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REVISED CONSOLIDATED FDI POLICY 2011: BRIDGING THE GAP BETWEEN DOMESTIC PARTICIPANTS AND FOREIGN PLAYERS

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ABSTRACT

Foreign direct investment (FDI) in India has played a stellar role in the development of the Indian economy. FDI is a key driving force enabling India to achieve a certain degree of financial stability, growth and in attracting sustained foreign investment into the country. The objective of the Government is to promote FDI through a policy framework which is transparent, predictable, simple and clear and reduces regulatory burden. To simplify the rules and regulations pertaining to the foreign direct investment policy, the system of periodic consolidation and updation is introduced as an investor friendly measure. The present paper seeks to appraise the major revised policy initiatives (FDI policy 2011, circular 2) announced by the government on 31st September 2011 to encourage FDI inflows into the economy and its impact on the domestic participants. The revised consolidated FDI policy appears to be investor friendly with liberal norms and regulations directed towards attracting more capital inflow into the country thus strengthening the orbit of the Indian economy in the current global economic scenario. However, there is a call for a more liberal FDI policy framework especially needed in the context of declining FDI flows during the quarter ending September 2011.

KEYWORDS

FDI, Industrial Policy, Economy.

INTRODUCTION

Although the present worldwide economic environment is going through a phase of turbulence, the Indian economy has slowly and gradually emerged as a global economic power. In the post-liberalization era, the foreign direct investment (FDI) has been strategically acknowledged as the life-blood of Indian economy uplifting and accelerating the pace of economic reforms in major sectors of the country. As a normal entry mode, the FDIs in India are permitted through financial collaborations, through private equity or preferential allotments, by way of capital markets through euro issues, and in joint ventures. The Foreign direct investment scheme and strategy depends on the respective FDI norms and policies in India. The FDI policy of India has imposed certain foreign direct investment regulations as per the FDI theory of the Government of India. Foreign investments into India are subject to the industrial policy established by the Department of Industrial Policy and Promotion (DIPP) under the Ministry of Commerce and Industry which is the apex agency. The policy framework on FDI serves as a 'ready reckoner' for the domestic as well as foreign participants on foreign investment related norms and regulations. FDI norms and regulations are governed by the Foreign Exchange Management Act, 1999 (FEMA). Besides, there are other regulations made under the various press notes, press releases and clarifications etc. issued on any of the important subjects from time to time. The Department of Industrial Policy and Promotion, in line with semi-annual consolidation of the FDI policy framework, issued Circular 2 of 2011 on 30 September 2011 to notify the updated FDI policy. The new policy document introduces certain important changes in the extant FDI policy framework and integrates Press Notes/ Press Releases/ Clarifications / Circulars issued by the Department since the previously notified consolidated FDI policy. The FDI Policy issued by DIPP vide circular 1 of 2011 dated March 31, 2011 (Circular 1 of 2011) has been replaced by Circular 2. The revised FDI policy seeks to regulate the foreign direct investment into India in the various manufacturing and service sectors. FDI policy is reviewed on an ongoing basis and measures for its further liberalization are taken. Change in sectoral policy/sectoral equity cap is notified from time to time through Press Notes by the Secretariat for Industrial Assistance (SIA) in the Department of Industrial Policy. Announcements by SIA are subsequently notified by RBI under FEMA. **The major question to be analyzed is whether the revised policy norms issued by Government of India will provide a level playing field for the domestic participant's vis-à-vis the foreign investors.**

FDI SCENARIO IN INDIA- AN OVERVIEW

The foreign direct investment policy has significantly contributed in injecting the foreign capital funds into the country. The FDI statistics and data pertaining to FDI inflows coming to India during the period 2000 to 2010 is presented in Table 1, that gives an indication of the emergence of India as both a potential investment market and investing country. The FDI inflow has continuously increased over the period expect during 2002-2004 where it decreased by nearly 14%. From a mere 4029 millions USD in 2000-01, the FDI has helped the Indian economy grow, and the government continues to encourage more investments of this sort. The Inflow of FDI during 2009-10 was 16232 million dollars.

