India's Investment Environment – October 2008

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I. Introduction

India has received foreign direct investment (FDI) worth US$17.2bn in the first six months of 2008, a massive 137 percent increase over the same period in 2007. The global financial crisis has prompted the Government to announce that it would further streamline the FDI policy, including easing of FDI norms in the defence sector to help meet the target of US$35bn for the fiscal. However, the general feeling is that the first quarter of 2009 would be challenging because by that time the effect of the global financial crisis would be seen on fresh FDI inflows into the country. The liquidity crunch would impact the realty sector, which has been one of the sectors getting maximum FDI. However, it is expected that the Government's move to increase the FDI limit in the insurance sector from 26 to 49 percent would help in attracting more FDI into India.

II. Expected Changes in FDI Rules

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

i FDI cap in insurance may be raised to 49 percent

The Government is going to introduce the much-awaited Insurance Bill in the Parliament which includes a proposal for a comprehensive amendment of insurance laws and a hike in the FDI ceiling to 49 percent from the existing 26 percent. Apart from raising the ceiling, another key amendment proposed is to give room to Indian promoters to continue to hold majority stakes in insurance companies. At present, the law requires Indian promoters to lower their stake to 26 percent after the tenth year of operation. Besides amending the Insurance Act 1938, the bill also proposes to amend General Insurance Business (Nationalisation) Act, 1972 (to enable state run companies to raise more capital from the market) and Insurance Regulatory and Development Authority (IRDA) Act, 1999 (providing more flexibility to IRDA to function effectively and efficiently).

The proposed changes to FDI rules would not apply to public sector insurance companies. In the case of private companies, most joint venture agreements allow the foreign partner to increase its stake once the Parliament approves the changes.

It is expected that an increase in the FDI ceiling may increase the total inflows into the life insurance segment industry almost two-and-a-half fold.

ii Government weighs 100 percent FDI in GPS enabled devices and commodity brokerage

The Government is all set to allow 100 percent FDI in global positioning system (GPS) enabled devices and commodity brokerage. At present, there is 100 percent FDI in products under telecom equipment category. Now the Government is going to bring GPS enabled systems under the list of FDI approved telecom equipments. The increased demand for security systems that are GPS enabled has fuelled interest among global security system providers to enter the Indian market.

Government is also considering the inclusion of commodity brokerage in the positive list of financial services in which FDI is permitted. The companies engaged in commodity broking business have to abide by minimum capitalisation norms within a stipulated time frame. As of now, only 12 services under the financial services category are open for FDI. Earlier in 2008, the Government allowed FDI in commodity exchanges through Press Note 8 but the Note was silent on the issue of FDI in commodity broking. The decision, if implemented, is expected to encourage large foreign brokerage houses to enter into the country and also help the nascent Indian commodity business to mature. This is also seen as a step towards allowing FII in the commodity broking business.

iii ECB norms may be eased

The Government is considering easing of external commercial borrowing (ECB) guidelines to enhance overseas fund flow. The Government is considering the option of putting loans up to US$500mn for rupee expenditure by Indian infrastructure companies under the automatic approval. At present, such loans need RBI approval. The Government may raise the limit for dollar borrowings for rupee expenditure that would need Reserve Bank of India (RBI) approval. So if a company is borrowing, say US$800mn, it can immediately access foreign funds up to US$500mn without prior permission, but will need approval for the remaining amount. Also the spreads of pricing of ECBs with maturity of five years and above may be widened further to accommodate the rising cost of dollar debt overseas.

iv FDI in tobacco sector likely to be reviewed

The Cabinet Committee on Economic Affairs (CCEA) is likely to review the FDI norms in the tobacco industry in the light of objections raised by the Health Ministry and its insistence on stopping all future foreign investments in the sector. At present, FDI up to 100 percent is allowed in tobacco through the Foreign Investment Promotion Board (FIPB) route on a case-to-case basis, subject to licencing. The Department of Industrial Policy and Promotion's (DIPP) view is that it would not be prudent on the part of the Government to go back on the FDI policy. After allowing 100 percent FDI in tobacco, banning it would be an investor unfriendly policy and send negative signals to the investor world.

v Indirect FDI to be reviewed

The Government is keen to introduce clear norms and grandfathering clauses that would check against confusion in the case of indirect investment. The issue has gained importance since foreign investment now comes in through several layers, routed through special purpose vehicles (SPVs) registered in tax havens like Mauritius and Cyprus.

III. Debate

It is being debated whether proactive policy measures that further liberalise the FDI regime can ensure the continuation of the current trend of increase in FDI, given the turmoil in global financial markets. The reason behind this confidence is the outlook on global FDI flows. It is being argued that the recession in the US, EU and Japan can be seen as an opportunity for India which can attract global investors looking for reasonable returns. This is the time the Government should come up with policy responses that will ensure that India remains an obvious choice for global investors once an appearance of normalcy returns to financial markets. Thus, reforms in certain sectors, where investor interest is high, must happen rapidly.

The Government has to radically review the current FDI policy. It is being argued that the top priority should be to remove restrictive rules like Press Note 18 and to lift foreign investment restrictions and caps in a number of sectors like insurance, banking, multi-product retail and aviation. The debates and dithering on the current restrictive norms have continued for too long and now there is an opportunity to liberalise. Also, shoring up FDI flows is seen as important in the context of decline in other capital flows and the need for it can be used to justify the liberalisation of FDI inflows.

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