

# Corpsec Hotline

September 06, 2013

## LIFELINE FOR DISTRESSED ASSETS- RELAXATION OF FOREIGN INVESTMENT CAPS IN ARCS

Foreign investment in distressed assets has once again been given a shot in the arm with the Department of Policy and Promotion ("DIPP"), an instrumentality of the Ministry of Commerce, Government of India allowing foreign investment in Asset Reconstruction Companies ("ARC") up to 100%, with foreign investment up to 49% being permitted under the automatic route (without any prior regulatory approvals) by way of a recent Press Note Dated August 22, 2013 ("Press Note"). DIPP had earlier on December 12, 2012 made significant relaxations to encourage foreign investment in ARCs, which were notified by the Reserve Bank of India ("RBI") by a circular dated August 19, 2013 ("Circular")<sup>1</sup>. This Hotline discusses the implications that the Press Note and the Circular may have on foreign investments in ARCs.

### BACKGROUND

In 2005, RBI permitted foreign investment in ARCs and security receipts ("SR") of each tranche of scheme of ARCs. Foreign direct investment ("FDI") up to 49% of the paid up capital of the ARC was permitted under the government approval route. In addition, foreign institutional investors ("FII") were also permitted to invest up to 49% of each tranche of scheme of SRs. Investment by a single FII was not permitted to exceed 10% of the issue of each tranche of scheme of SRs.

It was noted that the ARCs were unable to purchase bad loans from banks due to shortage of capital. The modus operandi of the ARCs was to set up schemes in the form of trusts. These trusts would acquire the bad loans from the banks against the money obtained by issuing SRs to investors. Sometimes, due to lack of capital to pay the banks for such bad loans, ARCs issued such SRs to the banks itself. However, in recent times, with banks becoming averse to subscribing to the SRs,<sup>2</sup> ARCs found it difficult to raise the funds for acquisition of such bad loans from the banks. Capital infusion was required with foreign investment being seen as the most viable option. The players in the ARC industry also sought opening up of foreign investment in the sector.<sup>3</sup> In the absence of capital flowing into the sector and the environment being non-conducive for setting up new ARCs, India currently has only 14 ARCs, despite growing NPAs on the books of banks.

### WHAT HAS CHANGED?

The Circular and the Press Note brought the following changes with respect to foreign investment in ARCs:

- FDI in ARCs:** FDI in the 'Capital' (defined to mean equity, and preference shares and debentures fully and mandatorily convertible into common equity) of ARCs has now been permitted up to 100% in the manner set out below.
  - FDI up to 49% of the Capital of the ARC shall be under the automatic route;
  - FDI above 49% in the Capital of the ARC shall require prior approval of the Foreign Investment Promotion Board ("FIPB"), an instrumentality of the Ministry of Finance, Government of India;
  - No sponsor of an ARC may hold more than 50% of the shareholding of the ARC, either by way of FDI or by routing through an FII.
- FII in ARCs:** FII in ARCs has now been permitted up to 100% in the manner set out below.
  - FII up to 49% of the Capital of the ARC shall be under the automatic route;
  - FII above 49% in the Capital of the ARC shall require prior approval of the FIPB;
  - The total shareholding of an individual FII shall not exceed 10% of the Capital of the ARC;
  - No sponsor of an ARC may hold more than 50% of the shareholding of the ARC, either by way of FDI or by routing through an FII.
- Investment in SRs:** FIIs are now permitted to invest in SRs up to a limit of 74% as opposed to 49% earlier in each tranche of scheme of SR issued by an ARC or a trust sponsored by an ARC. The earlier limit of 10% investment by an FII into each tranche of scheme of SRs issued by an ARC has also dispensed with. Such investment must however be within the investment in corporate bond limits, and the sectoral caps under the FDI policy must be adhered to.

Prior to December 2012

Prior To August 2013 (Changes introduced by the Circular)

Post August 2013 (Changes introduced by the Press Note)

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Foreign Investments in ARCs

FDI	49% Government route	74% Government route	49% - Automatic route; Beyond 49% - Government route.
FII	Not permitted		

Security receipts of ARC or scheme/ trust of an ARC

FII	49% 10%- limit for individual FII	74%	No change
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Analysis:

- It is estimated that ARCs pay the bank around 5% of the price of the loan agreed upon, while the remainder is paid in terms of SRs<sup>4</sup>. With the banks' reluctance to subscribe to SRs, ARCs can now depend on FDI to acquire assets from the banks.
- Prior to the Circular, FIIs were not permitted to invest in the capital of an ARC. Whilst a positive move, permitting FIIs to invest in the Capital of ARCs might not be very helpful since ARCs are not generally listed. Qualified Financial Investors ("QFIs") are not permitted to invest in the Capital of an ARC.
- The removal of investment limits for individual FIIs for each tranche of a scheme of an ARC is important because it permits a single FII to subscribe to 74% of the SRs issued in the tranche. This is a substantial relaxation, especially when coupled with the recent move to allow FIIs and QFIs to invest up to USD 51 billion in such SRs and other bonds.<sup>5</sup>
- By way of an amendment to the FEMA (Transfer or Issue of Security by a person resident outside India) Regulations, 2000 ("TISPRO") in March 2013, QFIs were permitted to invest in the SRs issued by scheme of ARCs. Such investment is limited to 10% of the issue in each tranche. In addition, the total investment of QFIs and FIIs in each tranche was not to exceed 49%.<sup>6</sup>

However, permission for QFIs to invest in SRs has not been incorporated into the FDI Policy 2013. Interestingly, RBI has also not notified the amendment to permit QFIs to invest in SRs to the authorized dealers, as is customary for RBI to do by way of A.P. (DIR Series) Circulars.

Debt conversion into equity:

Another encouraging step ARCs came through the Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Bill, 2011, which amends SARFAESI and the Recovery of Debts Due to Banks and Financial Institutions Act, 1993. By way of the amendment to section 9 of SARFAESI, a new clause (g) has been added by virtue of which an ARC now has the option to *'convert any portion of its debt into shares of a borrower company'*.<sup>7</sup>

Hence, an ARC can convert a portion of the debt into equity, similar to banks, which convert their loans into equity under the corporate debt restructuring process. As a result of this amendment to SARFAESI, ARCs can actively be a part of the management of revival and restructuring of the company and exit by selling the equity holdings at a later date.

However, it is to be seen whether an ARC which has foreign investment of an amount exceeding 51% of its share capital, would require the approval of the FIPB to convert the debt into equity, especially in the context of listed securities. Conversion of debt into equity might be an important consideration for ARCs in future.

In future, the acquisition of bad loans by the ARC might be driven by this factor, which might result in reluctance to acquire the loans in sectors where FDI sectoral caps might restrict such conversion.

CONCLUSION

Distressed asset investment is certainly an asset class which is receiving interest in current times and is likely to grow in the prevailing economic scenario. Relaxations in foreign investment in ARCs may provide ARCs with the much required funds and boost investment in distressed assets in India. A number of good companies have been under pressure due to the economic climate. It is expected that investment by foreign investors into ARCs would help such corporates in the revival and restructuring of their assets.

Whilst distressed asset investment has been done by way of listed non-convertible debentures, PIPE (private investment in public equity) model and other forms of distressed asset investing, ARCs in particular did not receive much foreign investment interest due to restrictions on foreign investment, among other reasons. While the government has now relaxed some of these restrictions, certain issues like inability to take control of the ARC, which are largely state sponsored corporations, and an immensely time consuming process of setting up an ARC are still likely to impede foreign investment interest in ARC.

- Abhinav Harlalka & Ruchir Sinha  
 You can direct your queries or comments to the authors

<sup>1</sup> <http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=8318&Mode=0>  
<sup>2</sup> [http://www.moneycontrol.com/news/business/rbi-plans-to-revive-stressed-loan-market-for-banks-arcs\\_896273.html](http://www.moneycontrol.com/news/business/rbi-plans-to-revive-stressed-loan-market-for-banks-arcs_896273.html)  
<sup>3</sup> [http://articles.economictimes.indiatimes.com/2012-11-07/news/34971064\\_1\\_security-receipts-fii-investment-asset-reconstruction-companies](http://articles.economictimes.indiatimes.com/2012-11-07/news/34971064_1_security-receipts-fii-investment-asset-reconstruction-companies)  
<sup>4</sup> [http://articles.economictimes.indiatimes.com/2012-03-13/news/31159835\\_1\\_bad-loans-arcs-npas](http://articles.economictimes.indiatimes.com/2012-03-13/news/31159835_1_bad-loans-arcs-npas)  
<sup>5</sup> The total debt limits available to FIIs was USD 25 billion for corporate bonds and USD 25 billion for infrastructure bonds. Later, even QFIs were allowed entry into the corporate debt markets but with a small window of USD 1 billion within which they could purchase listed corporate bonds.  
<sup>6</sup> The amendment can be found here <http://rbi.org.in/Scripts/NotificationUser.aspx?Mode=0&Id=7916>  
<sup>7</sup> The text of the Bill available at <http://www.prsindia.org/uploads/media/Enforcement/Enforcement...Bill%202011.pdf>

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