FOREIGN DIRECT INVESTMENT & REAL ESTATE SECTOR IN INDIA

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I. **INTRODUCTION**[1]:

I.1 As per the World Investment Report 2008[2], India is the second most attractive location for Foreign Direct Investment [FDI] for the years 2008-2010[3]. As per the said report, the total FDI that had come into India during the year 2005 was 7,606 Million US Dollars. The said amount increased to 19,662 Million US Dollars for the year 2006 and it further increased to an amount of 22,950 Million US Dollars for the year 2007.[4] It is also stated in the said report that there is a substantial increase in the flow of FDI in South Asia and more particularly to India[5].

I.2 The importance of the Real Estate Sector in FDI inflows into India is well established. According to the report published by the India Brand Equity Foundation[6] [2005], the total size of the Real Estate Sector Market was around 12 Billion US Dollars and it was estimated to grow at a 'Steady Clip' of over 30 percent per annum. The Report, mentioned above, also pointed out a Report by McKinsey [2003] in relation to the Construction Housing Sector in India. The McKinsey Report pointed out that the Construction Housing Sector in Developed Countries constitutes around 3 to 5 percent of its Gross Domestic Product [GDP]. However in

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[1] Disclaimer: The information contain herein is of a general nature and is not intended to address the circumstances of any particulars individual or entity. Although, we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

[2] The World Investment Report 2008 is prepared by the United Nation Conference on Trade and Development.

[3] The World Investment Report 2008: United Nation Conference on Trade and Development [Page 34]. In terms of Table I.20, India is ranked as the second most attractive location for FDI in the next 3 years. It is important to point out that China is the most preferred location during this period. This is based on the UNCTAD Survey conducted for the years 2008-2010.

[4] These figures have been provided in the World Investment Report 2008 at Annex Table B.1 [Page 255].

[5] World Investment Report 2008: United Nations Conference on Trade and Development [Page 47]

[6] Real Estate: India's Coming Reality Show: India Brand Equity Foundation. This Article can be downloaded from http://www.ibef.org. The Indian Brand Equity Foundation is a Public-Private Partnership between the Ministry of Commerce, Government of India and the Confederation of Indian Industry.

India, the Housing Construction Sector constituted only around 1 percent of the GDP. The Report further pointed out that the Capital Housing Stock in India constitutes around 5sq.mtr. per capita which is extremely low compared to other Develop or Developing Countries.

I.3 Having underlined the need and prospect for growth in the Housing and Real Estate Sector in India, it will be relevant to point out the contribution of Real Estate in FDI inflows to India. According to a Survey conducted by the Federation of Indian Chambers of Commerce and Industry[7] [FICCI], the share of Real Estate in the Total Foreign Direct Investment into India have increased from 4.5 percent in the year 2003 to 10.6 percent in the year 2004.

I.4 In terms of the said survey, it was estimated that the component of Real Estate in the total FDI for the year 2005 would be between 10 to 20 percent. This exponential growth of the component of Real Estate in the total FDI inflows has been due to the trigger provided by the liberalized FDI Policy as provided by the Press Note 2 [2005 series]. According to FICCI, this decision of the Government of Indian to liberalize the FDI announced in the construction sector is perhaps the most significant economic policy decision taken by the Union Government[8].

II <u>TRANSITION</u>:

II.1 Prior to the present Regime, the Foreign Exchange Regulation Act, 1973 [FERA] was in force. FERA was repealed by the Foreign Exchange Management Act, 1999 [FEMA][9]. At the time when FEMA came into existence, Press Note 2 [2000 Series] dated 11.02.2000 was governing the

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[7] Survey report on Foreign Direct Investment in Real Estate: Federation of Indian Chambers of Commerce and Industry: 2005. This can be downloaded fromhttp://www.ficci.com/surveys/fdi-survey-real.pdf

[8] Ibid Foot Note 7.

[9] The Foreign Exchange Management Act, 1999 was notified vide Notification No. GSR. 371[E] dated 01.05.2000.

field. Press Note 2 provided that no Foreign Investment will be permitted in the Housing and Real Estate Sector. However, NRIs/OCBs were allowed to invest on certain specific schemes.

