

DISCUSSION PAPER

SUBJECT: FOREIGN DIRECT INVESTMENT (FDI) IN DEFENCE SECTOR

- 1.1 The Department of Industrial Policy and Promotion has decided to release Discussion Papers on various aspects related to FDI. In the series of these Discussion Papers, this Paper is on 'Foreign Direct Investment in Defence sector'. Views and suggestions are invited on the observations made in the enclosed discussion paper, as also on the whole gamut of issues related to the defence sector, by July 31, 2010. It is requested that to the extent possible, facts, figures and empirical evidence may be furnished in the context of the specific observations/suggestions made.
- 1.2 The views expressed in this discussion paper should not be construed as the views of the Government. The Department hopes to generate informed discussion on the subject, so as to enable the Government to take an appropriate policy decision at an appropriate time.
- 1.3 Defence being a sensitive and strategic sector, the views of the Defence Ministry will be taken on board before taking the next steps forward.

DISCUSSION PAPER
FOREIGN DIRECT INVESTMENT (FDI) IN DEFENCE SECTOR

1.0 PRESENT SCENARIO:

1.1 India is one of the largest users and importers of conventional defence equipment. It ranks among the top ten countries in the world in terms of military expenditure. Its cumulative defence budget (including both-capital and revenue expenditure) grew at 13.4% CAGR during the financial years 2006-2007 (Rs. 89,000 crore/ US \$ 20.11 billion) to 2010-11 (Rs. 147344 crore/ US \$ 31.9 billion). Approximately, 40% of this is capital expenditure. According to estimates, nearly 70% of our defence requirements are met through imports¹, with only 30% being met through domestic production. Government's stated aim, as enunciated in Finance Budget 2009-10, is to reverse this trend and manufacture 70% or more of its defence needs indigenously.

1.2 The bulk of the domestic production is met either through the Ordnance Factories or the Defence PSUs. Even when defence products are manufactured domestically, there is a large component of imported sub-systems. While the import dependence is very high, there is a growing perception that the procurement regime has not kept pace with our requirements and there are very few Requests for Proposals (RFPs) for sourcing of defence equipment that have fructified in a timely manner. The defence equipment available today is of old vintage and needs replacement. Only 15% of the equipment can be described as 'state-of-the-art' and nearly 50% is suffering from obsolescence. There is, therefore, an urgent need to enhance the deterrent and operational capability of the armed forces through upgradation/ modernization of existing equipment, as well as acquisition of 'state-of-the-art' equipment.

1.3 The indigenous R&D has not kept pace with the requirements of present day warfare and manufacture through transfer of technology to Public Sector Units (PSUs)/Ordnance Factories (OFs) has proved to be an ineffective and slow process. Most of the time, the transfer of technology itself was not complete, as the suppliers were more keen to push their own product, rather than indigenizing the production in India. Also, in the absence of any

¹ Enhancing the role of SMEs in Indian defence industry-report by Ernst & Young and CII-2009

incremental technology, the OFs could not modernize or upgrade the platforms. As a result, the PSUs and OFs are getting more and more marginalized and becoming irrelevant as far as the goal of modernization of the armed forces is concerned. This is bound to result in more and more dependence on imports.

1.4 Most of the global defence equipment suppliers are only system integrators and they manufacture various equipment keeping in view the requirements of a particular order placed upon them. Since the companies keep on winding-up their operations and changing hands, it is virtually impossible to ensure maintenance and product support through their life cycle. This problem exists, in particular, with indigenous equipment manufactured with critical imported components. This raises the issue of the reliability of defence supplies in times of need. Since the indigenous manufacturing capabilities are not well developed, it is difficult to repair, modernize or upgrade the defence equipment. There is, therefore, a need to have a vibrant defence industry within the country to produce state-of-the-art defence equipment.

