LEGAL REVIEW OF POLICY CHANGES RELATING TO FOREIGN INVESTMENTS IN INDIA

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ABSTRACT

The present paper is an attempt to explore the key policy based changes that have contributed in shaping the laws relating to foreign investments in India. It was in response to the emergent balance of payment crisis that a conservative country had adopted and implemented a multi-dimensional model of liberalized economy for the very first time. The paper presents an insight on key propelling reasons behind suitable modifications to the foreign investment outlook of India and their impact on the economic discourse. It is since then that laws and policies relating to foreign investments is central to international collaborations and political dialogue in most of India's strategic deliberations with other countries of the world. This paper is also an attempt to justify that development of law relating to foreign investments in a careful and diligent exercise, most appropriately conducted by India.

1. The Background

India's conservative ideology of foreign trade was so intrinsic in its policies before liberalization that the same was evident in its legislations passed during that period. One such example is the Foreign Exchange Regulation Act, 1973 (FERA) which was a regulatory measure[1] to subject foreign investments in India to a web of aggressive regulations. Indian economic policy was undergoing vast changes and the Act, 1973 was becoming more unsuitable for the circumstances to address.[2] The immediate need of management as against regulation was pertinent to put the legal framework in line with the requirements of time and to serve the objectives laid down behind adoption of the foreign policy.[3] The legislation was categorized to be a severe regulator of current account transactions in foreign trade after independence and was based on transactions only to the effect that all transactions between residents and non-residents were prohibited except when permitted. The Report of High Level Committee on Balance of Payments[4] recommended the introduction of market- determined exchange rates, introduction of current account convertibility, strict regulation of external commercial borrowings and various other similar measures to provide for a relaxed environment for commencement of transactions with foreign entities in India.[5]

Management regime that had begun by adoption of Foreign Exchange Management Act, 1999 (FEMA) is characterized by introduction of sectoral caps and limits placed by the Government of India on an intelligible basis i.e. need of the hour. The government has dual objectives of promoting development of domestic economy and protection of security & interests of persons resident in India because of which it through a consolidated policy for various sectors, implements the scheme to monitor ownerships and control of Indian enterprises.[6] It was later clarified that the sectoral caps mentioned sector wise in the consolidated FDI policy includes all forms of investments, direct or indirect and no entity shall be allowed to exceed the maximum limit prescribed under any circumstances.[7] The law also prescribes purposes for

[1] Most of the dealings in foreign exchange required prior approval/ permission of the Reserve Bank of India.
[2] Dheeraj Gadhi & Dr. I C Kashyap, *A Journey from FERA to FEMA- Impact on Indian Forex*, International Journal of Research in Commerce, Economics and Economics, Volume 3 (2013), Issue No 07, ISSN: 2231-4245
[3] K Srinivasan, *The Shift from FERA to FEMA*, The Hindu- Business Line, 03 FEB 2000
[4] C. Rangarajan, Report of High Level Committee on Balance of Payments, New Delhi, 1993
[5] Shyamala Gopinath (Deputy Governor/ RBI), *Foreign Exchange Regulatory Regimes in India- From Control to Management*, Address at Conference organized by Forum for Free Enterprises, 25 January, 2005 available at https://www.bis.org/review/r050217h.pdf (13 FEB, 2019)
[6] Dipanwita Nayak & Pranjal Soni, *Sectoral Investment Cap on FDI*, Journal on Contemporary Issues in Law, Volume 2, Issue 2
[7] RBI Notification No RBI/2016-17/88, October 20, 2016

which the money so invested could be utilized and any contravention to the provisions shall be deemed against the law.

It is clear from the analysis of changes made to FDI policies over a period of time that the government has been decisive regarding objects & reasons behind any alteration made to policy statement. It is reflective of the fact that India does not intend to receive foreign investment for the reasons it may deem unfit or which does not have any corresponding objective to serve for. The object-oriented approach is a concern which is addressed internally and external counterparts have no role to play in the subject. It is also aimed at protecting sovereignty and economic independence of India.

