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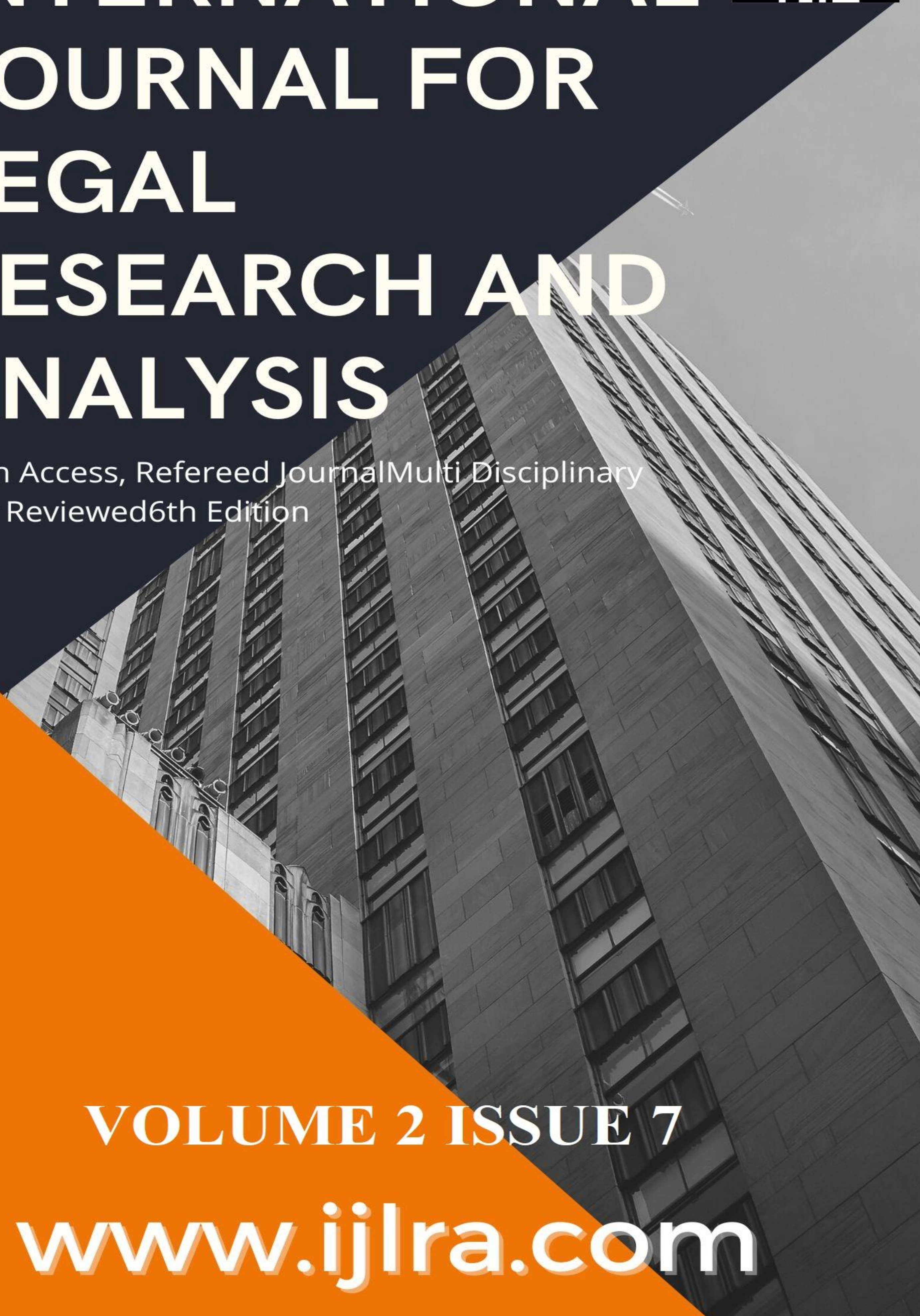

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FOREIGN DIRECTION INVESTMENT IN NBFC SECTOR

AUTHORED BY - ZEBA DARVESH

Abstract

This research paper conceptualizes the intermix of Foreign Direct Investment in the Non-Banking Financial Company with respect to Indian legislation regime which is governed primarily by "Foreign Exchange Management Act, 1999 (FEMA)"[1]. Furthermore, the accord of Foreign direct investment and Non-Banking Financial Company has undergone changes over the years such as the additional capitalization rules which is associated with foreign ownership has been eliminated and further changes with respect to minimum capitalization have been improvised to keep up with the global economy. The Reserve Bank of India has introduced changes in the FDI Policy with respect to NBFC vide its notifications to attract overseas investment. Lastly, FDI policy is governed by other legislations apart from the "Foreign Exchange Management Act, 1999 (FEMA)" namely the "Reserve Bank of India Regulation Act, 1934"[2], "Foreign Exchange Management (Non-Debt Instruments) Rules", 2019[3] and Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019[4] and the important provisions have been discussed forthwith.

