

Investment Funds: Monthly Digest

April 02, 2024

INADEQUATE RELIEF FOR AIFs IN RBI'S CLARIFICATION

- On March 27, 2024, RBI issued a circular to clarify its stance on investment by Regulated Entities ("REs") in AIFs.
- REs continue to be restricted from investing in AIFs which hold instruments other than equity shares in Debtor Companies of REs.
- Provisioning by REs is to be on a pro rata basis instead of the whole of its investment being provisioned.
- Significant concerns remain on operational aspects of participation by REs in AIFs which have exposure other than in equity shares of Debtor Companies of REs.

BACKGROUND

On December 19, 2023, the Reserve Bank of India ("RBI") had issued a circular¹ prohibiting all regulated banks, financial institutions and non-banking financial companies² (each, a "Regulated Entity" or "RE") from making investments in Alternative Investment Funds ("AIFs") which have downstream investments in a "Debtor Company"³ of such REs ("Original Circular").

This prompted numerous industry representations to the RBI, highlighting practical concerns around the implementation of the Original Circular. REs were compelled to consider prematurely selling their interests in AIFs and their investee AIFs were left with a potentially shrinking corpus.

Some REs provisioned as much as INR 1,070 crore for their AIF investments. It was anticipated that the Original Circular would lead to a 20-30% reduction in investments in the AIF industry. Our views on the Original Circular are available [here](#).

In order to address such industry concerns, RBI has now issued another circular⁴ in an attempt to provide clarity on the provisions of the Original Circular ("Circular"). The Circular seems to have provided some relief to the REs for provisioning but has also maintained disappointment for the AIF industry.

In this issue of the monthly digest, we delve into the nuances of the Circular.

CLARIFICATIONS PROVIDED

Scope of the Original Circular to exclude investment in equity shares of Debtor Companies by AIFs

The Circular now clarifies that investments by AIFs into equity shares of Debtor Companies are not covered (all other investments to be referred to as "Non-Equity Investments") under the liquidation/provisioning restriction applicable to REs under the Original Circular.⁵ However, there was an industry expectation of investments by AIFs in all instruments other than debt instruments to be excluded from the liquidation/provisioning restriction because the issues around evergreening should not arise in case of non-debt investments.⁶

However, there is still no clarity around whether there is a complete ban for REs from investing in any AIF which Non-Equity Investments, or if the ban is only on participating in those investments of such AIFs which are towards Non-Equity Investments (i.e. the RE may continue to participate in other investments of the AIF).

The confusion arises due to RBI's clarification around provisioning by REs to be done on a pro-rata basis. One view is that RBI has provided relief to REs by lowering the provisioning exposure, rather than providing the needed clarity to AIFs on their shrinking corpus.

The industry preference is to have an RE be permitted invest in an AIF with Non-Equity Investment insofar as its contributions are not utilised towards such Non-Equity Investment but utilised towards the other investments.

In terms of operational challenges associated with the implementation of the Circular, concerns such as (i) AIFs being required to intimate the REs before every investment is made to a Debtor Company to make way for adequate provisioning; and (ii) REs being required to intimate the AIF prior to lending to a Debtor Company, continue to remain. This increase in compliance requirements and provisioning may cause REs to seek an excuse from any form of investments into Debtor Companies or seek to entirely withdraw from AIF. Effectively, such excusals/withdrawals can cause an effective shrinkage of the corpus of existing funds and may be highly detrimental to the other investors, the fund, and the AIF ecosystem at large.

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The Circular has clarified that REs will now only need to provision to the extent of their investment in the AIF, which is subsequently invested by the AIF in the Debtor Company, rather than provisioning for the entire investment in the AIF.

Under the Original Circular, there was confusion around whether REs had to provide 100% provisioning against their entire holding in AIF, causing a significant impact on their financials. This clarification is a welcome move as it reduces some of the burden on REs. The primary obligation was to liquidate these investments under the Original Circular, the timeline for which has lapsed.

Other clarifications

RBI has limited the scope of the Original Circular to the effect that it now expressly excludes investments made by REs in AIFs through intermediaries such as fund of funds or mutual funds.⁷

Additionally, the Circular clarifies that a full deduction of a RE's investment in the subordinated units of any AIF scheme with a 'priority distribution model' shall only be triggered in cases where the AIF does not have any Non-Equity Investments. Further, the Circular clarified that such deduction shall be made equally from its Tier 1 and Tier 2 capital.⁸ However, if such AIF has Non-Equity Investments, then the RE will be required to liquidate/provision against such investments (in accordance with paragraph 2 of the Original Circular).

Although RBI limited the scope of the Original Circular at the fund-level, the scope remains too broad at the portfolio company level. This is because Original Circular is still applicable to both direct and indirect investment into Debtor Companies by the AIF, i.e. investments by an AIF's portfolio company is also covered. There is no clarity from RBI on the term 'indirectly'.

CONCLUSION

Inherently, AIFs are blind pool vehicles wherein investment decisions are taken by the investment manager without the investors' involvement. Generally, an investor (including an RE) cannot influence the investment decisions of an AIF, in order to undertake evergreening of non-performing assets. Thus, the restrictions placed on REs vis-a-vis investments into AIFs should only be applicable in instances where one can establish that an investor is able to influence the AIF's investment decisions.

Rather, a simpler approach that could have been adopted by RBI would be to limit the scope of the Original Circular to investments by REs in AIFs wherein (i) the RE holds a minimum of 50% of the AIF's corpus, or (ii) the RE has any majority ownership or control of the AIF's manager or sponsor.

Moreover, the absence of a bright line test to determine when exposure to a Debtor Company warrants provisioning reflects the complexity of the issue. Not all REs can be said to be involved in evergreening of loans by virtue of their investment in AIFs with Non-Equity Investments. Ideally, provisioning against such indirect exposure should only be required when there is a material risk of default or evidence to show involvement in such practices on the part of the Debtor Company. Although, there was an expectation that RBI would provide a more detailed framework for such scenarios, there is a looming concern that this will prevail as the definitive law governing provisioning against exposure to Debtor Companies.

With the move to exclude indirect investments by REs in AIFs via fund of funds/mutual funds from the purview of the Original Circular and the clarification that REs need to only provision a pro-rata share of its exposure in the AIF's Non-Equity Investment, as opposed to its entire investment in an AIF, the RBI seems to have partly addressed industry concerns.

— Athul Kumar, Dibya Behera and Nandini Pathak

You can direct your queries or comments to the authors.

¹Investments in AIFs, RBI circular RBI/2023-24/90 dated December 19, 2023.

²The circular refers to "regulated entities", which include all commercial banks (including small finance banks, local area banks and regional rural banks), all primary (urban) co-operative banks/state co-operative banks/ central co-operative banks, all all-India financial institutions, and all non-banking financial companies (including housing finance companies).

³A debtor company is any company to which a Regulated Entity currently has or previously had a loan or investment exposure anytime during the preceding 12 months.

⁴Investments in AIFs, RBI circular RBI/2023-24/140 dated March 27, 2024.

⁵Paragraph 2(i) of the Circular.

⁶'Securities' has been broadly defined under section 2 of the Securities Contracts (Regulation) Act, 1956 to include, "...*(i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or a pooled investment vehicle or other body corporate;..*".

⁷Paragraph 2(v) of the Circular

⁸Paragraph 2(iii) of the Circular

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