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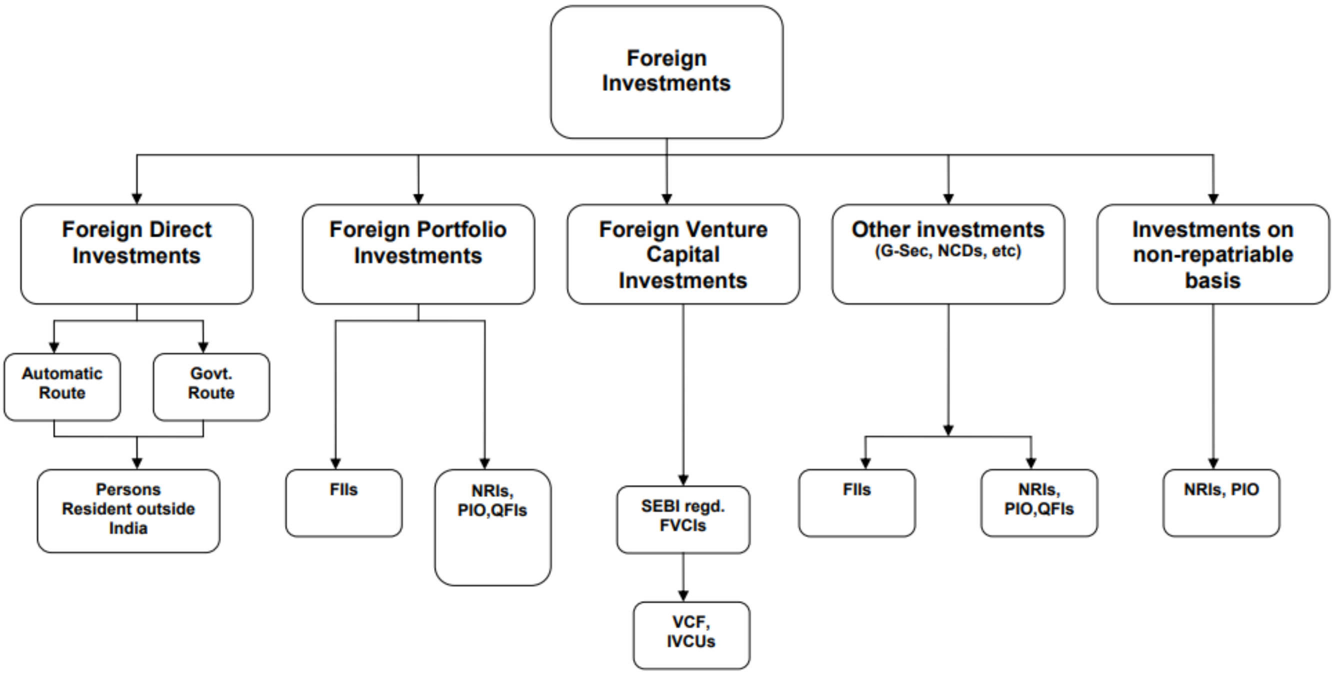
Reclassification of FPI to FDI

Why in news?

The Reserve Bank of India (RBI) introduced a streamlined operational framework to allow foreign portfolio investors (FPIs) to convert their investments to foreign direct investment (FDI).



> *Foreign investment in India is governed by sub-section (3) of Section 6 of the Foreign Exchange Management Act, 1999.*

What are FDI and FPI?

	Foreign Direct Investment (FDI)	**Foreign Portfolio Investment (FPI)**
Definition	Investment made by foreign investors to obtain a substantial interest in the enterprise located in a different country.	Investing in the financial assets of a foreign country, such as stocks or bonds available on an exchange.
Nodal Ministry	Consolidated FDI Policy is drafted Department for Promotion of Industry and Internal Trade (DPIIT), Ministry of Commerce and Industry.	Finance Ministry
Type	Direct Investment	Indirect Investment
Market	Inflows in primary market	Inflows in secondary market

Role of Investors	Active Investor	Passive Investor
Degree of Control	Direct control over the company management	No direct control but can influence board meeting decision.
Term	Long term investment	Short term investment
Investment Instruments	Direct Capital Investment involving mergers, acquisitions, or partnerships	Stocks, ADRs, GDRs, bonds, mutual funds, and exchange traded funds
Entry and Exit	Difficult	Relatively easy
Risks Involved	Stable	Volatile

What are the Pros and cons of FPI?

> *Single FPI Regime came into effect from 1st June, 2014 by subsuming FIIs, their sub-accounts and qualified foreign investors (QFIs).*

Pros	Cons
• Increases Capital availability. • Entry and exit are relatively easy. • Quick return on investment. • Increase the liquidity of domestic financial markets. • Encourages investment in growth opportunities. • Bring foreign exchange into the economy	• Volatility in markets when large outflows occur during market downturns. • No direct control on management. • Exposure to political risk

What is the new regulatory framework on FPI?

- FPI threshold - Under Foreign Exchange Management (Non-debt Instruments) Rules, 2019, investment made by the FPI should be less than ***10 %*** of the total paid-up equity capital.
- **Crossing threshold -** FPIs exceeding a ***10% stake*** in a company must divesting their holdings or reclassifying such holdings as *within 5 trading days* following the transaction that breaches the limit.
- **Approvals** - It is subject to approvals from both the Indian government and the invested company.
- **Increased disclosure requirements -** To ensure compliance, the RBI requires full reporting under the *Foreign Exchange Management Regulations, 2019.*
- They need to identify and disclose their ownership structure and the ultimate beneficial owners.
- **SEBI's revised guidelines** - It mandates that any FPI choosing reclassification must notify its custodian.
- The custodian will then facilitate the transfer of securities to the designated FDI account, ensuring compliance with all reporting requirements.
- **Prohibited sectors** -The facility of reclassification shall not be permitted in any sector prohibited for FDI, such as defense and telecom, to protect national security.

What are the implications of the framework?

- **Streamline foreign investments -** Providing a structured path to retain the investment , When an FPI, along with its investor group, inadvertently crosses the threshold.
- **Market stability -** This shift could bring more stability and reduce market volatility associated with short-term foreign investments.

FPIs have pulled out over Rs 1.36 lakh crore from the cash market since October 1 this year.

- **Enhanced governance -** The compliance requirements, especially those related to beneficial ownership, improve transparency in the market.
- **Increased compliance costs -** Stricter disclosure norms and other regulatory requirements increase compliance costs for foreign investors.
- **Promotion of long-term investment -** By encouraging FPIs to convert substantial

investments into FDI, the government aims to promote long-term foreign investments.
- **Change in investment patterns -** The restrictions may redirect FPI interest toward non-sensitive sectors with fewer ownership caps.
- Sensitive sectors might experience reduced foreign investment due to regulatory hurdles and caps on ownership.

- **Prevent tax evasion** – The rules aimed to prevent any attempts at tax evasion or money laundering.

What lies ahead?

- Focus on maintaining transparency while ensuring India remains competitive in attracting foreign capital.
- Reduce market volatility to make resilient economic foundation less susceptible to short-term market shocks.

References

1. Mint |Framework for Reclassification Of FPI
2. RBI | Master Circular on Foreign Investment in India