Govt. nod mandatory for FDI from neighbouring countries

Part of: GS-III- Economy - FDI (PT-MAINS-PERSONALITY TEST)

China’s footprint in the Indian business space has been expanding rapidly, especially since 2014.

- The Chinese investment in India in 2014 stood at $1.6 billion. This involved mostly investment from Chinese state-owned players in the infrastructure space in India.
- By 2017, the total investment had increased five-fold to at least $8 billion accompanied by a marked shift from a state-driven to market-driven approach.
- The report, titled “Following the Money: China Inc’s Growing Stake in India-China Relations” estimates that the total current and planned Chinese investment in India has crossed $26 billion in March 2020.

The major Chinese investments in India span a range of sectors with a significant share in the start-up space. A 2017 survey of Chinese enterprises in India by the Industrial and Commercial Bank of China’s Mumbai branch found that 42% were in the manufacturing sector, 25% in infrastructure and others in telecom, petrochemicals, software and IT.

Threat due to the COVID-19 pandemic: Many Indian businesses have come to a halt due to the lockdown imposed to contain the COVID-19 pandemic. Subsequently their valuations have plummeted. Many such domestic firms may be vulnerable to opportunistic takeovers or acquisitions from foreign players. Recently, People’s Bank of China made a portfolio investment through the stock market into the housing finance company HDFC and now holds a 1.01% stake in the company.

Details:

- In the light of threat of opportunistic takeovers/acquisitions of Indian companies due to the current COVID-19 pandemic, the government has revised the FDI policy.
- Under the revised FDI policy, prior government approval is mandatory for FDI from countries which share a land border with India. The new policy states that when an entity of a country, which shares land border with India or where the beneficial owner of an investment into India is situated in or is a citizen of any such country, can invest only under the Government route.

**India shares land borders with Pakistan, Afghanistan, China, Nepal, Bhutan, Bangladesh and Myanmar.

- As per the changed FDI policy, the transfer of ownership of any existing or future FDI in an Indian entity to those in the restricted countries would also need government approval.
- Investors from countries not covered by the new policy only have to inform the RBI after a transaction rather than asking for prior permission from the relevant government department.
- This move will help restrict Chinese investments in India and also help monitor the
investments.

Additional information:

- Though India’s FDI policy is directed at attracting FDI, it needs to also balance security aspects. Investments from Pakistan and Bangladesh face higher restrictions as compared to FDIs from other countries. They need government approval and there is no provision for automatic FDI from these two countries into India.
- Pakistani investors require government approval for FDI in defence, space and atomic energy sectors.

FDI new rules analysis

The revised FDI policy makes prior government approval mandatory for FDI from countries which share a land border with India. The objective is to curb opportunistic takeovers or acquisitions due to the current COVID-19 pandemic. This is indeed a risk that has also been identified by other countries.

Concerns:

Though well intended, the policy outlined in the press note released by the Department for Promotion of Industry and Internal Trade (PT SHOT) may have some unintended consequences.

Aimed at China:

- Given the fact that FDI restrictions were already applicable to Pakistan and Bangladesh and the fact that Myanmar, Bhutan, Nepal and Sri Lanka are not major investors in India, the new policy seems to be aimed at Chinese investors.
  - China has been the fastest growing source of FDI since 2014. The positive sentiment generated among industry players in China may well be punctured by the need for government approval.
  - This could lead to straining of the bilateral ties between the two economic powerhouses of the world.

Wide application:

The amended FDI policy does not restrict its application to only the takeover of vulnerable companies. The amended policy makes every type of investment by Chinese investors subject to government approval. Such a blanket application could create unintended problems.

1. The new policy does not distinguish between Greenfield and Brownfield investments.

- The new rules may pose obstacles to Greenfield investments where Chinese investors bring fresh capital to establish new factories and generate employment in India.

2. The new policy does not distinguish between listed and unlisted companies. It also does not distinguish between the different types of investors, such as industry players, financial...
institutions, or venture capital funds.

3. The restrictions on Venture capital funds may impact the prospects of many start-ups in the Indian market.

Applicability with respect to certain funds:

- Most investors in companies such as Zomato, Swiggy, Bigbasket, Makemytrip, Oyo, Ola and Snapdeal are either venture capital funds registered in off-shore tax havens or listed in stock exchanges in the U.S. or Hong Kong.
- It would be extremely difficult to attribute nationality to venture capital funds or fix the ultimate beneficial ownership of listed companies down to founders of a certain nationality.
- The most visible Chinese investment in India, mostly in the Internet space, may not even come under the definitions of the new rules.