Keywords: Foreign Exchange Management Act, 1999, Foreign Direct Investment, Reserve Bank of India, capitalization rules, non-Banking financial Company, Indian legislations.

[1] Foreign Exchange Management Act, 1999
[2] Reserve Bank of India Regulation Act, 1934
[3] Foreign Exchange Management (Non-Debt Instruments) Rules, 2019
[4] Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019

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Introduction

Foreign Direct Investment (FDI) is a stake in a foreign company or any project undertaken by a foreign investor, company, or government. This is a type of investment in which a party in one country makes a substantial and long-term investment in a business or corporation in another country. A long-term interest is generally considered to be established when an investor obtains at least 10% of the voting power in a company.

The presence of the element of control is required in order to establish a Foreign Direct Investment. Control is defined as the intent to actively manage and influence the operations of a foreign firm, highlighting the distinction between FDI and a passive foreign portfolio investment. FDI can take many forms, including acquiring voting stock in a foreign company, mergers and acquisitions, joint ventures with foreign corporations, or establishing a subsidiary of a domestic firm in a foreign country.

In India, the Foreign Direct Investment is governed by the Foreign Exchange Management Act, 1999 (FEMA) as the primary legislations along with the applicable rules and regulations prescribed including the "Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (NDI Rules)"[5] and the "Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019"[6] which function and operate under the guidance of the RBI.

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 2013 and is engaged in providing services pertaining to financial sector extending to acquisition of shares, stocks, debentures and providing loans and advances. These institutions have gained importance over the recent years for being able to fill the gap and the lacunae created by the traditional banks in providing credit and advances with respect to certain sectors of the economy pertaining to Small and medium-sized enterprises (SMEs).

The co-relation between NBFC's and Foreign Direct Investments is closely linked as FDI inflows have played a crucial in the NBFC sector which led to the overall development and growth of NBFC sector. The sector has been able to attract Foreign Direct Investment because

[5] Foreign Exchange Management (Non-Debt Instruments) Rules, 2019
[6] Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019

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of the sector being able to offer potential with respect to the growth and opportunities available to offer for investors to participate in the Indian Financial System along with complying with the regulatory bodies, primarily involving Securities Exchange Board of India (SEBI), 1992.

Foreign Direct Investment has various positive impacts on the NBFC sector such as capital infusion as Foreign direct investment (FDI) allows NBFCs to raise capital from foreign investors, providing them with an additional source of funds. This capital infusion assists NBFCs in expanding their operations, improving their product offerings, and increasing their market share. FDI brings advanced technology and best practises, which can assist NBFCs in improving their operations and increasing their efficiency. This can result in cost savings, better customer service, and higher profitability. Foreign direct investment enables NBFCs to diversify their business and product offerings. For example, an NBFC that specialises in lending can use FDI to diversify into insurance or wealth management, providing its customers with more comprehensive financial solutions. FDI brings risk management expertise, which can help NBFCs better assess and manage credit risk, market risk, and operational risk. This can result in more cautious lending practises and a reduction in non-performing assets.

Foreign Direct Investment and NBFC's

FDI in NBFCs can come in a variety of forms, including equity investments, debt investments, or a mix of the two. A stake in an NBFC is purchased through equity investments, giving the investor ownership rights and the chance to get involved in the management of the business. Contrarily, debt investments entail lending money to an NBFC in exchange for a predetermined interest rate and the repayment of the principle at a later time. FDI has been crucial in enabling NBFCs to grow their businesses and boost the amount of money they can lend. The introduction of new technologies, management techniques, and access to global markets by foreign investors has aided NBFCs in diversifying their loan portfolios and strengthening their risk management capacities. Owing to the understanding of the significance of these organisations in providing lending to SMEs and other underserved sectors of the economy, the Indian government has also been supportive of FDI in the NBFC industry. The government has put in place a number of initiatives to promote FDI inflows, including loosening rules on foreign ownership of NBFCs and allowing 100% FDI in specific NBFC sectors, such housing finance.