TABLE 1: AN OVERVIEW OF FDI INFLOW IN INDIA (Amounts in Millions USD)

Sl. No.	Financial Year	Total FDI Inflows	% Growth Over Previous Year
1.	2000-2001	4029	----
2.	2001-2002	6130	(+)52
3.	2002-2003	5035	(-)18
4.	2003-2004	4322	(-)14
5.	2004-2005	6051	(+)40
6.	2005-2006	8961	(+)48
7.	2006-2007	22826	(+)146
8.	2007-2008	34362	(+)51
9.	2008-2009	35168	(+)02
10.	2009-2010	16232	----

Source: FDI statistics, Ministry of Commerce and Industry, Government of India

The United Nations Conference on Trade and Development (UNCTAD) in its report titled, 'World Investment Prospects Survey 2009-2012' has ranked India at second place in global foreign direct investments (FDI) in 2010. The report has predicted India to be among the top five attractive destinations for international investors during 2010-12. As per the data of the report, the sectors which attracted higher inflows were services, telecommunication, construction activities and computer software and hardware. Mauritius, Singapore, the US and the UK were among the leading sources of FDI. While the FDI approvals witnessed a major appreciation since the liberalization of policy in 1991, the actual inflows have been much less than half of the approvals. The issue of concern is that a substantial part of these resources have gone into mergers and acquisitions and not in the formation of fresh capital. During 2009-2010 FDI in India showed a enormous increase mainly due to severe recession in other parts of the globe. FDI inflow in the country was USD 18.3 billion during April-February 2010-11, down 25 per cent from USD 24.6 billion in 2009-10. According to the latest data released by the Department of Industrial Policy and Promotion (DIPP), the FDI inflow rose by more than 100 per cent to US$ 4.66 billion in May 2011, which was the highest monthly inflow of previous 39 months, while the cumulative amount of FDI equity inflows from April 2000 to May 2011 stood at US$ 205.96 billion. The sector-wise analysis shows that the service sectors (including financial and non-financial) attracted highest FDI equity inflows during April-May 2011-12 at US$ 910 million.

TABLE 2: SECTORS ATTRACTING HIGHEST FDI EQUITY INFLOWS (FROM APRIL 2000 TO MARCH 2010) (Amounts in Millions USD)

Sl. No.	Sector	Amount of FDI Inflows	% As To Total FDI Inflow
1.	Service Sector(Financial & Non- Financial)	9,65,210.77	22.14
2.	Computer Software & Hardware	4,13,419.03	9.48
3.	Telecommunication	3,68,899.62	8.46
4.	Housing & Real Estate	3,25,021.36	7.46
5.	Construction Activities	2,65,492.96	6.09
6.	Automobile Industry	1,90,172.22	4.36
7.	Power	1,79,849.92	4.13
8.	Metallurgical Industries	1,25,785.57	2.89
9.	Petroleum & Natural Gas	1,11,957.00	2.57
10.	Chemical	1,01,680.18	2.33

Source: DIPP, Ministry of Commerce and Industry, Govt. of India

India received maximum FDI from countries like Mauritius, Singapore, and the US at US$ 56.31 billion, US$ 13.25 billion and US$ 9.71 billion, respectively, during April 2000-May 2011. As exhibited in Table 2, the sectors receiving the largest shares of total FDI inflows up to march 2010 were the service sector and computer software and hardware sector, each accounting for 22.14 and 9.48 percent respectively. These were followed by the telecommunications, real estate, construction and automobile sectors. The top sectors attracting FDI into India via mergers and acquisitions were manufacturing; information; and professional, scientific, and technical services. These sectors correspond closely with the sectors identified by the Indian government as attracting the largest shares of FDI inflows overall. As per ASSOCHAM's press release, FDI in Chemicals sector (other than fertilizers) registered maximum growth of 227 per cent during April 2008 – March 2009 as compared to 11.71 per cent during the 2007-08. The sector attracted USD 749 million FDI in financial year '09 as compared to USD 229 million in financial year '08. During the year 2009 government had raised the FDI limit in telecom sector from 49 per cent to 74 per, which has contributed to the robust growth of FDI. The FDI inflow in automobile sector has increased from USD 675 million to 1,152 million in year 2009 over financial year 2008.

The above discussion reveals that post liberalization there is definitely a shift in favor of service sector and a steep fall in the share of manufacturing sector. However, this trend matches the trend of change in the structure of FDI inflows to the developing countries and even the world.