1.5 Defence industry is highly technology driven and capital intensive. Since, it may take some time for domestic companies to acquire a technical edge, it is important to consider the vital question of accessing the technology through the modality of allowing foreign companies to set up production bases/ facilities within the country itself. *Manufacturing within the country, through foreign capital, with full transfer of state-of-the-art technology will be a better option than importing the equipment from abroad.*

2.0 REGULATORY REGIME FOR THE DEFENCE SECTOR:

2.1 The policy for Foreign Direct Investment (FDI) in the Defence Sector was first notified vide Press Note 4 of 2001, wherein the Defence Industry Sector was opened up to 100% for Indian private sector participation, with FDI permissible up to 26%, both subject to licensing and Government approval. Subsequently, guidelines for production of Defence equipment were notified, vide Press Note 2 of 2002. The extant FDI sectoral cap for the Defence Sector is, accordingly, 26%.

2.2 Other than the FDI policy, two other policy regimes govern the defence sector. These are the Defence Procurement Policy and the Industrial License regime.

2.3 The Defence Procurement Policy essentially lays down the procurement procedure, which *inter alia* provides for an offset policy, necessitating the involvement of a local JV partner/local supplier. The modes of discharge of offset obligations could include: (i) direct purchase from or execution of export

orders of goods or services manufactured or provided by Indian defence Industries (ii) FDI in Indian defence industries and Indian organizations engaged in defence R&D or (iii) discharge of banked offset credits. The Defence Procurement Manual (DPM 2009) covers all revenue procurement and procedures for the registration of firms. It provides the methodology for assessment and registration of vendors, as well as their performance appraisal on technical and financial aspects and classification.

2.4 The defence sector is also subject to an Industrial License (IL) regime, as an IL is mandatory for the defence sector. There are certain specific conditions related to the grant of an IL, which require, *inter alia*, (i) that the applicant should be an Indian company/partnership (ii) the majority of the Board of Directors and CEO should be resident Indians (iii) clearance through background checks for foreign collaborators and domestic promoters (iv) a 3-year lock-in provision. As in April, 2010, 127 Industrial Licenses (ILs) have been issued to private sector agencies for manufacture of defence equipment. The production through units which are operational is however not significant.

3.0 KELKAR COMMITTEE ON SELF RELIANCE IN DEFENCE PREPAREDNESS

3.1 The government had set up the Kelkar Committee in 2004, to examine and recommend changes needed in defence acquisition procedures and enabling a greater participation of private sector in defence production for strengthening self-reliance in Defence preparedness. The Committee submitted its report in two parts.

3.2 The first part of the report, submitted in April 2005, focused on the review of the defence procurement procedure and made several recommendations linked to the issue of enhancing indigenous production. The Committee's proposals focussed on encouraging involvement of country's best firms in Defence Capability Building, pursuing Offsets policy to bring in Technology and investment, exploring synergies amongst private sector Defence Public Sector Undertakings (DPSUs), Ordnance Factories (OFs) and the Defence Research and Development Organisation (DRDO), to promote high technology capabilities and creating an environment for quantum jump in export of defence equipment and services. The main recommendations of the Committee were:-

- *Preparation of a 15-year long-term plan, forming the basis for an acquisition programme*

- *Information sharing of the requirements of Armed Forces with the Industry*
- *Identification of entry points for the private sector in the acquisition process*
- *Accreditation and fostering of Raksha Udyog Ratna /Champion*
- *Evolve policy framework to promote participation of Small and Medium Enterprises in defence production*
- *Setting up a new professional agency for defence acquisition*
- *Providing Defence Research and Development opportunities, both to the DRDO and the industry*
- *Promoting transparency in decision making.*
- *Encouraging optimum utilization of existing capacity.*
- *Working out Request for Proposals (RFP) to include an Offset Clause for contracts valued at Rs. 300 crores and above.*
- *Re-examining the concept of Negative List for Defence exports and setting up of an Export Marketing Organisation.*

3.3 The committee recommended adoption of the South Korean model to identify Raksha Udyog Ratna (RUR) on the basis of their performance. Only firms of proven excellence, which are capable of contributing, depending on their technical, managerial and financial strength should be declared RURs. These firms would be essentially platform producers and system integrators and should be treated at par with the Defence Public Sector Undertakings.

3.4 Second part of the committee's report was submitted to MoD in Nov 2005. In this part, the committee has recommended that the Government should give greater freedom to the PSUs to form joint ventures and consortiums.