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The potential of foreign investors to inject long-term capital, which can assist stabilise the financial system and lower volatility, is one of the major advantages of FDI in NBFCs. This is crucial in the context of India, where the banking industry has historically been vulnerable to crises because of high rates of non-performing loans and poor governance. FDI can also assist NBFCs in expanding their international markets and diversifying their funding sources. This is critical for NBFCs as well because they rely heavily on domestic funding sources like bank loans and commercial paper. Diversifying funding sources can help NBFCs reduce their reliance on volatile sources of funding while also improving their liquidity profiles. FDI can also help NBFCs improve their risk management capabilities because foreign investors bring expertise and knowledge from other markets. This can help NBFCs implement best practises in credit risk management, operational risk management, and regulatory compliance.

However, there are risks associated with FDI in NBFCs, such as the possibility of foreign investors exploiting regulatory flaws or engaging in predatory lending practises. As a result, the Indian government must closely monitor and regulate FDI inflows to ensure that they do not pose a systemic risk to the financial system.

Changes made in the FDI structure in NBFC's in the recent years vide RBI notifications

Foreign direct investment is regulated by the Foreign Exchange Management Act, 2000 and has been governed by the Reserve Bank of India. FDI in NBFC sector vide RBI notification[7] has been allowed through either the government route or FDI automatic route. The 100% automatic FDI route refers to an Indian government policy that allows for 100% FDI in certain sectors or industries without prior government approval or permission. Foreign investors can invest up to 100% of their equity capital in an Indian company or sector under this route, with no restrictions or prior approval from the government. The Indian government specifies the sectors or industries that are eligible for 100% automatic FDI on a regular basis. Sectors such as information technology, construction, manufacturing, and wholesale trading are currently eligible for 100% automatic FDI. Although the 100% automatic FDI route eliminates the need for prior government approval, foreign investors must still adhere to certain regulatory requirements such as sector-specific regulations, reporting requirements, and investment restrictions, if any. Whereas, the Reserve Bank's approval is required for the Government route, whereas the Authority's approval is not required for the Automatic route. Foreign Direct Investment involves various procedures and compliances therefore has always been regarded

[7] Reserve Bank of India Notification dated September 09, 2016.

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as a complicated procedure because there has always been a regulatory apprehension in allowing foreign direct investment above the minimum capitalization norms.

Furthermore, "The Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000" have been amended, according to a Reserve Bank of India Notification[8]. Prior to the aforementioned notification, 100% FDI was permitted under the automatic route but the NBFC's are only permitted to engaged in 18 activities, which were further bifurcated into fund-based and non-fund-based activities with a minimum capitalization norm. Furthermore, the notification, permitted 100% FDI through the automatic route under the heading 'other financial services,' with no other restrictions. It has a comprehensive coverage under the said notification for financial service activities regulated by financial sector regulators and governed by the Reserve Bank of India, Securities Exchange Board of India, Insurance and Regulatory Development Authority of India or any other ancillary financial sector regulator as may be notified by the Government of India. There have been changes introduced with respect to the conditions for minimum capitalization norms which have been eliminated prescribing a greater ceiling limit to the capitalization requirements from INR 20 million to INR 20 billion which was aimed at attracting long-term and serious foreign investors to boost Indian economy[9]. In October, 2020, the Government along with the RBI has permitted 100% foreign investment in the debt-restructuring sector under the automatic route which is subject to regulatory approvals of the particular industry or sector.

On account of the changes made vide notifications of the regulatory bodies, foreign banks and venture capitalist are now permitted to invest in the Indian lending business and promote the growth and expansion of the Financial Market allowing NBFC to make long-term loans to the infrastructure sector in particular. Foreign loans, which are governed by the Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulation, 2000, the Foreign Exchange Management Act, 1999, and the RBI regulations, are another aspect of foreign direct investment in non-banking finance companies. However, NBFCs are only permitted to make loans for working capital, loan repayment for capital expenditure, or loan repayment for other than capital expenditure.

[8] Reserve Bank of India Notification dated September 9, 2016.
[9] Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (NDI Rules) Notification dated October 29, 2020.

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Lastly, the Single Master Form introduced in April, 2018 by the RBI[10] for reporting foreign investments in India which aimed at providing for a simplified reporting mechanism and for consolidating and replacing the obsolete method of multiple reporting forms for foreign investment, The SMF mechanism is a mandate upon the NBFCs to follow in order to report the requirements for foreign investment.

Legislations governing FDI in NBFC sectors

The Foreign Exchange Management Act (FEMA) of 1999 governs foreign exchange transactions in India. The Reserve Bank of India (RBI) is the regulator for foreign exchange transactions in India, and FEMA provides the legal framework for them. The provisions of FEMA, along with the RBI's regulations, establish the guidelines and regulations for foreign investment in NBFCs in India. It is critical for NBFCs to follow these regulations in order to avoid legal action or penalties.

