India's Investment Environment – November 2008

Table of Contents

I. Introduction

Undeterred by the global meltdown, India maintains a bullish outlook on FDI which may now be attracted through easier rules. The large volume of capital flows received by India last year was dominated by portfolio inflows. A reversal of portfolio flows together with a high merchandise trade deficit has caused a sharp depreciation of the rupee. It has made the government realise the importance of attracting of stable and less speculative foreign investment. Therefore, it is considering an overhaul of the FDI rules to boost capital inflows, which have slackened due to the global meltdown i.e. easing of sectoral limits on FDI and ironing out procedural glitches.

II. Expected changes in FDI rules

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

(i) FDI limit in credit information companies may go up to 49 percent
The RBI is considering allowing FDI up to 49 percent in credit information companies with voting rights restricted to 10 percent. This facility could be provided to the investors with a track record of running a Credit Information Bureau in a well regulated environment. Further, RBI would also ensure that no single investor, whether a resident of India or outside India, holds more than 10 percent of the equity capital of any credit information company. Currently, India has only one credit information company- Credit Information Bureau India (CIBIL) which provides corporate information and maintains information on corporate relationships.

(ii) FDI up to Rs 1000 crore (approx. $200 million) may not require CCEA approval
The government is considering a hike of the exemption limit for foreign investment proposals relating to approval by Cabinet Committee on Economic Affairs (CCEA) to Rs 1000 crore (approx. $200 million) from the existing level of Rs 600 (approx. $120 million) crores. However, proposals involving investments of more than Rs 1000 crores will still need mandatory clearance from CCEA. At present, if a foreign investor has invested Rs 600 crores in an existing venture and wishes to scale up its investment, it needs approvals from both FIPB and CCEA.

(iii) FIPB allows FDI in private equity funds registered as trusts
The FIPB has ruled that foreign investment can flow into private equity funds registered as trusts. FIPB is of the view that FDI can be allowed in trusts which intend to carry out private equity investments, provided they register themselves as venture capital funds

with SEBI. This will open up new window of funds for private equity players and venture capital funds registered as trusts. The decision of FIPB is seen to be in line with the larger objective of encouraging FDI inflows to counter the slow down resulting from the global meltdown.

(iv) Expecting FDI in investment companies

The government is expected to allow FDI in investment companies. The government is of the view that foreign investment should be allowed in investment companies as they are similar to holding companies. Since FDI is allowed in holding companies through the FIPB route, it is being felt that the same facility should be provided to investment companies which may invest foreign funds in downstream businesses. Thus, foreign investment would be used by the company concerned for investment in businesses other than its own.

(v) Government is considering withdrawing Press Notes 3 and 9

To ease the FDI norms, government is considering withdrawal of Press Note 3 of 1997 and Press Note 9 of 1999. Press Note 3 specifies that a foreign company will have to secure FIPB approval to set up a holding company in India. Press Note 9 relaxes the conditions for setting up holding companies and specifies that foreign owned Indian firms need not take FIPB approval to make downstream investment in sectors open to foreign investment. These notes are expected to lose their relevance once the new norms for direct and indirect foreign equity in an Indian company come into force.

III. Debate

(i) India's low ranking in doing business will not affect FDI inflows

It is being argued that high transaction costs are not a sufficient condition for discouraging FDI. This is because higher costs might be offset by higher benefits corresponding to other attributes of the host economy. India ranks pretty low (122 out of 181 economies) in World Bank's "Doing Business" report; yet India is one of the largest recipients of FDI. Its strong attributes of large market size and large skilled labour are viewed by long term investors as sources of benefits capable of negating transaction costs. Nevertheless, foreign investments can be further enhanced by ensuring single widow clearances and access to industrial land with world class infrastructure.

(ii) India needs a friendlier M&A environment to boost FDI

Globally, a large chunk of FDI now moves through cross border M&As. In India, too, acquisitions account for nearly one fourth of the FDI, but it is well below the potential. India needs a friendlier M&A environment, including simpler FEMA rules and a more permissive regime. Press Note 1, which requires a foreign investor to seek a no objection certificate from its joint venture partner to strike out on its own, though much diluted now, is still a hurdle to FDI.

Disclaimer: This information has been collected through secondary research and CUTS C-CIER is not responsible for any errors in the same.