4.0 CONCERNS RELATED TO LIBERALISING THE FDI REGIME FOR THE DEFENCE SECTOR:

4.1 The major reason for reluctance in encouraging the Private Sector into defence production and welcome FDI in the sector is on account of concern for the Defence PSUs and the Ordnance Factories. However, it is clear that if the import continues at the present level, the role of the Defence PSUs and the Ordnance Factories would only be further marginalised. If on the other hand, the major arms and weapon manufacturer companies set up their manufacturing units in India, there is strong possibility that they will collaborate with Defence PSUs and Ordnance Factories. As brought out earlier in the note, most of the major manufacturers are actually system integrators and would certainly like to outsource from the existing facilities in India. Further, if the FDI policy is properly leveraged by factoring this possibility optimally, we can actually

revive our Defence PSUs and Ordnance Factories and make them relevant to the process of modernization of Armed Forces. The flow of foreign capital and technology can therefore be used as a tool for strengthening the defence PSUs and Ordnance Factories. ***In areas where the Defence PSUs are capable of managing themselves like some of the ammunition factories, we need not give license to a manufacturer in the private sector.***

4.2 Another concern is that FDI could lead to ownership and control of firms operating in a critical and highly sensitive industry being passed on to foreign hands. Even if ownership or control does not pass on fully to the foreign investors, raising of the cap could lead to their enhanced influence and say in affairs of the company's management. A related concern is that this could lead to an increased dependence on foreign investment, for meeting our defence needs. Taken to an extreme, this could lead to a situation where a clear relationship of dependency, in terms of foreign capital and technology, develops with regard to investment drawn from specific countries/ blocs.

4.3 Unlike in the past, where manufacture of defence items was concentrated among a few select nations, this capability is much more dispersed today. Also, the ownership structure of many of the important defence production companies is in a state of continuous flux. Therefore, the fear that we may develop a relationship of exclusive dependence, with regard to a particular foreign country, for capital and technology, may not be well-founded in the present day context and the concern that increasing the cap would lead to control being passed on to foreign capital with a specific national denomination can be easily taken care of.

4.4 There can also be concern relating to availability or reliability of supplies in times of war. The availability of maintenance and repair capability, spare parts, material and other support to keep critical systems functioning in all circumstances is a vital concern. This is related to the vital question of whether the foreign investor would continue to serve India's defence needs in the times of war. This concern can be met by imposing a condition that the Government has a right to expropriate a manufacturing facility in case there is a need to do so due to the exigencies of national security, by payment of suitable compensation.

4.5 The fifth concern is related to the issue of passing on of the critical equipment, design or source code to other players-particularly, countries inimical to Indian interests. Such an apprehension will exist even in the case of imported equipment. In fact, in the case of indigenous equipment, the Government can exercise greater and more effective control on the production mechanism of a company located in India and subject to Indian laws compared

to a company located overseas. Government can reserve the right to inspect or control the production and dispatches in these facilities through deployment of necessary security agencies/ personnel.

4.6 There can be an issue of export of Defence equipment manufactured in India and exported to inimical countries. As of today, a significant number of export restrictions already exist to take care of this concern. Such restrictions can be strengthened, if need be. Export obligations, considered together with licensing conditions imposed upon the suppliers of such technology/products, should be sufficient safeguards to address our concerns in this regard. Export to enemy countries can be banned through a negative list. As an example, the United States, European Union and United Kingdom permit 100% FDI in the defence sector, with security issues being addressed through verification and clearance procedures, as well as export controls.

4.7 There is a general concern about the internal security aspect of manufacture of defence equipment especially small arms and ammunition. This concern can be met by devising a strong surveillance system in each factory/unit. This could include posting of defence/security personnel on a whole time basis to these locations.

5.0 THE CASE FOR INCREASING FDI CAP

5.1 The general perception is that the present FDI cap of 26% discourages original equipment manufacturers (OEMs) from bringing in proprietary technology, as OEMs are reluctant to license their proprietary technology to a company in which their equity is restricted to a minority of 26%. This has resulted in India not being able to access the latest high-end technologies available.

