RECENT CHANGES IN FDI REGIME FOR INDIAN REALTY

By Vivek Kohli and Anu Chowdhry

Significant changes have recently been made to the Foreign Direct Investment (FDI) regime governing India's cash-starved realty sector, which has been witnessing declining FDI inflows. The declining amounts are $2.94 billion in 2009-10, $1.23 billion in 2010-11, $0.73 billion in 2011-12, $0.13 billion in 2012-13, and $.12 billion in 2013-14, according to data compiled by Department of Industrial Policy and Promotion (DIPP), Government of India. In its Cabinet Note in October, 2014, the Government of India proposed numerous amendments to the Consolidated FDI Policy, 2014 (FDI Policy), aimed at increasing inflows and opportunities for growth and employment. With the release of DIPP's Press Note No.10 on December 3, 2014, the final amendments to the FDI Policy have come into effect, and are analyzed in this article.

Permissible Activities

With the inclusion of roads and bridges, Press Note 10 has expanded the scope of construction development activities that are eligible to receive 100% FDI under the "Automatic" entry route in the real estate sector. Further, by doing away with the erstwhile open-ended description of construction development activities (which had included but were "not restricted" to residential and commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure), Press Note 10 provides greater clarity on the kinds of projects that are eligible to receive 100% FDI. Importantly, FDI continues to be prohibited in "real estate business" (that is, dealing in land and immovable property with a view to earning profit or income therefrom), construction of farmhouses and trading of transferable development rights. In September 2014, the Securities and Exchange Board of India notified the regulatory framework for setting up Real Estate Investment Trusts (REITs) in India. As the nature of activities and investments in yield-generating immovable assets undertaken by REITs would be tantamount to "real estate business." an exception must be carved out in the FDI Policy so as to achieve the objective of promoting REITs as an alternative investment vehicle for foreign investors.

Capitalization Norms

With a view to encourage FDI inflows in smaller real estate projects, Press Note 10 sets the minimum capitalization requirement as $5 million, irrespective of whether the foreign investor participates through a Wholly Owned Subsidiary or a Joint Venture with domestic partners. This is a significant change from the earlier position where a foreign investor was required to commit a minimum capital of $10 million or $5 million, depending on whether it entered the market through its Wholly Owned Subsidiary or through a Joint Venture with domestic partners, respectively. As per DIPP's Clarification to Press Note 10 released in March, 2015 ("DIPP Clarification"), whether a foreign investor has fulfilled its mandate of minimum capitalization of $5 million is to be assessed on a project-specific basis, and not on a company-specific basis. Where minimum capital brought by a foreign investor into an Indian investee is allocated across more than one real estate project, such infusion shall not be construed as valid fulfilment of minimum capitalization norms.

Earlier, such minimum capital had to be invested within six months from commencement of business of the company. However, the previous FDI Policy had failed to clarify whether this period was to be calculated from the date of incorporation of the Company, or date of commencement of business

operations of a company, or from the date of commencement of the real estate project being undertaken by a new/existing company. Precise calculation of this timeframe was vital as contravention of FDI Regulations is liable to a steep penalty of up to thrice the sum involved (where the amount is quantifiable). To address this lacuna, Press Note 10 clarifies that at least $5 million must be invested within six months from the date of "commencement of the project," which in turn shall mean from the date of approval of the building plan for construction projects or layout plan for townships, as the case may be. The reckoning date for commencement of a project shall be the date of "first" approval of building plans/layout plans, as any further approvals would only be modifications/addendums to such first approval. Subsequent tranches can be brought in till ten years from commencement of the project or before completion of the project, whichever expires earlier.

However, infusion of large sums is not always or immediately required in the early stages of a real estate project. Conducting due diligence of land parcels, financial due diligence, project feasibility reports etc. is often a lengthy process. Therefore, mandating that minimum capital of USD 5 million be invested in a project within six months of its commencement may be counterproductive to attracting FDI in the long-term - foreign investors are justifiably wary of losing interest on funds lying idle, which in turn would drive up construction costs for projects. Additionally, this condition of requiring minimum capital investment within six months of "commencement of a project" is silent on whether and how it would operate in the scenario where a foreign investor seeks to infuse funds at a later stage in a project (i.e. when building plan/layout plan was issued more than six months ago).

Construction Milestones and Timelines

FDI in the construction development sector is permissible subject to fulfilment of rigorous performance-linked conditions in the FDI Policy. Earlier, the FDI Policy set out the minimum level of construction that was to be achieved for three categories of projects, namely, construction-development projects, serviced housing plots and combination projects. Press Note 10 introduces relaxations for all three categories. For construction-development projects, the minimum area to be developed was 50,000 square meters measured in terms of "built-up area" – this now stands reduced to 20,000 square meters, and is to be measured in terms of "floor area," instead. Floor area shall be defined according local laws or regulations of the respective State or Union Territory. Although widely used in industry parlance, the terms "built-up area," "super area" and "carpet area" are not yet defined in State legislation or municipal regulations. Hence, replacing "built-up area" with "floor area" is a positive step. The Indian investee is also now required to procure a certificate to the effect that the minimum floor area requirement has been fulfilled – this should help foreign investors monitor construction compliances.

Previously, FDI was permissible only in serviced housing plots (i.e. housing plots equipped with basic civic infrastructure) but not in non-residential plots. For serviced housing plots, the minimum land area that was required to be developed was earlier 10 hectares (approximately 24.7 acres). Press Note 10 has made two important changes here – firstly, it has omitted the word "housing". Thus, FDI will now be permissible even in plots meant for non-residential use, provided other conditions of FDI Policy are complied with. Secondly, the condition of minimum area required for development of serviced plots has been removed.

