REALTY CHECK

Realty Debt Funding in India

Onshore and Offshore Debt Funding

(With Special Focus on NBFCs)

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Contents

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Background

An increased number of realty funds that have approached us have shown an inclination to make debt investments, at times with expectation of a structure that could fetch equity upsides, yet protect the downside.

„Real Estate' and „Debt', however, happen to be areas that the Indian regulators have always treaded on with caution. With external commercial borrowings ("**ECB**") prohibited for the sector[1], restrictions on foreign direct investment ("**FDI**")[2] in real estate[3] coupled with aggressive regulatory overhang actions to discourage standard investor exit rights as *„put options'*, offshore realty funds have been struggling, for a while now, to explore avenues to fund the sector while maintaining standard investor protections and exit rights amidst the fluid regulatory environment.

The lucrative Indian real estate sector, however, continues to attract foreign investment and foreign debt has found its way into the sector. Whether it is non-convertible debentures ("**NCDs**") being purchased by foreign institutional investors ("**FII**")[4] on the floor of stock exchange under the FII route[5], or the more simplistic compulsorily convertible debentures ("**CCDs**") being subscribed to by any foreign investor under the FDI route, or the foreign investor lending/investing through its own non-banking finance company ("**NBFC**"), each route has its own set of challenges and apprehensions, both legal and perceptional.

As it happens, in the Indian context, with an aggressive regulator hostile to foreign debt, sometimes the perceptional issues outweigh the legal issues and we felt the need to analyze few issues under each of

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[1] Under the extant exchange control regulations, ECB proceeds cannot be used for real estate as specifically provided under the paragraph (1)(iv)(B) of Schedule I of the Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000. ECBs were, however, permitted for „integrated townships' for a limited window if the minimum area to be developed was 100 acres or more. That window is no longer available now. ECB for hotels, hospitals and SEZ is permitted up to USD 100 million under the automatic route. Industry representations have been made to allow developers to use ECBs and other fundraising tools to raise foreign debt on the premise that Permitting developers to raise foreign debt will go a long way in ensuring long-term funds are available to them at highly competitive rates, which will result in lower per unit costs, thereby fuelling higher demand.

[2] FDI policy refers to FDI as "a category of cross border investment made by a resident in one economy (the direct investor) with the objective of establishing a „lasting interest' in an enterprise (the direct investment enterprise) that is resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long term relationship with the direct investment enterprise to ensure the significant degree of influence by the direct investor in the management of the direct investment enterprise. Direct investment allows the direct investor to gain access to the direct investment enterprise which it might otherwise be unable to do. The objectives of direct investment are different from those of portfolio investment whereby investors do not generally expect to influence the management of the enterprise." It further mentions that it is the policy of the Government of India to attract and promote productive FDI from non-residents in activities which significantly contribute to industrialization and socio-economic development. FDI supplements the domestic capital and technology.

[3] Please refer to **Annexure I** for a brief overview of debt investment under the FDI route.

[4] FIIs are investors that are registered with the Securities and Exchange Board of India ("**SEBI**") for purchase and sale of securities primarily on the floor of the stock exchange. Purchase and sale of securities by FIIs is not subjected to the restrictions as applicable to FDI. FII investments are governed by Schedule 2 and Schedule 5 of Foreign Exchange Management (Transfer and Issue of Securities by a Person Resident Outside India) Regulations, 2000 ("**TISPRO Regulations**"), while FDI investments are governed by Schedule I of the TISPRO Regulations.

[5] See Annexure II.

these routes and bring to the fore the benefits and challenges of each route, not just as they are reflected in the policy documents, but as we have seen them in our experience.

This Realty Check analyses, from a legal, tax and regulatory perspective, each of the avenues that could be explored by offshore realty funds to infuse debt in the real estate sector and attendant challenges that each such route may be subjected to.

Offshore Debt Funding – The FDI and the FII Route

Foreign debt could be infused into the real estate sector in one of the following ways:

1. Through fully and compulsorily convertible debentures; and
2. Through purchase of listed non-convertible debentures by a FII on the floor of the stock exchange.

