A Trail of Confusion

Almost 10% of FDI flow in India is in the real estate sector. Yet the Consolidated FDI Policy fails to clear the air on a host of issues.

Ever since the Foreign Direct Investment (FDI) Policy of India embraced the real estate sector, the real estate industry has become the second largest employment generator in India after agriculture. The size of this industry is estimated to be in excess of US$ 12 billion. Recent studies have indicated that this figure had been growing at an astounding pace of 30% for the past few years. This sector has received more than US$ 9 billion of FDI until 2010. Almost 80% of real estate developed in India comprises residential space, and the remaining portion consists mainly of offices, shopping malls, hotels and hospitals. The off-shoring business, including high-end technology consulting, call centres and software programming houses, has been a significant contributor to this remarkable growth of the real estate industry. The persistent demand from the Information Technology (IT) sector, coupled with the fact that several

multinational companies continue to move their operations to India to make the most of lower costs of skilled manpower and logistics, has ensured a dramatic change in the urban landscape of India. Many international players, including developers such as Emaar, Ascendas, Keppel Land, Tishman Speyer and Nakheel Group, and investors such as Morgan Stanley, Och-Ziff Capital, Citigroup, Goldman Sachs, JP Morgan, Warburg Pincus and Deutsche Bank, have entered the Indian real estate market.

It is, therefore, a matter of concern that FDI in India has recorded a sharp decline in this financial year thus far. This decline is made more glaring when juxtaposed with the strong inflows that expanded by an astronomical 51% compounded annually over the five years ending 2010. The Reserve Bank of India (RBI) had earlier hinted that the decline in FDI was a result of the financial crisis in several European economies. However, the recent 21% jump in FDI in South American countries and the 18% increase in South, East and Southeast Asian nations seems to suggest otherwise. Moreover, the fact that the automatic route of FDI in India has been impacted more by the steep decline in fresh money seems to suggest that even in sectors where FDI could have come without having to seek approvals, foreign investors may be deliberately withholding investments.

Of the top ten sectors that receive FDI flows, the real estate sector seems to have been hit the worst. Money going into housing and real estate as well as construction activities that include road and highways has more than halved. The recent successes of other developing nations in increasing their FDI flows, leads to the conclusion that the decline in FDI flows in India has been due to more India-specific factors. It may be argued that foreign investors' confidence in the real estate sector has been more acutely affected due to the recent scams and corporate governance issues that have impacted the sector coupled with taxation issues in Special Economic Zones (SEZs) and the marked slowdown in infrastructure order flow. However, there seems to be a deeper underlying reason for this lack on foreign investors' confidence – uncertainties and ambiguities in the FDI Policy on real estate.

FDI Policy

The current Consolidated FDI Policy of India permits FDI up to 100% under the automatic route in townships, housing, built-up infrastructure and construction development projects (which would include, but not be restricted to, housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure facilities, such as roads and bridges, transit systems etc.), provided certain conditions are satisfied and guidelines are followed.

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Minimum Area of Development

Cause 5.2.13.2.(1) of the Consolidated FDI Policy mandates that a minimum land area of 10 hectares be developed in the case of serviced housing plots, while construction development projects should be characterized by a minimum built-up area of 50,000 sq. mts. Although stipulating a minimum area of development may be justified, the limit currently prescribed is more restrictive, rather than facilitative, of FDI in the sector. Since foreign investment in 'agricultural or plantation activities', in any form, is prohibited under the FEMA Regulations , many investors are finding it increasingly difficult to identify non-agricultural land in urban areas to undertake extensive real estate development at economical costs for end users.

Many mid-size and small investors feel that the minimum area restrictions imposed by the Consolidated FDI Policy can only be met by the acquisition of vast expanses of agricultural land. The consequent effect is that Indian developers have to first acquire agricultural lands and get the necessary approvals/clearances for conversion of the land for non-agricultural purposes from local authorities before they can look for foreign partners for the project. Ironically, pursuant to the recent admonishment issued by the Central Government, many State Governments are now tightening their rules pertaining to the conversion of agricultural lands

into other categories for residential, industrial and infrastructure use in a bid to curb indiscriminate development. Furthermore, upon the due conversion of the agricultural land, the value of the land increases manifold, and thereby decreasing its attractiveness for foreign investors.

The various land reforms legislations in the States have further compounded the difficulties faced by real estate investors. Such legislations limit the amount of land that can be held by providing a fixation of ceiling on land. In some instances the land ceiling is lower than the minimum area requirement of the Consolidated FDI Policy, thereby rendering the concerned policy redundant. In order to overcome this impediment, investors are forced to invest through different entities, which in turn results in the further complication of the procedure for the acquisition of land.