Regarding the third category of combination projects, the FDI Policy earlier stipulated that either of the two conditions (i.e. developing minimum 50,000 square meters of built-up area OR developing minimum 10 hectares of land area) would suffice. With removal of the condition of minimum level of construction for serviced-plot projects, having a condition in place for combination projects became redundant. Although this redundant condition was present in the Cabinet Note, the error has been rectified in Press Note 10.

In addition to the requirement of minimum level of construction described above, the FDI Policy had also prescribed stringent timelines for development of a project. Previously, at least 50% of a construction project was required to be developed within five years

from the date of having obtained "all" statutory clearances. For this purpose, undeveloped plots were described as lacking certain vital civic amenities. There were many problems with this provision. Ascertaining the 50% milestone, especially for large-scale projects, could only be determined on a case-to-case basis and left room for arbitrary evaluation. Moreover, prescribing a uniform time period of five years without regard to the scale of each project and penalizing investors for delayed completion due to unforeseen circumstances or force majeure conditions was a harsh measure. Given these problems, this condition has been eliminated in Press Note 10.

Development of Infrastructure

Press Note 10 has ushered in positive changes on the aspect of "trunk infrastructure". Under the previous as well as present FDI Policy, plots are permitted to be sold only after trunk infrastructure has been made available in the project. Hence, knowing what civic amenities constitute trunk infrastructure is important. While the erstwhile definition included the contentious phrase "other conveniences as applicable under prescribed regulations," Press Note 10 limits trunk infrastructure to mean roads, water supply, street lighting, drainage and sewage. To prove completion of development of trunk infrastructure, a certificate from a registered architect is required to be obtained.

Further, a foreign investor is no longer obligated to develop such trunk infrastructure itself. The absence of a single-window project clearance mechanism and computerized land records coupled with multiplicity of land laws that differ from State to State had made it cumbersome for foreign investors to obtain and comply with requisite permissions, approvals and licenses for construction and development of a project. Now, Press Note 10 places the responsibility of obtaining and complying with requisite permissions, along with payment of development charges and other charges, as well as the onus of developing internal and peripheral areas and other infrastructure facilities in a project, solely and entirely on the Indian investee. These measures shall greatly encourage the participation of foreign investors.

Affordable Housing

The Ministry of Housing and Urban Poverty Alleviation, Government of India, estimates that the domestic housing shortage is 18.78 million units out of which 96% pertains to households in the Economically Weaker Sections (EWS) and Low Income Group (LIG) segments. Press Note 10 introduces a novel measure to address this scarcity - an investee/joint venture which commits at least 30% of its total project cost for affordable housing shall not be required to fulfil the performance-linked conditions of minimum capitalization and minimum floor area to be developed.

In order to avail this benefit and qualify as an "affordable housing" project under the new FDI Policy, (a) a project should use at least 40% of its Floor-Area Ratio (FAR)/Floor Space Index (FSI) for dwelling units having floor area not more than 140 square meters; and (b) Out of FAR/FSI reserved for affordable housing, at least one-fourth should be for dwelling units having a floor area not more than 60 square meters. This is significantly different from what was proposed in the Cabinet Note, where to qualify as an "affordable housing" project (a) at least 60% of the FAR/FSI was to be used for dwelling units having a carpet area not more than 60 square meters; (b) 35% of total dwelling units constructed were to have a carpet area of 21-27 square meters for EWS; and (c) Servant's quarter appurtenant to a dwelling unit would not be counted as dwelling units for EWS/LIG. Comparing the proposed and final provisions reveals that more projects would now potentially fall within the ambit of "affordable housing" for the purpose of FDI Policy.

Repatriation and Exit

Previously, foreign investors were prohibited from repatriating their original investment (i.e. the entire amount brought in as FDI) before a period of three years from the date of completion of minimum capitalization or from the date of receipt of each tranche of FDI, whichever was later. Also, a foreign investor wanting to exit a project before expiry of such lock-in period was required to obtain prior approval of the Foreign Investment Promotion Board (FIPB). The Cabinet Note had proposed that a foreign investor be permitted to exit on completion of a project or after

three years from the date of final investment, subject to development of trunk infrastructure. To ease this process, Press Note 10 has done away with the concept of lock-in period of three years. There is a concern that easier exit norms may lead to an increase in both speculative activity and property prices, especially given the absence of a central real estate regulatory authority and the Real Estate (Regulation and Development) Bill, 2013 pending enactment.

Under the new FDI Policy, there are three distinct stages at which an investor may exit – (i) before completion of the trunk infrastructure; (ii) on completion of trunk infrastructure but before completion of the project; and (iii) on completion of the project. To exit at the first stage, a foreign investor requires prior approval of FIPB where proposals would be considered on a case-to-case basis. At the third stage, a foreign investor can exit freely without prior FIPB approval. The confusion arose at the second stage where Press Note 10 contains seemingly contradictory directions on the requirement of prior FIPB approval. This issue is now resolved by the DIPP Clarification which states that a foreign investor is permitted an automatic exit on completion of trunk infrastructure.

It is hoped the concerns critiqued above are suitably addressed by DIPP for the upcoming FDI Policy, 2015. Along with the introduction of separate regulatory frameworks in September, 2014 for setting up Real Estate Investment Trusts and Infrastructure Investment Trusts as new funding avenues, Press Note 10 is overall a welcome step in a series of recent measures to bring more FDI in India and give the required boost to the real estate sector, nearly a decade after 100% FDI first became permissible in this sector.

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