The FDI Route

The „CCD route' is subjected to the restrictions applicable to FDI (*as detailed in Annexure I*), and is essentially an equity route in as much as there is definite commitment to convert into common equity shares. In fact, any kind of put options in favour of a non-resident on such instruments is not seen favorably by the RBI, which regards any option as an ECB.

Though there were isolated incidents[6] where the RBI qualified put options granted to non-residents by either the investee company or the promoters of the investee company as ECB, regulatory aggression to foreign debt was manifested by the introduction of Clause 3.3.2.1 of the FDI Policy[7] issued on September 30, 2011, which read as follows:

> *"Only equity shares, fully, compulsorily and mandatorily convertible debentures and fully, compulsorily and mandatorily convertible preference shares, with no in-built options of any type, would qualify as eligible instruments for FDI. Equity instruments issued/transferred to non-residents having in-built options or supported by options sold by third parties would lose their*

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[6] The differentiation between an FDI Instrument and an ECB was essentially on the ability of a non-resident to draw out fixed returns from the investee company. This differentiation became manifest in the DLF Case. In that case, US-based private equity investor DE Shaw had invested $400 million as convertible preference shares into DLF Assets (DAL), the company floated by the promoters of DLF Ltd, in 2007 with assurances from the developer of a public listing in 2008. However, with the worldwide real estate market collapsing in 2008, the investor negotiated with the cash-strapped DLF promoters to provide them an exit at fixed return of at least 27% IRR. RBI, reports suggest, issued a show cause notice on why the investment (even though through FDI Instruments) be classified as an ECB on the ground that it carried a fixed rate of return. Whilst the DLF Case did indicate the regulatory perspective to fixed price exits for non-residents, there is no update on what ultimately transpired. However, as it happens, FDI Instruments continue to be issued with a fixed rate of return and regulatory intervention seems to be on a case to case basis. We understand there have been cases where the RBI has qualified put options without a fixed IRR also as ECBs.

[7] Foreign investments into India are primarily regulated by three regulators, the Reserve Bank of India, the Foreign Investment Promotion Board (an instrumentality of the Ministry of Finance) and the Department of Industrial Policy and Promotion (an instrumentality of the Ministry of Commerce). Policies announced by these regulators on foreign investments have been consolidated in the consolidated FDI policy of India issued by the Department of Industrial Policy and Promotion, which represents the current „policy framework' on foreign direct investment. FDI policy is issued bi-annually.

equity character and such instruments would have to comply with the extant External Commercial Borrowing guidelines."

The provision had the effect of nullifying the equity character of an equity instrument when such instrument was issued or transferred with an in-built optionality (a put option or a buy back provision, for example). Having lost their equity character, such instruments were required to comply with the extant ECB regulations. The regulatory chaos that ensued had led the legal community also to express its discomfort. We discussed, in elaborate details, the implications and consequences of this change in our hotline "**New Consolidated FDI Policy: Entry is welcome – Exit at our 'option'**"[8] on October 3, 2011.

Clause 3.3.2.1 received categorical and unequivocal opposition from the industry. Representations were made to the DIPP by industry associations pointing out the severe implications that such a provision could have on legitimate foreign investments in India. Clause 3.3.2.1 cast a cloud of uncertainty over a host of options, including call options, put options, or even tag along and drag along rights or any right that the investor could exercise at a future date, even though these „standard' investor rights were contractually agreed between sophisticated parties. The ban on put options denied private equity players a safe exit in the event the promoters of the investee company failed to deliver as per the projected business plans. It also adversely affected the „options' available to joint venture partners to consolidate or alienate its stake in the joint venture, in case of a fall-out between the joint venture partners.