2. Rationale behind policy alterations

Indian economy was clutched into conservative business ideology prior to the adoption of industrial policy 1991 that concentrated on regulation of foreign investments in India.[8] It was well thought that foreign investment is much required to boost economic development and acquisition of new technology so that better operational practices may be incorporated. The industrial policy made several relaxations to the long-existing legal framework that was hindering free flow of investment and trade in and out of India. FEMA was one such categorical example of India's developing attitude of incorporating global practices to offer the best to its citizens. The legislation for the first time introduced automatic routes of entry to India's domestic market which was earlier foreclosed by government norms of licensing and reservations to domestic players.[9] The law also focused on upholding the national integrity and sovereignty by ensuring government's supervision in sectors which were considered to be sensitive for the economic and security interests.[10]

It is also important to mention here that it was not just the adoption of FEMA that resulted in birth of foreign investments in India. There were various other significant measure that had propelled the economic venture by supplementing domestic worth with foreign investment among which adoption of Foreign Trade (Development and Regulation) Act, 1992 and modifications to the existing Monopolies & Restrictive Trade Practices Act, 1973 are

[8] Regulation is said to mean controlling all activities, whether in public or private behavior that are deemed to be detrimental to public or government's interest. See Richard A Posner, *Theories of Economic Regulation*, Working Paper No 41, Center for Economic Analysis of Human Behavior & Social Institutions, 2004
[9] Foreign Exchange Management Act, 1999
[10] Vijay Vir Singh, *Regulatory Management & Reform in India*, Background Paper for OECD, CUTS International, available at https://www.oecd.org/gov/regulatory-policy/44925979.pdf

considered to be most important in time.[11] There are many objectives that run behind any modification to existing industrial policies such as upholding the environmental concerns, protection of public interest (which has been incorporated in Bureau of Indian Standards Act, 1986), creation of opportunities for marginalized and small sectors of business activity etc. Although long carried approach of close economy watch has not been withered away in the laws that have been passed post-liberalization, protection of domestic economy from exploitation and excessive competition is also incumbent on the government. Recent measures have been criticized by various commentators that replacement of the word 'regulation' in FERA to 'management' in FEMA has neither relaxed the norms in entirety nor has made foreign investments free from restrictions holds true and legitimate if government is placed under a duty to take measures for granting reservations, exemptions and incentives to domestic economy.[12]

3. A Different Outlook to Foreign Investments in India

It is therefore clear from the discussion made above that adoption of a uniform policy, innovative economic module and establishment of regulatory/ managing framework to attract foreign equity investments was an act conducted in series of stages that has also encompassed various other factors for consideration. Other factors have been in importance not because of the fact that prevention of domestic virtues was important but that the government was also under the duty to justify any progressive improvement to the policy directive on the paradigm of object-oriented approach. It is important to mention here that various aspects concerned to foreign investments were dealt by the government in the similar way and on similar outlines.

Supplementing the realm of foreign investments in terms of equity and capital contributions was the emerging importance of 'external commercial borrowings' and 'trade-credits' for which India had adopted a complex multi-dimensional system of capital controls.[13] Before heading to the policy update on external commercial borrowings in India, it is pertinent to explore the reasons behind such borrowings by Indian firms. In contrast to Foreign Direct Investment and Foreign Indirect Investments which are preferred categories of equity investments; foreign borrowing is a debt-based financing scheme resorted by large enterprises in India. The foreign debt borrowing is permissible in two ways: trade credits which include

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[11] *Ibid*.
[12] Ruma Dubey, Special Note to Arab News, 23.09.2002 available at http://www.arabnews.com/node/224422
[13] Ila Patnaik, Ajay Shah & Nirvikar Singh, *Foreign Currency Borrowings in Indian Firms- Towards a New Policy Framework*, Working Paper No. 167, National Institute of Public Finance & Policy, 2016

buyers' credit & suppliers' credit and external commercial borrowings.[14] The division of debt borrowing needs stringent regulation pursuant to the fact that foreign currency borrowing comes coupled with possibilities of currency mismatches which significantly affects the balance sheet records in a long run and both governments and firms may get exposed to greater systemic risk, if proper corrective measures are not implemented to reduce the effects. It therefore becomes important for the government to consider supervision by prescribing limits, conditions and eligibilities before any Indian entity resorts to external debt borrowings from outside India.

