

India's Investment Environment – July 2008

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I. Introduction

The Government of India has liberalised the External Commercial Borrowings (ECB) norms and also considering the further liberalisation of foreign direct investment (FDI) norms for sectors, such as insurance and higher education. The Government is also planning to do away with the requirement of Foreign Investment Promotion Board (FIPB) clearance in case of issuance of warrants of Indian companies. In contrast to this, the Government has also decided to impose a country-specific ban on port project investment due to security threats to Indian naval bases. Certain changes regarding policy for FDI in sensitive areas/sectors are also under consideration.

II. Expected Changes in FDI Rules

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

i Liberalisation of ECB norms

The RBI has liberalised charges on immovable assets, financial securities and issue of corporate or personal guarantees to secure External Commercial Borrowing (ECB) to be raised by resident borrowers. Before this change, the Reserve Bank of India (RBI) circular No 5 of 2005 mentioned that ECB under automatic/approval route that would be considered by the RBI was in practice. Now to secure the ECB to be raised by the borrower, the RBI (Circular No 1 of July 11, 2008) has allowed Authorised Dealer Category-1 banks (AD banks) to issue No Objection Certificate (NOC) under the Foreign Exchange Management Act (FEMA), 1999 for creation of charge on immovable assets, financial securities and issue of corporate or personal guarantees in favour of overseas lenders/security trustees. Before granting such NOC, the AD banks have to ensure and satisfy themselves that ECB is in compliance with the existing ECB guidelines (<http://rbidocs.rbi.org.in/rdocs/notification/PDFs/85685.pdf>). These amendments have done away with the need for applying to the RBI for grant of approval and the creation of security for ECB becomes much simpler.

ii Possible rise in FDI cap in insurance

A bill to increase the FDI cap in the insurance sector from 26 to 49 percent is being considered by the Empowered Group of Ministers (EGOM). Now with the change in the composition of the coalition partners of the Government, the EGOM is expected to give a green signal to this rise soon. After the approval of the Cabinet, the bill is likely to be introduced during the monsoon session of the Parliament. Domestic partners in most of the 18 operating companies have already given their nod in principle to their foreign partners to increase their stake to 49 percent; the Government allows them to do so.

iii Country-specific ban on port project investment

Considering possible security threats to India's naval bases, private players from Dubai (United Arab Emirates), Hong Kong, China and Pakistan have been banned from investing in port infrastructure projects in India. Consequently, the ports and Shipping Ministry will reopen bids for at least 10 port projects. FDI proposals from these countries have also been rejected earlier on certain occasions, but this is the first time that the Government is introducing a blanket ban on companies from these countries at the bidding stage itself.

The Government currently allows 100 percent FDI in port development. Under the National Marine Development Policy, the Government has invited investment worth Rs 34000 crores (US\$8.1bn) from private players, 90 percent of which is expected to come from FDI.

iv Policy on FDI in sensitive areas, sectors expected

- The Cabinet Committee on Security (CCS) is expected to consider issues in FDI policy like building up Indian capabilities, the visa regime and country-specific exclusion as proposed by the Ministry of Home Affairs (MHA).
- The proposed guidelines for participation of foreign companies in hydel-power projects would also be vetted by the CCS and would form part of wider FDI policy in sensitive areas. These guidelines list security parameters to be followed by power and construction companies participating in hydel-power projects close to the international borders.
- At present, any project that falls within 50 km of international borders is a sensitive project. Various ministries have suggested changing the definition of sensitive areas to those lying within 150 km of international borders instead of the earlier 50 km.
- It is proposed by the MHA that multilateral agencies should be asked to accept the provision of prior security clearance for foreign manpower engaged in construction activities under the National Security Clause.
- On country specific bans, it is proposed that there should be a case-by-case security vetting of sensitive projects instead of a blanket country-specific ban. In contrast, the Finance Ministry has been recommending inclusion of an upfront country-specific ban on international tenders, especially for hydro-power projects.
- On the visa regime, a separate project work visa, like that required in other countries has been proposed. It is proposed that a foreign national should apply first for a work permit and after receiving the work permits/he may apply for a visa.

v MNCs on automatic FDI route may not require FIPB approval for warrants

- New foreign companies may not need to wait for an approval from the FIPB for subscribing to warrants (instruments that entitle its holder to a specific number of shares in a company on a specific date) of Indian companies as the Government is set to simplify the procedure.
- While the FDI policy does not explicitly mention the need for FIPB clearance in the case of issuance of warrants of Indian companies these often end up seeking FIPB's approval. At present, lack of clarity on the issue has been driving foreign investors to FIPB doors even in sectors where 100 percent FDI is allowed through the automatic route. It is an unnecessary hurdle which the Government is planning to do away with.

vi Government to ease investment norms in higher education

Foreign investment may soon be allowed into Indian higher education with the Government considering a move to salvage a critical legal grey area that has hindered such investments for long. It is also expected that the Foreign Education Providers (Regulation) Bill (cleared by the

Cabinet in 2007) allowing foreign universities and institutions in India may be introduced in the Parliament in the coming monsoon session.

III. Debates

i. Press Note 1 of 2005

- There is widespread debate in India about the scrapping of Press Note 1 of 2005, which protects the interest of domestic companies' *vis-à-vis* their foreign joint venture partners by mandating that foreign companies must obtain approvals to set up second ventures in India. Experts opine that it has the potential to be misused. A notable feature of Press Note 1 is the provision that parties to joint ventures enlisting after the date of the referred press note may contractually safeguard their interest by citing 'conflict of interest' arguments.
- Further, the Press Note provides a protective environment to the Indian partner in foreign/technical collaborations which existed prior to January 12, 2005 and continue to exist by necessitating that the foreign partner is required to obtain prior approval from the FIPB before a new venture in the same area of business as the existing one is set up. This unduly burdens the foreign investors who are part of such arrangements, and have continued to honour relationships as opposed to those who either terminated such arrangements or have chosen to enter the Indian market after January 12, 2005, and accordingly have not been governed by such regulation but purely by contract. Experts argue that in a liberalised and competitive market, an unfair bias is created against those foreign investors who are covered by Press Note 1.
- Some experts opine when Press Note 18 was scrapped and replaced by Press Note 1 of 2005, some of the loopholes that the Indian partners took advantage of have been dropped. Fresh investments in industries like Information Technology (IT) and mining do not require NOC from the Indian partners. Also 'conflict of interest clause' has been inserted in the Note to provide a level playing field for Indian and foreign partners for speedy dispute disposal. They support progressive flexibility in FDI inflows and argue for expanding the segments where NOCs are not insisted upon from the Indian partner.
- On a different note, it is also debated that apart from easing entry norms for foreign partners, the Government needs to liberalise restrictions it has placed on foreign participation in many sectors. The experts are debating that plans to allow higher FDI limit in sectors, such as insurance, banking and retail which have been stalled for long must be implemented at the earliest to attract good quality FDI in the medium term.

ii. Policy on FDI in tobacco

An old debate related to FDI in the tobacco or cigarette manufacturing business has been initiated again in India, i.e. whether fresh FDI can be permitted in companies that produce cigarettes. People are arguing that the Government has to take a final call on whether the policy of 100 percent FDI is valid or not. It is being debated that the Government should take a call as to whether the proposal would lead to propagation of smoking. The current policy allows 100 percent FDI in the area through FIPB route on a case-to-case basis.

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