

M&A Hotline

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HOLDING COMPANY STRUCTURES UNDER REGULATORY SCANNER

In a move to regulate the corporate holding company structures, the Reserve Bank of India ("RBI") vide Circular DNBS (PD) CC. No. /03.10.001/2009-10 dated April 21, 2010 announced the proposed regulatory framework ("Proposed Framework") for governing investment companies having an asset size of more than INR 1 billion (approximately USD 22.5 million). The Proposed Framework that seeks to regulate 'Core Investment Companies' ("CICs") will bring in the much needed clarity surrounding holding company structures and the need for their registration with the RBI.

The Proposed Framework comes in light of the announcements made by the RBI in its Annual Policy Statement for the year 2010-11 issued on April 20, 2010 ("Policy Statement") where CICs were referred to as companies which have their assets predominantly as investments in shares not for trading but for holding stakes in group companies and also do not carry on any other financial activity.

BACKGROUND

Section 45 IA of the RBI Act, 1934 ("RBI Act") mandates every company in the business of acquisition of shares, stock, bonds, debentures or securities issued by a government or local authority or other marketable securities of a like nature to procure a certificate of registration ("COR") from the RBI as a non banking financial company ("NBFC").

Having said that, as we understand, the RBI did not earlier consider CICs as carrying on the business of acquisition of shares and securities, if (i) not less than 90% of their assets were in investments in shares for the purpose of holding stake in the investee companies; (ii) they were not trading in these shares except for block sale (to dilute or divest holding); (iii) they were not carrying on any other financial activities; and (iv) they were not holding / accepting public deposits. To that extent, a more relaxed approach was usually taken by the RBI towards CICs, whereby the RBI exempted such CICs from procuring a COR on a case to case basis. As is apparent, there are several such CICs existing, which are not registered with the RBI.

The Proposed Framework marks a departure from this approach towards CICs and mentions that "In view of the systemic implications of access to public funds¹ by CICs, RBI has now decided to bring them under its regulatory framework." The Proposed Framework acknowledges that CICs find it difficult to comply with statutory net owned funds ("NOF")² requirements and exposure norms for NBFCs, and has accordingly been drafted considering the peculiar business model of CICs such as holding stake in group companies and also aiding their funding requirements.

THE CHANGE

The Proposed Framework proposes to make two important changes to the extant regulatory framework governing CICs:

1. CICs with asset size of less than INR 1 billion exempted from RBI supervision

The Proposed Framework has exempted CICs having an asset size of less than INR 1 billion, that is, non systemically important CICs ("NSICIC") from obtaining a COR, subject to the following conditions: (i) 90% of the total assets of CIC is in investments in shares of investee companies for the purpose of holding stake in the said investee companies; (ii) they should not trade in shares (except for block sale to dilute or divest the holding); (iii) they should not accept or hold public deposits; and (iv) they should not carry on any other financial activities referred to in Section 45 I(c) and 45 I(f) of the RBI Act except investments in bank deposits, government securities, loans to and investments in debt issuances of group companies, or guarantees issued on behalf of group companies.

Earlier, irrespective of the asset size, a CIC was required to obtain a COR from the RBI.

2. CICs with asset size of more than INR 1 billion to be exempted from maintenance of statutory minimum NOF and the requirements under the Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 ("Prudential Norms")

CICs having an asset size of more than INR 1 billion, that is, systemically important CICs ("SICIC") may now be exempted from (i) maintenance of statutory minimum NOF; and (ii) requirements of Prudential Norms, subject to the following conditions:

(i) 90% of the total assets of SICIC should be in investments in equity, debt, or loans in group companies, provided that the investment in equity shares of group companies for the purpose of holding stake in these companies is not less than 60% of total assets;

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(ii) they should not trade in shares except for block sale to dilute or divest the holding;

(iii) they should not accept or hold public deposits;

(iv) they should not carry on any other financial activities referred to in Section 45 I(c) and 45 I(f) of the RBI Act, except investments in bank deposits, government securities, loans to and investments in debt issuances of group companies, or guarantees issued on behalf of group companies;

(v) every SICIC shall ensure that at all times it maintains a minimum capital ratio whereby its Adjusted Net Worth³ shall not be less than 30% of its aggregate risk weighted assets on balance sheet and risk adjusted value of off balance sheet items as on the date of the last audited balance sheet;

(vi) the Outside Liabilities⁴ of a SICIC shall not exceed 2.5 times of its Adjusted Net Worth calculated as on the date of the last audited balance sheet;

Earlier, no such exemption was available to a SICIC.