5.2 There could be significant advantages to be gained from raising the FDI cap in defence. It could provide a significant incentive for transfer of know-how/technology, leading to higher levels of technological expertise. International experience suggests that this would lead to significant spin-offs, in terms of absorption of such technologies, into related areas of civilian use.

5.3 A higher FDI limit would also provide a significant incentive for transfer of know-how/technology to the country, leading to higher levels of technological expertise. This, in turn, would assist in achieving the government's objective of 70% indigenization, by indigenizing defence production through encouraging transfer of new and state of the art technologies to the Indian defence industry, as also through the absorption of latest

technologies, thereby promoting the government's objective of self reliance. It would also encourage original equipment manufacturers (OEMs) to bring in proprietary technology and lead to corresponding modernization of our defence equipment and help promote private Research & Development, by complementing the efforts of the public sector.

5.4 As the Defence industry is highly capital intensive it would be difficult for our indigenous defence industry to develop without the supplemental funds made available through FDI. Higher levels of foreign investment would reduce the corresponding fund requirements of the Indian partners. At the same time, this would promote growth and expansion of Indian companies in the defence sector, over which the government can exercise higher control, as compared to overseas firms/entities.

5.5 A large share of Indian foreign exchange goes towards defence purchases. Allowing more FDI in defence would result in significant savings in foreign exchange, as more foreign companies will establish defense industries in India.

5.6 Liberalisation of the FDI regime would strengthen India's export potential by way of exports of defense products to other countries. India's defence exports have ranged between 1.5 to 2.4 % of the total production², with an import: export ratio of 194:1, as compared to 1.3:1 in the case of Israel, 8.8:1 in the case of South Korea and 19.7:1 in the case of Singapore³. India's defence exports in 2005 were \$ 15 million, as compared to \$ 1,026 million of U.K., \$ 382 million of China, \$ 402 million of Israel and \$ 86 million of South Africa.⁴

6.0 OPPORTUNITY BEFORE US:

6.1 In spite of emerging as a large economy, India has a very low manufacturing base. The production of military equipment within the country will provide immediate impetus to the manufacturing sector in the shape of large scale ancillarization as has happened in the case of major industrialized nations like USA, France and Germany

6.2 A large number of manufacturers of defence and dual use products are finding it difficult to manage their production in western countries due to increasing costs of labour and other inputs. This is the right time for India to project itself as a new hub for manufacturing. A number of global defence majors are waiting to set up an alternative/additional manufacturing base in

² MoD Annual Reports

³ SIPRI Database, 2005

⁴ SIPRI Database, 2005

India. *It is, therefore, not at all necessary for us to underwrite production. The FDI policy will not interfere with the prerogative of the Armed Forces to choose an equipment of their choice as per their GSQR.*

7.0 WHAT SHOULD BE THE CAP IN FDI IN DEFENCE SECTOR?

7.1 The present cap of 26% in FDI has failed to attract the state of the art technology in the defence sector. Increase of cap from 26% to 49% will not give any additional say to the foreign investor in the affairs of the company as per the provisions of the Company Law. Therefore, increasing FDI cap from 26% to 49% as is being advocated by some industries associations will not really help us in getting the best technology partners to invest in India. By merely increasing the limit from 26% to 49% we may be accused by posterity of doing too little and too late. Therefore, in case we really want to have the state of the art technology, we have to permit anything above 50% if not 100%. It may be, therefore, desirable to allow either 100% or 74% as in the case of telecom sector. Since there is licensing provision also in the defence sector, we can refuse to permit FDI in the sector by refusing the license where the background of the company is suspect.

8.0 SUGGESTED POLICY

8.1 The established players in the Defence industry should be encouraged to set up manufacturing facilities and integration of systems in India with FDI upto 74% under the Government route. *There need not be any commitment on procurement and these players will have to participate in the RFP to technically qualify and also compete in the financial bid.*

8.2 For future RFP's by MoD, a condition may be imposed that the successful bidder would have to set up the system integration facility in India with a certain minimum percentage of value addition in India. The successful bidder should be allowed to bring equity upto the proposed sectoral cap.