The key points of concern in foreign currency borrowings arise because the domestic entities and government gets exposed to systemic risk occurring periodically and if the same remains un-hedged for a long period of time, it may also invoke possibilities of insolvency and bankruptcy. One of such factors is currency mismatch in debt borrowing which can lead to national crisis if the firms under such borrowing come to distress principally because of currency fluctuations.[15] Another factor worth of consideration is political uncertainty which is heavily dependent on circumstances amongst the countries. Diplomatic negotiations at international levels cause a direct impact on both investments and borrowing which puts firms to a greater risk of uncertainty.[16]

4. Assessment & Policy Updations

In order to emphasize on need of regulation of foreign currency borrowings by Indian firms, the government of India in 2013 had set up **Sahoo Committee** to look inside existing framework and suggest for improvements, if any. The committee in its **3rd Report** had recommended that regulatory interventions must be guided by an analysis of potential market failure and must seek to target and correct those failures. The most critical market failure associated with ECB was identified to be externalities arising from systemic risk, on account of currency exposure.[17] It is also notable that although the report records risks that may be associated with foreign currency borrowings and has argued for allowing the same on the count

[14] Partha Roy & Abhishek Sur, *India's External Commercial Borrowings- Trends, Composition & Determinants*, Working Paper Series No. 802, Indian Institute of Management- Calcutta, 2017
[15] Eichegreen, Berry, Ricardo Hausmann & Ugo Panizza, *Currency Mismatches, Debt Intolerance & Original Sin- Why they are not the Same and Why it all Matters?*, NBER Chapters, National Bureau of Economic Research, 2007
[16] Radhika Pandey, *Motivations for Capital Controls & Their Effectiveness*, Working Papers for Bank of Canada, Canada, 2015
[17] See Sahoo Committee, Report III

of calculated risks, the same has not suggested any alternative method to address currency mismatches apart from hedging.

While hedging as a method to counter the currency risks associated with foreign currency borrowings could be a preferable option, another supplementary measure could be '**trade offsetting**'. Although it has not been covered in literature to a great extent, but it could be a substantial method of balancing currency effects. The system of offsetting involves placing contractual liabilities on the foreign counterpart to perform certain purchase transactions with any Indian entity for any product (whether of use or not of use for the foreign counterpart) against a pre-negotiated portion of payment liability that may arise on Indian entity. Increasing access to rupee denominated borrowing could also be a suitable alternative to address risks connected to currency exposure. India has recently made significant changes in line with recommendations of **Sahoo Committee**. It has been prescribed that all entities eligible for FDI shall be automatically eligible to raise ECB. This will be beneficial not only in promoting the disallowed categories to get financed through ECB but also by removing the multi-layer regulation on foreign investments.[18] It has also been indicated that for the first time, 'Limited Liability Partnerships (LLPs)' registered in India shall also be eligible for accessing foreign currency borrowings.[19]

In order to control the effects of currency mismatches due to external commercial borrowings by Indian entities, there was also a need to allow them for issue of rupee denominated corporate bonds which has the effect of by-passing currency deficits. The revised framework on external commercial borrowing is also exemplary in terms avoiding conflicts in definitions and interpretations, prescribing wider categories of eligibilities and removing principles of categorization that have become meaningless over a period of time.[20] Apart from this, there are considerable efforts being done to implement independent decisions of policy on matters of foreign investments to specific sectors pertaining to their needs and requirements.[21] Needless

[18] Reserve Bank of India, *Master Direction – External Commercial Borrowings, Trade Credit, Borrowing and Lending in Foreign Currency by Authorised Dealers and Persons other than Authorised Dealers*, 16 January 2019
[19] *Ibid*.
[20] Nishith Desai & Associates, External Commercial Borrowings: Regulatory Framework Substantially Relaxed, 01 FEB, 2019 available at http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/external-commercial-borrowings-regulatory-framework-substantially relaxed.html?no_cache=1&cHash=225df0a15bad7dc66b993edb783fe9f8
[21] Ernst & Young, *India amends foreign investment rules governing foreign debt investment into Indian Entities and foreign direct investment in e-commerce sector*, 11 January, 2019.

to say, it is important that all major policy changes are appropriately backed with intelligible criteria and objectives for larger commercial benefits.