Will further drive down evaluations:

- The COVID-19 pandemic has and will definitely cause financial stress in many unlisted or private companies.
- Making government approval necessary for acquisitions in private companies by Chinese investors will only reduce the number of potential investors available and will drive down the valuation.

Consequences for the companies:

- Given the global nature of the crisis there has been a drastic outflow of foreign capital from the Indian economy and there are very little chances for foreign investment to revive in the medium term.
- There seems to be very little interest among the domestic investors too.
- The absence of an investor may cause bankruptcy in the struggling companies and lead to job losses.
  - A recent study notes that over half of the top 500 companies listed on the National Stock Exchange could find themselves strapped for cash to even make routine payments in the aftermath of the COVID-19 induced lockdown.
  - Majority of the firms could find themselves in liquidity trouble, unless if promoters step in with equity or banks lend to them.
  - There is a significant likelihood that at some companies will need to go for cost rationalisation through measures such as salary cuts, payment deferrals or even job cuts.

Future foreign investment:

- The abolishing of the Foreign Investment Promotion Board in 2017 helped boost India’s image as a FDI friendly destination economy.
- The amended policy may have unintended consequences in the minds of foreign investors and might disincentivize future investments.

Conclusion:

- The Indian government could have considered a more precise and focused intervention with respect to the new amendments in the FDI policy.
The Committee on Foreign Investment in the United States (CFIUS) framework allows or promotes FDI with limited national security exceptions to deal with genuine threats to national security or black swan events like the COVID-19 pandemic can act as a guiding light for India’s own policy.

ABOUT FDI

Foreign direct investment (FDI)

It is an investment from a party in one country into a business or corporation in another country with the intention of establishing a lasting interest. Lasting interest differentiates FDI from foreign portfolio investments, where investors passively hold securities from a foreign country. Foreign direct investment can be made by expanding one’s business into a foreign country or by becoming the owner of a company in another country.

Review of FDI policy on various sectors (August 2019)

Major Impact and Benefits from FDI Policy Reform

i. The changes in FDI policy will result in making India a more attractive FDI destination, leading to benefits of increased investments, employment and growth.

ii. In the coal sector, for sale of coal, 100% FDI under automatic route for coal mining, activities including associated processing infrastructure will attract international players to create an efficient and competitive coal market.

iii. Further, manufacturing through contract contributes equally to the objective of Make in India. FDI now being permitted under automatic route in contract manufacturing will be a big boost to Manufacturing sector in India.

iv. Easing local sourcing norms for FDI in Single Brand Retail Trading (SBRT) was announced in Union Budget Speech of Finance Minister. This will lead to greater flexibility and ease of operations for SBRT entities, besides creating a level playing field for companies with higher exports in a base year. In addition, permitting online sales prior to opening of brick and mortar stores brings policy in sync with current market practices. Online sales will also lead to creation of jobs in logistics, digital payments, customer care, training and product skilling.

v. The above amendments to the FDI Policy are meant to liberalize and simplify the FDI policy to provide ease of doing business in the country, leading to larger FDI inflows and thereby contributing to growth of investment, income and employment.

Background

FDI is a major driver of economic growth and a source of non-debt finance for the economic development of the country. Government has put in place an investor friendly policy on FDI, under which FDI up to 100% is permitted on the automatic route in most sectors/activities. FDI policy provisions have been progressively liberalized across various sectors in recent years to make India an attractive investment destination. Some of the sectors include Defence, Construction Development, Trading, Pharmaceuticals, Power Exchanges, Insurance, Pension,
Other Financial Services, Asset reconstruction Companies, Broadcasting and Civil Aviation.

These reforms have contributed to India attracting record FDI inflows in the last 5 years. Total FDI into India from 2014-15 to 2018-19 has been US $ 286 billion as compared to US $ 189 billion in the 5-year period prior to that (2009-10 to 2013-14). In fact, total FDI in 2018-19 i.e. US $ 64.37 billion (provisional figure) is the highest ever FDI received for any financial year.

Global FDI inflows have been facing headwinds for the last few years. As per UNCTAD's World Investment Report 2019, global foreign direct investment (FDI) flows slid by 13% in 2018, to US $1.3 trillion from US $1.5 trillion the previous year - the third consecutive annual decline. Despite the dim global picture, India continues to remain a preferred and attractive destination for global FDI flows. However, it is felt that the country has the potential to attract far more foreign investment which can be achieved inter-alia by further liberalizing and simplifying the FDI policy regime.

In Union Budget 2019-20, Finance Minister proposed to further consolidate the gains under FDI in order to make India a more attractive FDI destination. Accordingly, the Government has decided to introduce a number of amendments in the FDI Policy. Details of these changes are given in the following paragraphs.