FDI POLICY 2011-MAJOR AMENDMENTS (AS PER CIRCULAR 2)

Some key changes made to the old FDI policy vide the New FDI Policy concerning various sectors/issues and its implications are as follows:

1. CONVERSION OF IMPORTED CAPITAL GOODS/MACHINERY INTO EQUITY

Conversion of imported capital goods/machinery and pre-operative/pre-incorporation expenses to equity instruments had been permitted in the last circular on FDI policy, effective 1April, 2011. It was stipulated that such conversions must be made within a period of 180 days of the date of shipment of capital goods/machinery or retention of advance against equity and that payments made through third parties would not be allowed. This conveyed the sense that the onus of conversion is on the investor with no allowance for the FIPB process involved. This has been clarified through the present amendment (circular 2), under which the time limit for making applications for such conversions will be 180 days. The New FDI Policy further permits pre-incorporation/pre-operative expenses to be paid by the foreign investor to the Indian company directly into the bank account of the Indian company – which leaves one guessing how would such Indian company come to have a bank account even before its incorporation. The procedure would need to be further corrected to remove such gaps in the next consolidated FDI Policy.

2. FDI IN SINGLE BRAND RETAIL

As per the old policy provisions, FDI in single brand retail was allowed up to 51% subject to the approval from FIPB and other conditions as imposed under FDI Policy. Vide the Master Circular No.2 of 2011 DIPP has imposed an additional condition that "the foreign investor should be the owner of brand". Hence, only foreign investor who owns a brand can enter into single brand retail segment in India.

3. PLEDGE OF SHARES FOR ECB

The New FDI Policy now allows promoters of an Indian Company to pledge their shares in an Indian company against external commercial borrowings (ECB) raised by such company from foreign lenders. Further a NRI holding shares in the Indian company may pledge such shares to (i) secure credit facilities given to such Indian company by an Indian bank, and (ii) secure credit faculties given to such NRI/ non-resident promoter of the Indian company or its overseas group company by overseas bank. The pledge of shares is also subject to applicable terms and conditions as contained in the New FDI policy. This relaxation should enable making inflow of funds via ECBs more attractive to financial institutions and should give a boost to access of overseas/ECB funds to Indian Companies. Typically any foreign / domestic investment will have an exit option for the investor. Normally after 3 to 5 years from the date of investment, the investor exit from the Company either through IPO / buyback by the promoters / selling to third party. Now, vide Master Circular No.2 of 2011 DIPP has clarified that any of above said instruments with in-built options of any type (i.e exit by way of buy back or selling to third party) will not be considered as FDI and it will be treated as ECB and subject to compliance with ECB Policy.

4. RELAXATIONS CONCERNING ESCROW ACCOUNTS

The New FDI Policy permits foreign investors to open escrow accounts in India towards payment of share purchase consideration or for keeping securities. The approval earlier required from RBI can now be obtained from the authorized dealer bank.

5. OPENING OF NON-INTEREST BEARING ACCOUNT BY NON-RESIDENT

As per the revised policy initiative, only authorized dealers are now permitted to open and maintain non-interest bearing Escrow accounts in Indian Rupees in India under automatic route, on behalf of the non-residents, towards payment of share purchase consideration and/or for keeping securities to facilitate FDI transactions, subject to the terms and conditions as specified by RBI.

6. INCREASING FDI LIMIT IN TERRESTRIAL BROADCASTING/ FM RADIO

The New FDI Policy has increased the permitted FDI in terrestrial broadcasting/FM Radio to 26%. The Old FDI Policy provided a cap of 20%. The increase of the cap from 20% to 26%, although falling short of the wish of the industry, will further help the cash-strapped FM radio sector to leverage funds through FDI to meet the expansion and roll out plans in tier-2 and tier-3 cities.

7. INDUSTRIAL PARKS

The New FDI Policy has now included 'basic and applied R&D on bio-technology, pharmaceutical sciences/ life sciences' as an industrial activity for setting up industrial parks under the 100% holding vide automatic route. This would thus open the gates for automatic route investments in projects in which quality infrastructure exists in the form of plots of developed land or built up space or a combination with common facilities for the said activities. This move comes alongside the proposed bio-technology bill and shows the steadfastness of the government to keep the focus for developing new emerging sunrise industries.

8. EDUCATION SECTOR AND OLD-AGE HOMES

As per the old exiting policy, 100% FDI was permitted in construction development under the automatic route subject to conditions like minimum build up area, minimum capital requirement, lock-in period, etc. Vide Master 2 of 2011 DIPP clarified that the conditions imposed for construction development activities shall not be applicable for construction in the education sector like construction of schools, college, university, etc and in respect of old-age homes. Hence, the construction development companies can utilize this effectively to get more FDI without any conditionality.