5. Propelling Reasons behind A Robust Policy

It is therefore clear from the discussion made above that it would not be completely inappropriate to say that despite liberalization policy being implemented in India through Industrial Policy-1991, mechanism of foreign investments through foreign debts has remained in control of the government because of the charges that they seek to create on assets of Indian entities. The objective behind regulation of welcoming ECB was to minimize the risk of exposure to foreign currency and political uncertainties in order to protect the interests of domestic economy. As the entities are gaining more stability and control over their liabilities, government is taking steps to liberalize the framework so that benefits may accrue to various categories of players and sectors depending on fair analysis of their competence and possibilities of market failure. Whatever the case may be, government's decision of removing several legislative roadblocks in currency borrowing will be beneficial to the domestic entities.

The general scheme for foreign investments in India provides for both equity and debt based investment mechanisms that are governed by specific regulations laid down by the empowered regulators in order to minimize risks and prevent losses. As seen from the discussions made above, transition from 'regulatory' approach to approach of 'management' has opened new avenues of experience and collaboration among domestic and foreign enterprises. There have been various efforts to attract foreign investments in India among which reforms to trade and licensing norms, instrumentalities of taxation and accounting provisioning hold paramount importance.[22] The need of laying down uniform policy objectives, definite legal principles in matters of regulation has been responded well but, there is still a lot that could be done. It is widely felt at global level that Indian economy is not that much liberalized owing to complex tax structure, absence of decision taking power at state levels etc. which continue to frustrate foreign investors from entering in India's domestic market. Introduction of '**Goods & Services Tax**' under the banner of '**One Nation One Tax**' was also a positive move to send a message to the world that India is continuously working to put the hindrances of legal system to rest and open new opportunities for both domestic as well as foreign entities.

[22] Anand Sharma, Minister of Commerce & Industry, Government of India in press note to The New York Times reported in '*India opens Door to Foreign Investments*', 4 September, 2012

Despite various creative efforts to boost economic development, create new opportunities of employment and manufacturing at domestic level, critics have always viewed the key policy decisions to be anti-people and disastrous. Their concentration for the same has been based on government's response to welcome foreign investment on the one hand and putting domestic entities at greater competition and risks by such entry. But whatever the case may be, cumulative effect was economic progress of the country and supplementation of domestic capital with foreign investment. Yet there are some aspects on which government's attention is required to a greater extent so that the process and modalities could be simplified in both equity and debt based investment schemes. Government should also consider that its legislations are competent enough to address the challenges that may arise during such liberalization among which issues of jurisdiction holds the prime importance. Extra-territorial jurisdiction of regulators such as Competition Commission of India is categorical among these.[23]

6. Concluding Remarks

As has been discussed above, laying down comprehensive policy framework for FDI in India involves a series of political deliberations and discussions. There are many objectives which the government needs to address that may or may not be reflected in the policy statements. It is therefore necessary to develop a thorough understanding of background in which any policy directive is being implemented for certain specified objectives. It is indeed essential to uphold the concept of parity and justice so that forward steps could lead to eventual results. Students, researchers and academicians in India have to understand that a mere literary interpretation of laws and policies would not justify the purpose unless the teacher and the taught are aware of circumstances in which any policy statement has been promulgated by the government. It is therefore incumbent on the readers to develop a holistic approach to subjects such as investments & securities.

Law relating to foreign investments is albeit a less explored area in contemporary jurisprudence but holds extreme importance for a fast developing economy like India. There is therefore a need of academic deliberation, research and interaction on critically intersecting issues related to the field.

[23] Section 32 of Competition Act, 2002