Though Clause 3.3.2.1 was deleted within 30 days of it being introduced, the ambiguity over the inclusion of put options continues to haunt. While there is one school of thought that interprets the deletion to mean that options on equity instruments are now permitted, we are of the view that deletion of Clause 3.3.2.1 merely restores the *status quo*. RBI had in the past issued notices, on a case to case basis, with respect to put options being granted to non-resident investors on the following two counts:

(1) *The ECB Perspective:* RBI has issued notices to several private equity investors in the past on the ground that equity investments with a put option attached qualified the instrument as a redeemable instrument, which was akin to a debt instrument. Interestingly, RBI was indifferent if such a put option was exercisable on the company or on any of its shareholders; if there was a put option, the regulatory approach was to look at such instruments as ECB. Pertinently, RBI's objections to options were rather absolute. It had no nexus to the question whether the options warranted the investor an assured return, thus arguably diluting his commitment to the „risk' capital. It also did not treat options differently on the basis of their trigger event. An option available to an investor as an exit mechanism whether on the occurrence of a material event of default or on the failure of the investee company to initiate an Initial Public Offer was treated alike. In our interactions with the regulators, RBI re-emphasized that FDI Policy refers to FDI as „lasting interest' in the company, and a put option at the divorces such lasting interest from the commitment to risk capital by allowing the foreign investor an assured exit.

(2) *The Derivative Perspective*: Another regulatory approach to options that did not find a mention in the FDI Policy is the RBI's perception of such options being regarded as derivative contracts separate from the underlying equity security. RBI, in its notices issued to a few private equity investors, regarded any kind of option attached to equity securities as a derivative contract, which are not

[8] http://www.nishithdesai.com/New_Hotline/CorpSec/CORPSEC%20HOTLINE_Oct0311.htm

permissible under the FDI route, as only FIIs and non-resident Indians are allowed to invest in exchange-traded derivative contracts where the underlying securities are equity shares of an Indian firm.

This view was taken by the RBI notwithstanding representations that in the first place, no separate consideration over and above the purchase consideration for the securities was paid by the foreign investor to secure these options, and more importantly such options were not independently tradable contracts to qualify as „derivatives'.

Accordingly, even though Clause 3.3.2.1. has been deleted, the debate on put options is far from being put to rest. More importantly, it is the *„derivative perspective'* that is more concerning. The risk of enforceability and the likelihood of RBI penalizing the grant of options to a non-resident (on a case to case basis), cannot clearly be ruled out for reasons mentioned above. Considering that private equity funds have limited life, put options are crucial and such regulatory overhang concerning such options happens to be very discouraging for investment under the FDI route.

The FII Route

Under this route, any private or public company could list its privately placed NCDs on the wholesale debt market segment of any recognized stock exchange. Any FII or any sub-account[9] of an FII entity could then purchase these NCDs on the floor of the stock exchange. Entities of offshore realty funds may have their own FII registration or register as a sub-account to an existing FII to purchase the NCDs. For an exit, these debentures may be sold on the floor of the stock exchange, but most commonly these NCDs are redeemed by the issuing company. So long as the NCD are being offered on private placement basis, the process of offering and listing is fairly simple without any onerous eligibility conditions or compliances.

The NCDs are usually redeemed at a premium that is usually a function of the sale proceeds received by the real estate company, with at least 1x of the purchase price being assured to the NCD holder.

Whilst creation of security interest[10] is not permissible with CCDs under the FDI route, listed NCDs can be secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee that acts for and in the interest of the NCD holders. Also, since NCDs are subscribed to by an FII entity under the FII route and not under the FDI route, the restrictions applicable to FDI investors (such as the minimum area requirements, minimum capitalization requirements, lock-in requirements etc.) are not applicable to NCD holders. NCDs, in fact, are also in some situations favored by developers who do not want to share their equity interest in the project. Further, not only are there no interest caps for the NCDs, the redemption premium on the NCDs can also be structured to provide equity upside to the NCD holders, in addition to the returns assured on the coupon on the NCD.

However, this route hinges on the availability of corporate debt allocation limit with the FII. The corporate debt allocation limits, which had run out earlier have recently been replenished by the Government on

[9] See Annexure II.

[10] Security interest is created in favour of the debenture trustee that acts for and on behalf of the NCD Holders. Security interest cannot be created directly in favour of non-resident NCD holders.

November 30, 2011[11]. However, the SEBI *vide* Circular No. CIR/IMD/FIIC/1/2012 dated January 3, 2012 has done away with the facility of reinvestment of the corporate debt limits available with the FIIs. Thus, the debt limits which would be acquired by the FIIs henceforth shall expire on sale or maturity of the debt investments and the FII would be required to obtain the limits again through the bidding process or first come first serve basis.[12]

While this route is prevalent, one school of thought has been apprehensive of using such route for non-FDI compliant real estate projects as there was a perceived apprehension that this was an indirect route of bringing foreign investment into the sector without complying with the sectoral investment conditions applicable to FDI, such as the minimum area requirements, minimum capitalization requirements etc. But that apprehension seems to have settled down with an increased number of Indian real estate companies listing their NCDs.