Further, SICICs, even those exempted earlier, have been given six months from the date of notification to apply to the RBI for obtaining a COR. A failure to do so would be regarded as a contravention of Section 45 IA of the Act. But, in order to operationalize the changes in a non-disruptive manner the RBI has given the leeway to such companies to continue their existing business till the disposal of their application by the RBI, provided they make an application for COR within the stipulated time of six months. Also, CICs which currently do not have an asset size of INR 1 billion but may cross it at a later date, will now be required to apply to RBI for COR within three months of crossing such limit.

ANALYSIS

The Proposed Framework is likely to have far reaching implications for investment holding companies that have an asset size of more than INR 1 billion. While these companies have been afforded the opportunity to be exempted from capital adequacy and exposure norms on one hand, the ability of such companies to raise debt or leverage on equity investments have been clipped.

Few aspects of the Proposed Framework that may need a closer look are as follows:

(1) *Investee companies may not be group companies*: The Policy Statement seemed to have indicated that CICs are companies predominantly holding group company shares. However, as the Proposed Framework refers to the term 'investee companies' and not 'group companies' in case of NSICICs, it remains to be seen as to whether the Proposed Framework has extended the exemption from obtaining COR to NSICICs holding shares beyond 'group companies' as well.

(2) *Extent of exemptions for SICIC*: All SICICs will now have to approach the RBI for COR even if they were earlier exempted for such registration. However, as the intent of the RBI behind the Proposed Framework seems to stem from the ability of SICICs to access public funds (as defined above), it remains to be seen whether RBI intends to apply the Proposed Framework to even CICs that do not access public funds.

Further, to get an exemption from NOF and Prudential Norms' requirements, 90% of the total assets of SICIC need not now be in investments only in equity; it can be in debt and loans as well, provided however that atleast 60% is in equity.

CONCLUSION

Though, relaxation of the requirement of registration for NSICIC is a definite move towards positive direction, the RBI has thrown up a big dampener by requiring SICIC to obtain a COR. This change will not only impose an extra burden on such CICs, but could also be a major challenge for the industry houses which have adopted holding company structures for their businesses. As such, this move may not go well with the industry and is most likely to face resistance from them.

Further, by limiting the Outside Liabilities of a SICIC to 2.5 times of its Adjusted Net Worth calculated as on the date of the last audited balance sheet, RBI has capped the leveraging by such holding companies, which is likely to impact fund raising at holding company levels.

Moreover, even though the Policy Statement mentioned that SICICs fulfilling minimum capital and leverage criteria will be given exemptions from minimum NOF and exposure norms, these exemptions have been left to the discretion of the RBI in the Proposed Framework. For holding companies, failure to get an exemption from exposure norms could lead to a direct violation of the Prudential Norms. However, irrespective of grant of exemptions from the requirements, SICICs will now come under the radar of the regulators and be saddled with disclosure requirements.

Also, from an exchange control perspective, with the policy on CICs now being unambiguous, it remains to be seen if the FIPB will now grant its approval on applications for investments into investing companies subject to such companies being in compliance with the provisions listed above.

Deepak Jodhani & Ruchir Sinha

¹ Public funds being defined as funds raised either directly or indirectly through public deposits, commercial paper, debentures, inter-corporate deposits, bank finance and other borrowings.

² All NBFCs registered after April 21, 1999 were required to have minimum net owned funds of INR 20 million (approx. USD 450 Thousand).

³ Adjusted Net Worth means:

(i) the aggregate of

a. Owned Funds as defined in Non Banking Financial (Non Deposit Accepting or Holding) Companies Prudential

Norms (Reserve Bank) Directions, 2007;

b. 50% of the amount standing to the credit of the revaluation reserve arising from valuation of shares, if any, as per the latest audited balance sheet; and

c. an amount equal to 50% of the appreciation in the book value of quoted investment (calculated as the excess of the aggregate market value of quoted investments over the book value of such investment as appearing in the latest audited Balance Sheet);

Note: Aggregate Market Value shall be calculated scrip-wise based on the daily closing price as on the Balance Sheet date;

(ii) reduced by the amount of diminution in the aggregate book value of quoted investments (calculated as the excess of the book value of such investments as appearing in the latest Balance Sheet over the aggregate market value of such investments).

⁴ Outside Liabilities means total liabilities other than paid up capital and reserves but including bank borrowings, all forms of debt, obligations having characteristics of debt whether created by issue of hybrid instruments or otherwise, and value of guarantees issued.

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