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LIBERALIZING THE CONSTRUCTION-DEVELOPMENT SECTOR: COMPREHENSIVE CONCESSIONS IN THE FDI POLICY

"... but there is not a shred of doubt in my mind that when you open an economy you should do it in totality. Foreign investment adds a sense of competition; we should see this as a wake-up call to modernise and upgrade." - Ratan Tata [1]

I. INTRODUCTION

Effective 3 December 2014, the Department of Industrial Policy and Promotion (DIPP)[2] has amended and consequently further liberalized the foreign direct investment (FDI) Policy ("Policy") for the "Construction and Development sector: Townships, Housing, built-up infrastructure" by easing the conditions for 100% FDI under the automatic route, as specified in the Press Note No. 10 (2014 Series)[3]. Previously, in May 2001 the Construction-Development sector was first opened for 100% FDI under the approval route. Eventually, in 2005, the government allowed 100% FDI in the sector under the automatic route, subject to conditions.

The revised Policy reduces minimum development area and capital requirements, eases exit and lock-in requirements, and makes special provisions for low-cost affordable housing projects.However, it remains to be seen how the government will treat ongoing projects which have already commenced under the older Policy.

The relaxations are aimed at inducing foreign investment for creation of affordable housing and employment generation[4]. The move will also help create demand for products of related industries like cement and steel.The change in the Policy comes at a time when foreign investment into housing are far below levels in 2006-07 to 2009-10[5] and when, as per Press Information Bureau's statement dated 29 October 2014, "enhancement of the affordable housing stock is urgent need in order to stem the proliferation of slums in and around the cities". The construction industry is also currently facing a liquidity crunch and is relying heavily on debtto finance projects. Renewed access to funds from abroad will help developers undertake and complete new projects, and will lead to recovery and growth of the industry as a whole.

II. SCOPE

Foreign investment is not permitted in an entity which is engaged in 'real estate business', construction of farm houses and trading in transferable development rights (TDRs). This was the case even prior to the revised Policy. 'Real estate business' is defined under FEMA Notification No. 1/2000-RB dated 3 May 2000 read with RBI Master Circular, as the dealing in land and immovable property with a view to earning profit or income there from and does not include development of townships, construction of residential/ commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships. Thus, 100% FDI under the automatic route is only permitted in construction-development projects; including development of townships, construction of residential/ commercial premises, roads or bridges, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure. Further, it has been clarified that 100% FDI under the automatic route is permitted in completed projects for the operation and management of townships, malls/shopping complexes and business centres.

III. ANALYSIS OFPROVISIONS

The revised Policy permits 100% FDI under the automatic route subject to certain conditions[6], the implications of which are analyzed below:

- ***Minimum Area requirement for all projects:***
    - In case of 'serviced plots' it has been done away with. Previously, the minimum area required to be developed was 10 hectares for 'serviced housing plots'. The word 'housing' has also been removed, thus bringing all plots falling under the description of serviced plots within the purview of this exemption. However, the term 'serviced plot' itself has not been defined in the Policy. This lack of clarity may lead to structuring of projects as projects for development of 'serviced plots', to avail of the exemption from the minimum area requirement.
    - In case of 'construction-development projects', the minimum area of the project has been reduced from built-up area of 50,000 sq. meters to "floor area' of 20,000 sq. meters. Therefore, under the revised Policy the developers with smaller projects would be entitled to receive FDI. As per the revised Policy, the term 'floor area' will be defined as per the local laws and regulations of the respective State Government. The reason for change in terminology from 'built-up area' to 'floor area' is not clear. Further, a recipient of foreign investment is required to procure a certificate from an empanelled architect to the effect that the

minimum floor area requirement has been fulfilled.
  - The previous Policy contained a further option in which 'Combination' projects, i.e. projects with elements of both serviced housing plots and construction-development, any of the two minimum area conditions would suffice. This arguably ambiguous provision has been removed in the revised Policy.

- ***Access to construction-development sector for smaller foreign investors***

  Minimum capital requirements have been reduced. All investee companies are now uniformly required to bring in a minimum foreign investment of USD 5 million. Previously, the minimum FDI requirement was bifurcated into USD 10 million for wholly owned subsidiaries and USD 5 million for joint ventures with Indian partners.

  The time allowable for bringing in the capital has also become less stringent. The minimum capital as above is to be brought in within 6 months from the commencement of the project[7] and subsequent tranches can be brought till the period of ten years from the commencement of the project or before the completion of the project, thus ensuring that the capitalization is capped to ten years from the commencement of the project. Under the earlier Policy, the minimum capital was to be brought in within 6 months of the commencement of business of the Company and there was no time limit for bringing in the subsequent tranches of investment. The amendment made in the Policy relating to bringing in capital on commencement of projects is a boost for foreign investors,as the Indian investee companies may have 'commenced business' under the relevant statute, but are unable to commence the projects due to varied factors including approval of plans by the competent authority which may take a long time.

  The lesser stringent conditions for minimum capital and time period of capitalization will permit smaller foreign investors access to the Indian markets. Smaller projects will also be permitted to be undertaken, which may encourage greater competition with Indian developers.

- ***Shorter term investments and quicker turnaround of projects due to easier exit***

  Once the "trunk infrastructure", i.e. the roads, water supply, street lighting, drainage and sewerage has been completed, the foreign investor may exit the project. Earlier, the Policy stipulated a 3-year lock-in period for the entire original investment, to be applied from the date of receipt of each installment/tranche of foreign investment or from the date of completion of minimum capitalization whichever was later. This lock-in period has been completely done away with.

  However under both the revised and the earlier Policy, the government may on a case-to-case basis permit repatriation of foreign investment or transfer of stake by one foreign investor to another, even before the completion of the project.