II.2 With the repeal of the FERA, the field came to be governed by the FEMA. In regard to the Transfer or Issue of Security by a Person Resident outside India, the same was regulated by the Foreign Exchange Management [Transfer or Issue of Security by a Person Resident outside India] Regulations 2000[10]. Regulation 6 of the said Regulation, provided that a person resident outside India may purchase 'equity or preference shares or convertible debentures' only in terms of the Foreign Direct Investment Scheme provided in schedule 1 of the said regulations.

II.3 Therefore, Foreign Direct Investment in India has to follow the procedure and the limitations prescribed in Schedule 1 of the said regulation i.e. it has to follow the Foreign Direct Investment Scheme. Rule 2 of the scheme prescribe that an India Company can issue shares or convertible debentures to any person resident outside India provided that the Indian Company is not 'engaged in any activity or in manufacturing of item included in Annexure-A'. Annexure- A, at the time when the said regulation was introduced [i.e. 03.05.2002] had an entry at serial no. 5, which read as under:-

> "5. Housing and Real Estate Development sector for investment from persons other than NRIs/OCBs."

Annexure B of the said regulations provided for the sectoral caps for FDI in various sectors. Item No. 2 of Annexure B provided the NRIs/OCBs[11]

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[10] The Foreign Exchange Management [Transfer or Issue of Security by a Person Resident outside India] Regulations 2000 was notified vide Notification No. GSR 406 (E) dated 03.05.2000.

[11] The expression OCBs was omitted by the FEMA [Withdrawal of Genuine Permission to Overseas Corporate Bodies (OCBs)] Regulations 2003 with effect from 03.10.2003.

were allowed to invest in certain specific schemes. Therefore, there was no difference between the Regime which existed prior to the coming into force of the FEMA and the Regime prescribed by the Original Regulations of FEMA. Therefore, the Limitations and Scope of Press Note No. 2 [2000 Series] was applicable at this stage.

II.4 Thereafter, Press Note No. 4 [2001 series][12] revised the existing sectoral guidelines on FDI. It inter-alia permitted the following:-

> iv. FDI up to 100% is permitted for development of integrated townships, including housing, commercial premises, hotels, resorts, city and regional level urban infrastructure facilities such as roads and bridges, mass rapid transit systems, and manufacture of building materials. Development of land and providing allied infrastructure will form an integral part of township's development, for which necessary guidelines/norms relating to minimum capitalization, minimum land area, etc., will be notified separately by the Government. FDI in this sector would be permissible with prior Government approval.

Although, the FDI policy was changed as per the Press Note 4 [2001 series] there was no corresponding amendment to the Regulation mentioned herein above[13].

II.5 The guidelines in relation to the implementation of the FDI policy [in regard to the development of integrated township including housing and building material] as change by Press Note No.4 [2001 Series] was

[12] Press Note 4 [2001 Series] was issued by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India on 04.01.2001.

[13] The effect of not incorporating the change in the Regulation is significant. In terms of the Regulations, the only way that a Person resident outside India can invest is by way of the manner prescribed by the Regulations. The effect, therefore, is that no one can by way of any right claim under the Press Notes. However, the Union Government cannot act except in accordance with the said Press Notes as it is the 'avowed policy of the Government'. Therefore, from a jurisprudential point of view there is a huge difference between the two situations. Yet, for all practical purpose the Government has to follow the Press Notes. However, this was very different under the earlier FERA Regime whereby by a mere issuance of a Press Note, the Policy in relation to FDI could be changed. This is however not true to the FEMA Regime.

given by Press Note No. 3[2002 series][14]. It provided for certain minimum requirements, such as:-

i) The Foreign Company seeking to invest shall be registered as an Indian Company and would be allowed to take up land assembly and its development as a part of Integrated Township Development.

ii) All cases will be processed by FIPB on the recommendation of the Ministry of Urban Development & Poverty Alleviation.

iii) The core business of the company seeking to make investments should be integrated township development with a record of successful execution.

iv) The minimum area to be developed by such company should be 100 acres.

v) The minimum capitalization norm was 10 Million US Dollars for a wholly owned subsidiary and 5 Million US Dollars for joint ventures with Indian partners.

