

# Regulatory Hotline

May 30, 2016

## 100% FOREIGN INVESTMENT IN ARCS: FINALLY THERE?

- 100% FDI permitted in the share capital ARCs;
- Amendment of SARFAESI to remove maximum sponsor shareholding tabled in Parliament;
- 100% investments in security receipts issued by a scheme of an ARC permitted

The Department of Industrial Policy and Promotion, Ministry of Commerce & Industry, Government of India ("DIPP") released Press Note 4 of 2016 on May 6, 2016 ("Press Note") permitting 100% foreign direct investment ("FDI") in asset reconstruction companies ("ARC"). In this hotline, we have analyzed the changes proposed by the Press Note, and the potential implications of such changes.

### BACKGROUND

The Indian government had enacted the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("SARFAESI") in an attempt to assist banks and financial institutions in cleaning up their bad loans, or non-performing assets. However, almost a decade and a half later, experience has shown that very few ARCs have been set up and a very small quantum of banks' bad loans have been acquired by asset reconstruction companies ("ARC")<sup>1</sup>.

One of the main reasons attributed to the lack of the success of ARCs was that the ARCs were under-capitalized. A modest attempt was made by the central government back in 2013, when the foreign investment in ARCs was liberalized, and foreign investment up to 49% was permitted under the automatic route, and up to 100% was permitted under the government route (against the earlier limit of 74% completely being under the government route). However, this failed to evoke sufficient interest in ARCs, and foreign investment in ARCs still remained low, largely due to the fact that foreign investors were still minority investors without adequate control of the ARC, and accordingly, enforcement.

With foreign investment in ARCs being restricted from the very outset, measures were required to encourage further investment in ARCs. The Finance Minister, in his budget speech for the year 2016-17 had proposed to make changes with respect to ARCs to attract further investment. These measures included permitting (i) 100% FDI in ARCs under the automatic route; (ii) foreign portfolio investors ("FPI") to hold up to 100% of the security receipts ("SR") issued by a scheme of an ARC; and (iii) a sponsor to hold up to 100% of the share capital of an ARC. The Press Note seeks to give effect to the first two proposals of the Finance Minister.

### CHANGES AND ANALYSIS

The Press Note revises the Para 6.2.18 of the Consolidated FDI Policy Circular of 2015 ("FDI Policy"), which deals with foreign investment in ARCs. The changes have been analyzed below.

#### Foreign investment limits

Proposed changes as per the Press Note	FDI Policy
100% foreign investment permitted under the automatic route	100% foreign investment permitted as follows: <ul style="list-style-type: none"> <li>■ Up to 49% under automatic route;</li> <li>■ Beyond 49% under the government route</li> </ul>

Under the existing regime for FDI in ARCs, 100% foreign investment was permitted in ARCs, subject to the condition that up to 49% of the investment was permitted under the automatic route, while investment in excess of 49% was to be permitted under the government or approval route.

Under the Securitisation Companies and Restructuring Companies (Reserve Bank) Guidelines and Directions, 2003 ("RBI Directions"), an ARC requires the prior approval of the Reserve Bank of India ("RBI") in case of a substantial change in the management of an ARC by way of transfer of shares. The guidelines provided that any transfer of shares, which resulted in the change in the sponsors, or which amounted to a transfer of shares in excess of 10% of the existing share capital of the ARC would require the prior consent of the RBI.

Accordingly, any substantial transfer in the shares of the ARC, required the approval of the financial regulator, the RBI. In light of this requirement, it was always felt that the requirement of obtaining the approval of the Foreign Investment Promotion Board ("FIPB") was an unnecessary administrative hurdle which could have been avoided. It was probably for these reasons, and to further 'ease of doing business' in India, that the Finance Minister proposed to do away with the requirement of the FIPB, and bring investment into ARCs under the automatic route. The Press Note seeks to give effect to the intention of the Finance Minister.

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**Proposed changes as per the Press Note****FDI Policy**

Investment limits of sponsors to be governed by SARFAESI

No sponsor permitted to hold more than 50% of the shareholding in the ARC, either by way of FDI or by routing it through FII/ FPI controlled by a single sponsor

The FDI Policy stated that no sponsor could hold more than 50% of the shares of the ARC, whether under the FDI route or by way of holdings under the foreign institutional investor ('**FII**') or FPI route. This was in line with the restrictions contained under SARFAESI. Section 2 (zh) of SARFAESI defines 'sponsor' as a person holding not less than 10% of the paid up capital of the ARC. Further, Section 3 (3)(f) states that no sponsor (i) can be a holding company of the ARC, or (ii) can hold a controlling interest in the ARC. Accordingly, under SARFAESI, no single sponsor could hold more than 50% of the shares of the ARC in any case, and the FDI Policy reflected the same.

However, the Finance Minister, in his budget speech, proposed removing the limits on the shareholding of a sponsor of an ARC. Since the restriction was provided in Section 3 of SARFAESI, an amendment to SARFAESI would be required. To give effect to removing the restrictions on sponsor's shareholding, 'The Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Bill, 2016' ('**Debt Amendment Bill**') has been drafted and introduced in the Lower House of the Parliament on May 11, 2016.<sup>2</sup> The Debt Amendment Bill proposes to remove the restriction contained in Section 3(3)(f).