Further, the budget 2012-13 which though has shaken investor trust with the introduction of retrograde laws, proposes the introduction of a new route for providing debt funding. The Budget has proposed to allow Qualified Foreign Investors[13] ("QFI") to invest in corporate bonds. The QFI regime was recently introduced in January, 2012[14] under which foreign investors are now allowed to invest directly in the Indian listed equities market without any registration/approval requirements as opposed to the FII route. The budget has proposed to expand this route to allow investments in debt as well, which if implemented would allow high net worth individuals to directly invest into listed debt instruments of developer entities without any requirement of pooling their funds with others. The budget has also proposed to allow ECB for low cost affordable housing.

On Shore Debt Funding – The NBFC Route

In light of the challenges that the FDI and the FII route are subjected to, there has been a keen interest in offshore realty funds to explore the idea of setting up their own NBFC to lend or invest to real estate.

[11] Government increased the debt limits for corporate debt and in government securities by US$ 5 billion each on November 30, 2011 to be allocated to FIIs and sub-accounts in an open bidding platform on the Bombay Stock Exchange (BSE). The enhanced cap for FII investments now stands at US$ 15 billion for government securities and US$ 20 billion for corporate debt. The minimum amount which can be bid for is Rs 1 crore (approx. US$ 200,000). Under the bidding process, no single entity would be allocated more than Rs 2000 crore (approx. US$ 400 million) of the investment limit.

[12] Refer to out Hotline titled „*SEBI Strips FIIs of Re-Investment Facility in Debt*' dated January 10, 2012.

[13] Qualified Foreign Investor (QFI) shall mean a person resident in a country that is compliant with Financial Action Task Force standards and that is a signatory to International Organization of Securities Commission's Multilateral Memorandum of Understanding (MMOU).

Provided that such person is not resident in India,

Provided further that such person is not registered with SEBI as Foreign Institutional Investor or Sub-account.

Explanation - For the purposes of this clause:

(1) the term "Person" shall carry the same meaning under Section 2(31) of the Income Tax Act, 1961

(2) the phrase "resident in India" shall carry the same meaning as in the Income Tax Act, 1961

(3) "resident" in a country, other than India, shall mean resident as per the direct tax laws of that country.

[14] Please refer to SEBI Circular No. CIR/IMD/FII&C/3/2012 dated January 13, 2012 and RBI A.P. (DIR Series) Circular No. 66 dated January 13, 2012

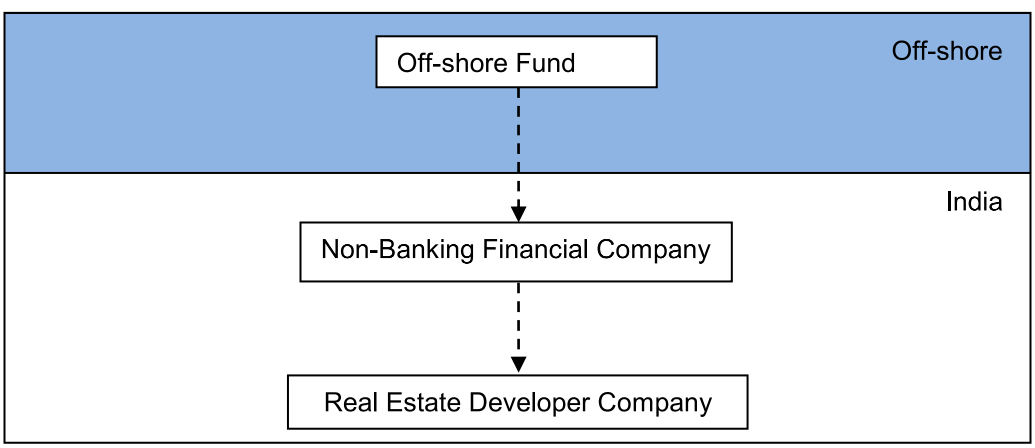
An NBFC is defined in terms of Section 45I(c) of the RBI Act 1934 as a company engaged in granting loans/advances or in the acquisition of shares/securities, etc. or hire purchase finance or insurance business or chit fund activities or lending in any manner provided the *principal business* of such a company does not constitute any non-financial activities such as (a) agricultural operations (b) industrial activity (c) trading in goods (other than securities) (d) providing services (e) purchase, construction or sale of immovable property. Every NBFC is required to be registered with the RBI, unless specifically exempted.