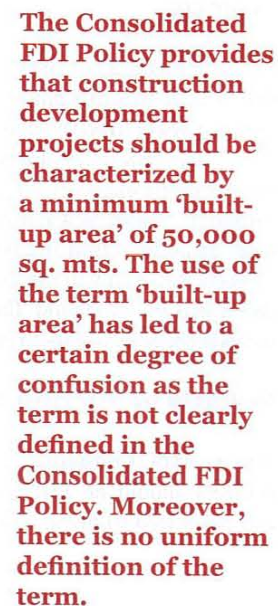
The Department of Industrial Promotion and Policy (DIPP), therefore, needs to consider lowering the mandated minimum area requirement in the Consolidated FDI Policy in order to ensure that a greater quantum of FDI is channelized into viable real estate projects. Moreover, the FEMA Regulations, Consolidated FDI Policy and other applicable laws need to be harmonized in such a manner that FDI for the purchase of agricultural lands is permitted, provided that the use for the same is duly converted to non-agricultural purposes in accordance with applicable laws. The existing land reforms enactments also need to be brought into synchronization with the Consolidated FDI Policy.

The Consolidated FDI Policy provides that construction development projects should be characterized by a minimum 'built-up area' of 50,000 sq. mts. The use of the term 'built-up area' has led to a certain degree of confusion as the term is not clearly defined in the Consolidated FDI Policy. Moreover, there is no uniform definition of the term. Although the Consolidated FDI Policy states that bye-laws and rules of local authorities must be complied with, thereby implying that 'built-up area' will have the definition recognized by the concerned local authority, the DIPP ought to consider defining and adopting an enforceable standard code of measurement. This would ensure greater symmetry and transparency in calculations for permissible investment levels.

Minimum Capitalization

The Consolidated FDI Policy subjects investments by foreign investors to minimum capitalization requirements. Under Clause 5.2.13.2(2), for wholly-owned subsidiaries of foreign companies, this limit has been set at US$10 million. In the case of a 'joint venture' with an Indian partner, the minimum requirement is US$ 5 million. Initially, ambiguities had arisen with regard to the computation of the value of minimum investment, more specifically with respect to whether the minimum investment should comprise only of the face value of shares or should include premium as well. Subsequently, the DIPP has opined that the minimum capitalization requirement should include only the paid-up capital and not premium. This opinion, however, has not been substantiated by any regulation of the RBI or SEBI. Under these circumstances, including a clarification to this effect in the Consolidated FDI Policy may provide greater clarity to prospective investors.

The minimum capitalization requirement has manifestly pushed up the capital requirements for the sector as most companies have more than one ongoing project. The DIPP should also consider lowering the minimum capitalization



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requirements in the Consolidated FDI Policy. The real estate sector in India has traditionally been run by mid-size and smaller players, who have been impacted the most by this requirement. Lowering the minimum capitalization requirement would provide these players with a level playing field.

In the absence of any definition of 'joint venture' in the Consolidated FDI Policy, it may be argued that an Indian partner in a joint venture may have as little as 1% stake. This, obviously, cannot be the intention of the Government. The Consolidated FDI Policy, therefore, needs to contain specific provisions pertaining to the requirements of a joint venture in the real estate sector, such as the Indian partner's investment, its responsibilities as a partner, etc.

Clause 5.2.13.2(2) also mandates that the foreign funds/investments have to be brought in within 6 months of the 'commencement of business' of the company. In order to ensure greater clarity, the Consolidated FDI Policy should specifically define the phrase 'commencement of business' and stipulate whether the same means the date on which the relevant agreement is executed or the date on which the joint venture company is incorporated.

The current Consolidated FDI Policy prohibits FDI in 'real estate business'. The ambit of the phrase 'real estate business' can be extended to include development or construction of real estate, which would clearly infringe Clause 5.2.13 of the Consolidated FDI Policy.

Timely Completion of Projects

Clause 5.2.13.2(4) of the Consolidated FDI Policy provides that at least 50% of a project must be developed within a period of 5 years from the date of obtaining all statutory clearances. This requirement has a deterrent effect on foreign investors proposing to invest in large scale real estate projects. Although 5 years is a reasonable time to complete 50% of most projects, it may not be sufficient for particularly large projects, especially in the Indian environment. The Consolidated FDI Policy should, therefore, be suitably amended to provide some flexibility to certain large scale projects.