9. REAL ESTATE SECTOR

The New FDI Policy has delinked construction developments concerning education sector and old-age homes from the real estate construction and thus has set the construction and development activity for these two purposes free from the conditions otherwise applicable on real estate construction. These conditions include minimum built-up area, minimum capitalization of $5 million to $10 million and lock-in period of three years. Hotels and tourism, hospitals, SEZs and investment by NRIs were already kept outside these conditions in the Old FDI Policy.

10. AGRICULTURE SECTOR

Under the New FDI Policy apiculture (bee-keeping) has been allowed under the category of permitted agricultural activities under controlled conditions with 100% holding under automatic route. The Old FDI Policy permitted investments in floriculture, horticulture and cultivation of vegetables and mushrooms in a similar manner under controlled conditions with 100% holding under automatic route. This move is a step forward in rationalising the controls and restrictions on FDI in agriculture sector on the one hand and to necessity to bring home the needed technology and expertise to keep afloat the agricultural activities not doing well.

All the above initiatives by the Government of India outline the Government's focus on enhancing the FDI inflows, besides creating a conducive investor-friendly environment for the foreign players.

FINDINGS AND IMPLICATIONS

The new revised policy document facilitates better comprehension and readability of the FDI policy framework by re-organizing similar subjects under common chapters. Although, as compared to the previous modified policy in April 2011, the new policy appears to be jaded with largely incremental advancements and clarifications. It is devoid of any material changes in any sector that is of significance in the overall development of the economy. The revised policy initiatives in issuance of equity shares is a sigh of relief for domestic firms as it has brought in its forth greater flexibility and ease to get an investment dose of the foreign capital. The companies operating in automobile components, telecom and power have been benefitted from the amendments related to the conversion of imported capital goods into equity. Some of the changes introduced in the FDI policy related to exempting education and old-age homes from minimum area, minimum capitalization norms and enlargement in scope of FDI in Industrial Park and Apiculture are welcome move.

Though the 2011 consolidated FDI policy has liberalized rules to a greater extent yet some concerns still remain to be sorted out and pondered over seriously in order to fully reap the benefits of enhanced FDI in our much volatile economy.The DIPP in its consolidated FDI policy issued on 30th September 2011, had laid down that equity instruments, rather having inbuilt options or supported by options, sold by third parties, would lose their equity character and such instruments would have to comply with the ECB guidelines. ECB guidelines are governed by the RBI and are rather strict and have specific end use restrictions. Now, since call and put options are ever-present in most share purchase agreements, the inclusion of this clause threatened several existing and future investments. Based on the enormous negative feedback, the DIPP in an important move on 31st Oct 2011 has deleted this clause. The additional condition as to ownership of the brand for permitting FDI in single-brand retail trade is likely to hurt investment and expansion plans for foreign as well as Indian retailers. Some of the other much anticipated reforms, for instance enhancing of FDI limits for multi-brand retail sector, defense sector, relaxation of conditionalities for FDI into construction-development sector, remain unaddressed. The amendment relating to Real estate sector requires more clarity in terms of its applicability and scope as the same is likely to have far reaching impact on flow of foreign investments in India and flexibility to foreign investors in structuring their investments. With 100 percent FDI in agriculture sector, the new policy can lead to increasing dependency on foreign companies and shut down of small domestic firms not in a position to keep up with the foreign players.

In the era of globalization, the basic objective of a sustained foreign investment policy is to provide equal opportunities and comfort to both domestic as well as foreign players in order to utilize the growth momentum to the fullest. The revised foreign investment policy of government of India is a welcome step as it conveys a positive gesture towards the progress and advancement of Indian economy. To ensure steady flow of FDI there has been always a demand from the investor circles that legal framework should be so simplified and slackened that investors have an ease in investing. But the investor destinations inherently and specifically the emerging economies like India; many times have to face contradictions and paradoxes with its domestic demands i.e. protecting the interests of the domestic producers and in parallel to promote scales of FDI as well. The domestic participants and International firms can look forward to the measures announced in Circular 2 as a crucial tool to promote the competitiveness of India as an investment destination, instrumental in attracting higher levels of FDI and technology inflows into the country. **Thus it can be concluded that the revised policy norms issued by Government of India will definitely provide a level playing field for the domestic participants to uphold the thrust of the foreign players and together they can promote Indian economy to new dimensions.**

CONCLUSION

On the whole the revised FDI policy will surely carry forward the process of liberalization which further would assist in enhancing of the FDI into the Country. However, In order to reap the actual benefits of the foreign capital investment, there is a need for a more liberal FDI policy framework to attract larger foreign investments, especially in the context of declining FDI flows in the last quarter ending 30th September 2011.

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