To ensure that the entire share capital of an ARC could be held by a single non-resident sponsor, the FDI Policy has been amended by the Press Note to state that the foreign investment limits of a sponsor shall be governed by SARFAESI, which would be permitted post the notification of the Debt Amendment Bill.

Till the Draft Amendment Bill is passed, a non-resident sponsor could hold up to 50% of the share capital of the ARC and cannot hold the controlling interest of an ARC. However, once the Draft Amendment Bill is passed and is notified into law, a single sponsor could hold up to 100% of the share capital of the ARC and control the board of directors of the ARC as well.

**FII/ FPI holdings**

The FDI Policy stated that the individual shareholding of an FII/ FPI shall be below 10% of the paid up capital of the ARC. The Press Note does not change this position. In any situation, the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 ('**FPI Regs**') requires the shareholding of a FPI to be less than 10% of the paid up capital of a company. Accordingly, this merely clarifies this position.

**FII/ FPI investment in security receipts****Proposed changes as per the Press Note****FDI Policy**

FII/ FPIs can invest up to 100% of each tranche of the schemes of the ARC.

FII/ FPIs can invest up to 74% of each tranche of the schemes of the ARC.

Such investment would be within the limits on corporate bonds prescribed from time to time, and the sectoral caps under the exchange FDI regulations should also be complied with.

- The FDI Policy stated that investment by FII/ FPIs were permitted up to 74% of the security receipts ('**SR**') of each tranche of a scheme of an ARC. This meant that at least 26% of the SRs were required to be held by resident entities, which could also be the ARC itself.

The Press Note now states that FII/ FPIs can invest up to 100% of the SRs of each scheme of an ARC. This is an extremely important relaxation, because ARCs need not look for domestic investment in the SRs when they have potential offshore investors willing to acquire all the SRs for a particular scheme.

However, while the FDI Policy makes room for FPIs/ FIIs to invest in 100% of the SRs of each scheme of an ARC, the RBI Directions require that the ARC itself holds at least 15% of the SRs of each tranche of the ARC, to ensure some 'skin in the game'.<sup>3</sup> As of today, it seems that the SRs of most schemes may end up being held 85:15 by the FII/ FPI and the ARC respectively.

For an FPI to hold 100% of the SRs issued by a scheme of an ARC, the Directions would need to be amended. While RBI increased the requirement of an ARC from 5% to 15% in 2014, it may be pertinent to relook at this requirement in certain cases, especially where the holders of the other SRs are willing to relax this requirement. The requirement ensures alignment of the interests of the ARC with that of the holders of the SRs, and was considered important to protect the holders of the SRs. However, in cases where the holders of the SRs are sophisticated investors, especially FPIs, and a supermajority or all of the SR holders (except the ARC itself) agree that the ARC's commitment of 15% could be dispensed with, it would be beneficial to dispense with such requirement. This would provide flexibility for ARCs to acquire more distressed assets.

- Currently, FII/ FPIs are permitted to invest an amount of up to USD 51 billion into corporate bonds. Investments by FII/ FPIs into SRs were hitherto taken into consideration when calculating the limit of USD 51 billion. It seems that Press Note seeks to provide that investment by FII/ FPIs into SRs shall not be within the limits on corporate bonds, notified from time to time. It is to be seen if the amendment to Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 ('**TISPRO**') by the RBI, which would be necessary to give effect to the Press Note clarifies this position.

**CONCLUSION**

The changes to foreign investment in ARCs and SRs issued by ARCs should prove to be a major shot in the arm for ARCs in India. Foreign investment being largely regulated, coupled with challenges on enforcement of security interest resulted in merely 14 ARCs being registered with the RBI over the last 14 years. While distressed investments was on the rise, these were structured through alternate modes of investment, such as equity linked instruments or debt based equity tickers. The

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investments in ARCs remained substantially low, since enforcement of security interests under the ARC route meant reliance on domestic partners, which foreign investors were not comfortable with.

However, with the Government sending the right signals to mushroom ARCs, it is expected that investments in ARCs and SRs issued by schemes of ARCs would be on the rise. In fact, a large number of corporate houses have already applied or initiated steps for setting up their own ARCs in the last few months.<sup>4</sup> It is expected that the steps contemplated in the Press Note, once notified by the RBI, coupled with the recently passed Bankruptcy Code, and the passing of the pending Debt Amendment Bill shall provide ARCs in India a conducive regulatory framework for its operations, and in turn help in cleaning up bad loans of banks in India.

– Ruchir Sinha & Abhinav Harlalka

You can direct your queries or comments to the authors

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<sup>1</sup> <http://www.businesstoday.in/magazine/cover-story/distressed-assets-market-in-india-witnessing-unprecedented-boom/story/221604.html>

<sup>2</sup> A draft of the Debt Amendment Bill can be accessed at <http://www.prsindia.org/administrator/uploads/media/Enforcement%20of%20Security/Enforcement%20of%20Security%20Bill,%202016.pdf>

<sup>3</sup> This 15% SR holding requirement (which was increased in 2014, from the earlier requirement of 5%) meant that ARCs required larger discounts for upfront payments to the banks. This ultimately resulted in disagreement on the valuation of assets.

<sup>4</sup> <http://www.livemint.com/Industry/Pq69OvxlG5Kvg9FJD4xeON/Stressed-asset-specialists-queue-up-for-RBI-licences-to-star.html>

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