II.7 It is important to point out that the aforementioned regulations were amended from time to time. One of such amendments was the Foreign Exchange Management [Transfer or Issue of security by a person resident outside of India] [Second Amendment] Regulations 2003[15]. The Second Amendment substituted Annexure A and B of the Regulations. In the list of activities for which FDI was prohibited, the following were included:-

"5. Housing and Real Estate Business"

[14] Press Note No. 3 [2002 series] was issued by the Department of Industrial Policy and Promotion, Ministry of Commerce & Industry, Government of India on 04.01.2002.

[15] The Foreign Exchange Management [Transfer or Issue of security by a person resident outside of India] [Second Amendment] Regulations 2003 were notified in the Official Gazette dated 18.06.2003.

However, Annexure B which provided the sectoral caps on investments by person's resident outside India included an entry relating to 'Housing and Real Estate Business.'

II.8 It is significant to note that the expression 'Housing' was introduce [for the first time] in Annexure A as an activity to where FDI is prohibited. At the same time, Annexure B had an entry in relation to Housing and Real Estate. However, Annexure B only allowed NRIs/OCBs to invest in specified scheme. This is a serious anomaly. However, by way of a reasonable construction it can be assumed that except the permitted activity provided in Annexure B, the other areas of the Housing and Real Estate Sector is barred from any FDI. This was in line with Press Note 2 [2000 series]. However, it did not incorporate the change provided by Press Note 4 [2001 series] as well as Press Note No. 3 [2002 series].

III. PRESS NOTE NO. 2 [2005 SERIES]:

III.1 In this backdrop, the Government of India issued Press Note No. 2 [2005 Series][16]. Press Note No. 2 substantially liberalized the 'FDI Policy' in relation to 'townships, housing, built-up infrastructure and construction-development project'. The objective of this new policy is to ensure that investments in these areas 'create new employment opportunities and add to the available housing stock and built-up infrastructure'[17].

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[16] Press Note No. 2 [2005 Series] was Department of Industrial Policy & Promotion, Ministry of Commerce & Industry, Government of India

[17] Press Note No. 2 [2005 Series]. It is important to note that there is a greater realization with the Policy Makers that there is a need to increase FDI in Real Estate and Housing Sector. The Eleventh Five Year Plan [2007-2011] in Chapter 11 [Urban Infrastructure, Housing, Basic Service & Poverty Alleviation] has commented that the ratio of urbanization in India is the lowest [at 27.8%] and has lead to 'tremendous pressure' on civic infrastructure. The Eleventh Plan further points out that there is an urgent need to create urban infrastructure by way of private participation.

III.2 As per Press Note No. 2 [2005 Series], the Government has decided to allow FDI up to 100% under the automatic route in 'townships, housing, built-up infrastructure and construction-development projects [which would include, but not restricted to, housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional infrastructure'. Therefore, Press Note 2 [2005 Series] included a specific as well as at the same time a more comprehensive and exhaustive list of activities where FDI up to 100% were allowed under the Automatic Route. This is the first and most significant change in the Policy as compared to the FDI Policy in terms of Press Note 4 [2001 Series][18]. Therefore, Press Note 2 [2005 Series] brought about a more crystallized policy.

III.3 The other significant change brought about by Press Note 2 [2005 Series] was the changes brought about in the development criteria, investment criteria as well as other conditions required to avail the benefit of Press Note 4 [2001 Series][19]. The fresh conditions required the following:-

i) The minimum area to be developed in relation to the development of a serviced housing plot is 10 hectares, in relation to a construction-development project the minimum built up area was 50,000 sq meters, and in relation to a combination of the two any one of the conditions; **[Development Criteria]**

ii) The minimum capitalization that was required for a wholly onwed subsidiary was 10 Million US Dollars and for a Joint Venture with an Indian Partner the minimum capitalization required was 5 Million US Dollars. It was also mandatory that the funds have to be brought in within 6 months of commencement of business. **[Investment Criteria]**

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[18] A Comparison between Press Note No. 4 [2001 Series] and Press Note No. 2 [2005 Series] would clearly reveal that hospitals, educational institutions, recreational facilities etc. do not find mention in Press Note No. 4.