Now, the interest of the foreign investor is aligned with that of the government. These changes will (i) incentivize foreign investors to invest for the short-term, as they will be permitted to exit even prior to 3 years if trunk infrastructure has been completed, and (ii) encourage faster completion of trunk infrastructure, as exit is only possible once trunk infrastructure has beencompleted. Thus project turnaround till trunk infrastructure stage may also be faster under the revised Policy.

Under the earlier Policy, at least 50% of each project was to be developed within a period of 5 years from the date of obtaining all statutory clearances. This stipulation was subjective, and hence difficult to enforce. The stipulation of completion of at least 50% of the project within 5 years has been done away with under the new Policy.

- ***Sale of only Developed Plots/ requirements for completion***

  Apart from the condition that the foreign investor can exit a project only after trunk infrastructure is in place, under both the earlier and the new Policy, sale is only permitted in 'developed' plots, i.e. plots where the trunk infrastructure has been completed. So, this provision reinforces that the investor cannot engage in real estate business, i.e. business of dealing in land or immoveable property (or arbitrage) without adding value to the land, under the guise of investing in construction-development.

  Further, the earlier Policy provided for obtaining a separate completion certificate from the concerned local body/service agency before disposal of serviced housing plots,which has now been done away with[8]. Completion of projects will now be determined as per the local bye-laws, rules and regulations of State Governments.

Development of low-cost housing

In order to encourage the construction of low-cost housing and prevention of proliferation of slums and shanty towns across Indian cities, the revised Policy has provisions relating to Affordable Housing Projects (AHP). AHP are projects using atleast 40% of the FAR/FSI for dwelling units of floor area of not more than 140 sq. meters. Out of total FAR/FSI reserved for affordable housing at least 1/4th should be for houses of floor area of not more than 60 sq. meters. Investee/ joint venture companies which commit at least 30% of the total project cost for affordable housing are exempt from the minimum area and minimum capitalization requirements as described above.This exemption may be used in conjunction with other exemptions available for low cost housing, such as slum rehabilitation schemes as per the applicable laws in India. This will serve the dual purpose of making projects attractive investment options for foreign investors and will help reduce the proliferation of slums as envisaged by the government.

Impact on real estate investment trusts (REITs)

The revised Policy is not sufficient to facilitate real estate investment trusts (REITs), which investment structures have been allowed under the SEBI (REIT)Regulations (notified on 26 September 2014). The business of a REIT may be considered 'real estate business' under the present Policy, for which FDI is in any case prohibited. Separate FDI norms willbe necessary for REITs. In fact, the Finance Ministry has circulated a draft cabinet note to amend Foreign Exchange Management Act, 1999 to permit foreign investors to invest in REITs as allowed under the SEBI (REIT) Regulations.[9]

IV. CONCLUSION

Kofi Annan, the former UN Secretary General had in 2000 prophetically stated, "It has been said that arguing against globalization is like arguing against the laws of gravity." This statement cannot be more relevant to post-protectionist India, where the government has since the nineties consistently, although gradually, been lowering its barriers to foreign competition.

The growth of the housing and infrastructure industries are vital for the overall health and growth of the economy. The revised Policy for construction-development will bring down the cost of capital and increase the flow of funds into the cash-strapped real estate sector. Lowered barriers to investment, such as reduced minimum capital requirements and lock-in requirements along with mitigated procedural hurdles will make the Indian real estate sector a more attractive investment destination for foreign investors. Greater foreign investment in the sector will help to augment the available housing stock including affordable housing and commercial infrastructure and service the much-needed capital requirement in the sector. Allied industries may also be positively affected.

However, the ambiguity about how the government deals with ongoing projects under the earlier Policyremains to be seen. One needs to be cautious and may seek assistance of a legal professional to understand the intricacies of the Policy and its implications. Further, while infusion of more funds into the sector will lead to more supply, unless demand also increases, the introduction of supply will only lead to more pricing pressure and lower margins for investors, which is a potential Catch-22 situation.

- By Anirudh Hariani (Associate)

Editor: Trupti Daphtary

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[1] In step with the nation', interview with Mr. Ratan Tata, November 2007, available at http://www.tata.co.in/media/interviewsinside/KmqN8d384OM=/TLYVr3YPkMU=.

[2] The DIPP is responsible for formulation of the foreign direct investment (FDI) Policy and facilitation of FDI inflows into the country

[3] The Reserve Bank of India (RBI) has also issued a circular dated 22 January 2015 in line with

the Press Note, stating that the RBI has since amended the Principal Regulations through the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Sixteenth Amendment) Regulations, 2014 notified vide Notification No. FEMA.329/2014-RB dated 8 December 2014, c.f. G.S.R. No. 906(E) dated 22 December 2014.

[4] Press Information Bureau's statement dated 29 October 2014.

[5] Between April 2000 and August 2014, the construction sector received FDI worth USD 23.75 billion or 10 per cent of the total FDI attracted by India during the period. Source: Times of India, 'Government notifies relaxed FDI norms for construction sector', 3 December 2014.

[6] The conditions in the revised Policy inter alia relating to minimum area, minimum capital and exit do not apply to hotels and tourist resorts, hospitals, special economic zones (SEZ), educational institutions, and old age homes.

[7] "Commencement of the project" is the date of approval of the building plan/layout plan by the relevant authority.

[8] Although the amended Policy is silent about obtaining a completion certificate, it states that the project has to comply with the rules and regulations and all other requirements of the State Government/ Municipal/Local Body concerned.

[9] Economic Times, 'Draft Note floated for foreign funds in REITs', 30 January 2015.