Projects of Varying Sizes

The current Consolidated FDI Policy requires that all projects should be FDI compliant. Foreign investors are not permitted to invest into companies that have multiple projects, some of which may not be FDI compliant. This also acts as a major impediment for FDI in the real estate sector in India. The DIPP ought to consider modifying its guidelines in such a manner so as to provide greater flexibility in this regard by allowing foreign investors to invest in such companies, provided that certain strict measures are adopted to ensure that the FDI compliant and non-complaint projects are adequately ring-fenced.

Real Estate Business

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Presently, foreign investors are not allowed to acquire property for the purpose of leasing, as this would amount to real estate business. The Central Government has taken the view that FDI may be permitted where the property is constructed and then leased out. The RBI, however, does not appear to be in agreement with this view. Unfortunately, the Consolidated FDI Policy does not explicitly clarify the correct position, and consequently foreign investors are unduly constrained to obtain the prior clearance from the FIPB. Under these circumstances, the Consolidated FDI Policy ought to clarify whether FDI is permitted for the construction and leasing of property.

The importance of foreign investment into real estate development cannot be over emphasized. The perpetually increasing demand for housing, commercial space, townships and infrastructure in India can be sufficiently met only when foreign investment into this sector is facilitated. Increased foreign participation will also positively affect the quality and professionalism in which real estate development takes place in the country. The Government has recognized this, and has been updating its policy on the real estate sector from time to time. However, the abovementioned uncertainties and ambiguities in the current Consolidated

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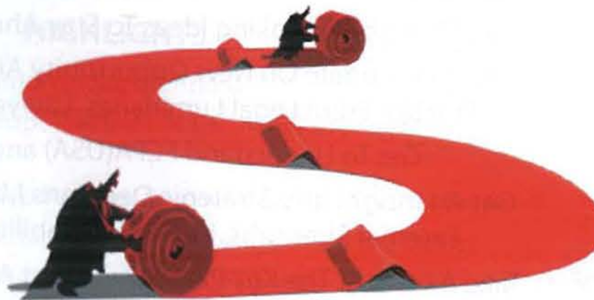
FDI Policy on real estate is hampering the flow of foreign investments in the real estate sector, and is also playing a contributing role in the ongoing decline in FDI in India. These uncertainties and ambiguities, therefore, need to be adequately addressed in order to ensure a robust economy through favourable demographics and liberalized foreign investment rules.

The Indian Government has recently decided to allow FDI in Limited Liability Partnerships (LLPs). This is a welcome measure, and will undoubtedly benefit the economy by attracting greater FDI, creating employment and bringing in international best practices and latest technologies. This development is expected to especially help LLPs engaged in areas such as IT, hospitality, healthcare and R&D. Nonetheless, as of now, FDI in LLPs is only going to be permitted in sectors where 100% FDI is allowed through the automatic route and there are no FDI linked performance related conditions, thereby effectively taking the real estate sector out of the ambit of this development. It is, however, imperative that FDI is permitted in LLPs engaged in the real estate sector is permitted.



The Indian Government has recently decided to allow FDI in Limited Liability Partnerships (LLPs). This is a welcome measure, and will undoubtedly benefit the economy by attracting greater FDI, creating employment and bringing in international best practices and latest technologies. This development is expected to especially help LLPs engaged in areas such as IT, hospitality, healthcare and R&D.

Upon receipt of concerns regarding the lack of clarity on what constitutes real estate, the Government is also planning to widen the definition of real estate in its Consolidated FDI Policy to include consultants, advisers, valuers and brokers. In this regard, the DIPP has circulated a draft note for comments of various ministries on the proposal. The draft note proposes to include, in the definition of real estate, all consultancy or advisory services related to space and property issues of any kind. Agents, advisers, brokers and consultants dealing with any facet of residential, commercial and industrial property will consequently be included in the FDI policy if they offer certain services. If implemented, this proposal is likely to make the FDI policy more restrictive rather than facilitative as it would effectively restrict the entry of foreign players in these specialized services. The proposal may even adversely affect the existing players who only offer advisory services, and do not in any manner control liquidity or make investments in the real estate sector. Such retrograde measures, especially at a time when FDI is on a decline, need to be avoided.

It cannot be doubted that a boost in FDI in the real estate sector will go a long way in alleviating the recent decline in the overall FDI in India. The fact that almost 10% of FDI flow in India is in the real estate sector is testament to this fact. It has, therefore, become imperative that the Consolidated FDI Policy addresses the issues discussed above. This has become even more important in the context of the widening gap between FDI flows and portfolio flows in India. The RBI in a recent statement has expressed its concern over the fact that the country's high current account deficit is increasingly becoming dependent on financing by the volatile foreign portfolio investments as against the more stable long term FDI. Under these circumstances, real estate investors expectantly await the next half yearly update of the Consolidated FDI Policy.

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