[19] The criteria/condition for availing the benefit of Press Note 4 [2001 Series] was prescribed in Press Note No. 3 [2002 Series] and briefly described in Para II.5 herein above.

iii) The other conditions that were required to be followed were as follows:-

a) Atleast 50% of the project must be developed within 5 years from obtaining all statutory clearances;

b) Investors were not permitted to sell undeveloped plots[20].

c) The Project has to conform to the norms & standards laid down by respective State authorities.

d) Investor is responsible for obtaining all necessary approvals as prescribed under the applicable laws etc.

e) The State Government/ Municipal Board/ Local Body, which approves development plan, would monitor compliance of all the criteria mentioned herein above.

III.4 The significant change brought about by the new Policy was that the Development and Investment Criteria has been reduced. This reduction enables a FDI in a project within or near about an existing Urban Area. Previously, the Development criteria [100 acres] were so large that it was practically not possible for an FDI investor to invest in a Project near an existing urban centre.

III.5 The change in the FDI Policy brought about by Press Note No. 2 [2005 Series] was incorporated in the Regulations mentioned herein above. The Foreign Exchange Management [Transfer or Issue of Security by a Person Resident Outside India] [Third Amendment] Regulations 2005[21] included Item No. 23 in Annexure B. Item No. 23 created a new sector which reads as under:-

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[20] Undeveloped Plots has been defined in Press Note No. 2[2005 Series] to mean a plot where roads, water-supply, street lighting, drainage, sewerage & other conveniences, as applicable under the prescribed regulations, have not been made available. It will be necessary that the investor provided this infrastructure and obtains a completion certificate from the concerned local body/ service authority before he sells such a plot.

[21] The Foreign Exchange Management [Transfer or Issue of security by a person resident outside of India] [Third Amendment] Regulations 2005 were notified in the Official Gazette dated 19.07.2005.

> “23. Townships, housing built-up infrastructure and construction development projects. The sector would include, but not be restricted to, housing, commercial premises, hotels, resorts, hospitals, educational facilities, city and regional level infrastructure.

The conditions mentioned in Press Note No. 2 [2005 Series] was introduced in the said Regulations. It is important to still note that the anomaly pointed out at Para II.8 hereinabove still existed.

III.6 The anomaly mentioned herein before, was however rectified by The Foreign Exchange Management [Transfer or Issue of Security by a Person Resident outside India] [Second Amendment] Regulations 2008[22]. The said amendment Regulations amended Annexure-A [i.e. which provided for the Sectors prohibited for FDI]. By way of this amendment Regulations, the entry being ‘Housing and Real Estate Business’ [23]has been removed from the list of sectors prohibited for FDI. Further, the earlier Entry at Annexure B [being Entry No. 6 being ‘Housing and Real Estate’ was also removed. With this amendment the position has become clear.

III.7 The position in relation to FDI in the Real Estate Sector is permitted only for the activities mentioned in Item No. 23 of the Regulations or the Press Note No. 2 [2005 Series]. The advantages of the change in policy have already been dealt with while commenting on Press Note No. 2.

III.8 While concluding, it would also be pertinent to point out that that for the Objective of the New Policy to be implemented, it is required that huge systematic and regulatory changes are conducted at the State Level.

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[22] The Foreign Exchange Management [Transfer or Issue of security by a person resident outside of India] [Second Amendment] Regulations 2008 were notified in the Official Gazette dated 22.08.2008.

[23] Please see Paras II.7 & II.8 of the present Note as well as The Foreign Exchange Management [Transfer or Issue of security by a person resident outside of India] [Second Amendment] Regulations 2003.

One of the inhibiting factors in the free flow of FDI in the housing and township sector is the varied legal framework of each Indian state. This is evident from the fact that availability of land for housing has been constrained by various laws like the Land Reforms Laws etc. This brings confusion to the investor, and makes it all the more necessary to have a consolidated document specifying the approvals required from the concerned authorities & procedure thereof so that they are clear on the legal requisites before investing.