified time period would be considered as part of equity under the FDI policy and hence eligible to be issued to foreign investors. Foreign investments in optionally or partially convertible debentures, such as share options, would be considered as debt and would have to conform to ECB norms and caps.

(iv)Ensure technology transfer to domestic industry by the foreign investor

It is being debated that India's policy framework has not been able to ensure transfer of technology to the domestic industry from foreign investors. Technology transfer is an essential component of FDI policy of eight high growth countries, but not India. China stipulates local content for FDI in that country. Even the US has federal statutory restrictions on foreign investment in areas such as shipping, aircraft, mines, energy etc., all essentially meant either to safeguard national interest or encourage technology transfer.

In India, there are elaborate rules and regulations regarding foreign ownership/management control of Indian firms but there is no credible mechanism to ensure technology transfer and value addition, especially in manufacturing, on Indian soil. It is being debated that this regulatory negligence is at the core of India's below potential performance in the global manufacturing scenario, in addition to high costs of energy, red tape and an infrastructure deficit.

It is being suggested that steps should be taken to create an investor friendly atmosphere which also enriches the Indian people, even as foreign investors rightfully get their due and national treatment to a considerable extent. Policies and regulatory norms must be so designed as to persuade foreign investors to engage in value addition activities within the Indian territory.

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