The Consolidated Foreign Direct Investment Policy, 2020[11] establishes a comprehensive framework for FDI in India. It is updated annually by the Department for Promotion of Industry and Internal Trade (DPIIT) and lays out the various regulations and conditions for foreign investment in various sectors, including NBFCs. The policy establishes the maximum allowable foreign investment in various types of NBFCs. For example, under the automatic route, the maximum permissible foreign investment limit for an NBFC engaged in infrastructure finance is 100%. However, under the automatic route, the maximum permissible foreign investment limit for an NBFC engaged in microfinance activities is 74%.

Regulations of the Reserve Bank of India (RBI) is India's NBFC regulator, and it has issued several regulations regarding FDI in the sector. The key RBI regulations governing FDI in NBFCs as prescribed by the NBFC Master Direction which establishes the guidelines and regulations for NBFCs in India. It contains provisions concerning foreign investment in NBFCs. Foreign Exchange Management Act, 1999 (FEMA) Master Direction on Reporting specifies the reporting requirements for foreign investments in India. Other FDI in NBFCs Notification which the RBI has issued notifications regarding FDI in NBFCs, including minimum capitalization requirements and sectors eligible for FDI.

[10] Reserve Bank of India Notification dated June 07, 2018
[11] Department for Promotion of Industry and Internal Trade “Consolidated FDI Policy Circular of 2020”

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Foreign direct investment (FDI) in Non-Banking Financial Companies (NBFCs) is permitted under FEMA in various ways, firstly, FEMA allows 100% FDI in the NBFC sector through the automatic route for certain activities[12]. These include investment advisory services, stock brokerage, merchant banking, and underwriting. FDI is not permitted in certain activities, such as chit funds, Nidhi companies, and agricultural or plantation activities. Secondly, the Investment Route which enumerates that FDI in NBFCs can be made via the automatic route or the government route. Foreign investors can invest up to 100% of their equity capital in an Indian company under the automatic route without obtaining prior government approval. Investments made through the government, on the other hand, require prior approval from the Foreign Investment Promotion Board (FIPB). Thirdly, the reporting Requirements provide that all NBFCs that receive foreign investment must comply with FEMA reporting requirements. The Reserve Bank of India (RBI) has introduced the Single Master Form (SMF) for reporting foreign investments in India. SMF reporting requirements for foreign investments apply to all NBFCs[13]. Furthermore, the Investment Restrictions have been imposed upon foreign investment in NBFCs. Foreign investors, for example, are not permitted to invest in companies engaged in agricultural or plantation activities, or in real estate activities, except in the development of integrated townships and affordable housing projects.

The Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019[14] are a set of regulations issued under the governance of RBI oversee the reporting and the payment mechanism for non-debt instruments. The Regulations prescribe for a specific mode of payment that is through inward remittance[15] (transfer of funds from a foreign account to an Indian account through a banking channel). The NBFC's that receive such FDI's are required to comply with the aforementioned regulations as per the Single Master Form (SMF) for reporting of foreign investments. Furthermore, these regulations also provide for pricing guidelines which must not be less than the fair market value of the shares and securities and prescribe for a lock-in period of 3 years. Foreign investment in the NBFC sector is subject to sectoral caps under the NDI Regulations. The sectoral caps differ depending on the NBFC's activity. For example, under the automatic route, foreign investment in investment advisory services, stockbroking, and merchant banking is permitted up to 100%, while foreign investment in asset reconstruction companies is permitted up to 74%.

[12] Reserve Bank of India Notification dated October 04, 2021.
[13] Reserve Bank of India Notification dated June 07, 2018
[14] Notification No FEMA. 395/2019-RB on October 17, 2019
[15] The Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations Rule 3

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Conclusion

The relationship between NBFCs and FDI in India is one which is mutually beneficial, as FDI has played an important role in the development of the NBFC sector, allowing these institutions to expand their operations and improve their risk management capabilities. However, foreign direct investment inflows must be carefully monitored and regulated.

Thereby, allowing 100% FDI in the NBFC sector is a game changer for the Indian economy because it allows the sector to grow on a larger scale and contributes significantly to economic growth. Non-banking finance companies contribute more to economic growth than any other sector. Foreign direct investment has increased capital inflows to the Non-Banking Finance sector, allowing NBFCs to invest in large projects or meet day-to-day business needs. Foreign direct investment has also aided in the dismantling of domestic monopolies held by large investors, giving NBFCs a competitive advantage in a market. It is correct to say that FDI in the NBFC sector has become the backbone for Non-Banking Finance companies, assisting them in efficiently achieving their vision and objectives.