Coal Mining

As per the present FDI policy, 100% FDI under automatic route is allowed for coal & lignite mining for captive consumption by power projects, iron & steel and cement units and other eligible activities permitted under and subject to applicable laws and regulations. Further, 100% FDI under automatic route is also permitted for setting up coal processing plants like washeries subject to the condition that the company shall not do coal mining and shall not sell washed coal or sized coal from its coal processing plants in the open market and shall supply the washed or sized coal to those parties who are supplying raw coal to coal processing plants for washing or sizing.

It has been decided to permit 100% FDI under automatic route for sale of coal, for coal mining activities including associated processing infrastructure subject to provisions of Coal Mines (special provisions) Act, 2015 and the Mines and Minerals (development and regulation) Act, 1957 as amended from time to time, and other relevant acts on the subject. "Associated Processing Infrastructure" would include coal washery, crushing, coal handling, and separation (magnetic and non-magnetic)

Contract Manufacturing

- The extant FDI policy provides for 100% FDI under automatic route in manufacturing sector. There is no specific provision for Contract Manufacturing in the Policy. In order to provide clarity on contract manufacturing, it has been decided to allow 100% FDI under automatic route in contract manufacturing in India as well.

- Subject to the provisions of the FDI policy, foreign investment in 'manufacturing' sector is under automatic route. Manufacturing activities may be conducted either by the investee
entity or through contract manufacturing in India under a legally tenable contract, whether on Principal to Principal or Principal to Agent basis.

**Contract manufacturing**

The business model in which a firm hires a contract manufacturer to produce components or final products based on the hiring firm’s design. **Companies outsource their production to other companies.** Contract manufacturing offers a number of benefits:

- **Cost Savings:** Companies save on their capital costs and labour costs because they do not have to pay for a facility and the equipment needed for production.
  - Some companies may look to contract manufacture in low-cost countries, such as India, to benefit from the low cost of labour.
- **Advanced Skills:** Companies can take advantage of skills that they may not possess, but the contract manufacturer does.
- **Focus:** Companies can focus on their core competencies better if they can hand off base production to an outside company.
- **Economies of Scale:** Contract Manufacturers have multiple customers that they produce, it may lead to reduced costs in acquiring raw materials by benefiting from economies of scale.

**Single Brand Retail Trading (SBRT)**

i. The extant FDI Policy provides that 30% of value of goods has to be procured from India if SBRT entity has FDI more than 51%. Further, as regards local sourcing requirement, the same can be met as an average during the first 5 years, and thereafter annually towards its India operations. With a view to provide greater flexibility and ease of operations to SBRT entities, it has been decided that all procurements made from India by the SBRT entity for that single brand shall be counted towards local sourcing, irrespective of whether the goods procured are sold in India or exported. Further, the current cap of considering exports for 5 years only is proposed to be removed, to give an impetus to exports.

ii. The extant Policy provides that as regards local sourcing requirement, incremental sourcing for global operations by the non-resident entities undertaking single brand retail trading, either directly or through their group companies, will also be counted towards local sourcing requirement for the first 5 years. However, prevalent business models involve not only sourcing from India for global operations by the entity or its group companies, but also through an unrelated third Party, done at the behest of the entity undertaking single brand retail trading or its group companies. In order to cover such business practices, it has been decided that 'sourcing of goods from India for global operations' can be done directly by the entity undertaking SBRT or its group companies (resident or non-resident), or indirectly by them through a third party under a legally tenable agreement.

iii. The extant policy provides that only that part of the global sourcing shall be counted towards local sourcing requirement which is over and above the previous year's value. Such requirement of year-on-year incremental increase in exports induces aberrations in the system as companies with lower exports in a base year or any of the subsequent years can meet the current requirements, while a company with consistently high exports gets unduly discriminated against. It has been now decided that entire sourcing from India for global operations shall be considered towards local sourcing requirement. (And no incremental value)
iv. The present policy requires that SBRT entities have to operate through brick and mortar stores before starting retail trading of that brand through e-commerce. This creates an artificial restriction and is out of sync with current market practices. It has therefore been decided that retail trading through online trade can also be undertaken prior to opening of brick and mortar stores, subject to the condition that the entity opens brick and mortar stores within 2 years from date of start of online retail. Online sales will lead to creation of jobs in logistics, digital payments, customer care, training and product skilling.

Digital Media

The extant FDI policy provides for 49% FDI under approval route in Up-linking of 'News & Current Affairs' TV Channels. It has been decided to permit 26% FDI under government route for uploading/ streaming of News & Current Affairs through Digital Media, on the lines of print media.

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