The Act has however remained silent on the definition of „principal business' and has thereby conferred on the regulator, the discretion to determine what is the principal business of a company for the purposes of regulation. Accordingly, the test applied by RBI to determine what is the principal business of a company was articulated in the Press Release 99/1269 dated April 8, 1999 issued by RBI. As per the said press release, a company is treated as an NBFC if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) and income from these financial assets is more than 50 per cent of its gross income. Both these tests ("**50% Tests**") are required to be satisfied in order for the principal business of a company to be determined as being financial for the purpose of RBI regulation.

The Working Group on the Issues and Concerns in the NBFC Sector chaired by Usha Thorat ("**Working Group**")[15] has recommended that the twin criteria of assets and income for determining the principal business of a company need not be changed. However, the minimum percentage threshold of assets and income should be increased to 75 per cent. Accordingly, the financial assets of an NBFC should be 75 per cent or more (as against more than 50 per cent) of total assets and income from these financial assets should be 75 per cent or more (as against more than 50 percent) of total income.

The NBFC could be structured as follows.

Structure diagram



The Offshore Fund sets up an NBFC as a loan company, which then lends to the real estate companies. The NBFC may either lend by way of loan or through structured instruments such as NCDs which have a

[15] The Working Group report was released by the RBI on August 29, 2009. Recommendations have not yet been accepted.

protected downside, and pegged to the equity upside of the company by way of redemption premium or coupons.

<u>Advantages of the NBFC Route</u>

1. *Assured Returns*: The funding provided through NBFCs is in the form of domestic loans or NCDs, without being subjected to interest rate caps as in the case of CCDs[16]. These NCDs can be structured to provide the requisite distribution waterfall or assured investors' rate of return ("**IRR**") to the offshore realty fund.

2. *Regulatory Uncertainty:* The greatest apprehension for realty funds has been the fluid regulatory approach towards foreign investment. Introduction of Clause 3.3.2.1 (discussed above) has been one example. The NBFC being a domestic lending entity is relatively immune from such regulatory uncertainty.

3. *Security Creation:* Creation of security interest in favour of non-residents on shares and immoveable property is not permitted without prior regulatory approval. However, since the NBFC is a domestic entity, security interest could be created in favour of the NBFC. Enforceability of security interests, however, remains a challenge in the Indian context. Enforcement of security interests over immovable property, in the Indian context, is usually a time consuming and court driven process. Unlike banks, NBFCs are not entitled to their security interests under the provisions of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act[17].

4. *Repatriation Comfort:* Even though repatriation of returns by the NBFC to its offshore shareholders will still be subject to the restrictions imposed by the FDI Policy (such as the pricing restrictions, limits on interest payments etc.), but since the NBFC will be owned by the foreign investor itself, the foreign investor is no longer dependent on the Indian developer as would have been the case if the investment was made directly into the real estate entity.

5. *Tax Benefits to the Investee Company:* As against dividend payment in case of shares, any interest paid to the NBFC will reduce the taxable income of the investee company. However, an NBFC may itself be subjected to tax to the extent of interest income so received, subject of course to deductions that the NBFC may be eligible for in respect of interest pay-outs made by the NBFC to its offshore parent.

<u>Challenges involved in the NBFC Route</u>

1. *Setting up*:

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[16] Exchange control regulations do not prescribe for any cap on coupon in case of CCDs, but only prescribe for a cap on payment of dividends on a CCPS, which is three hundred basis points over and above the state bank of India prime lending rate, prevailing at the time of issue of the CCPS. Nevertheless, it is market practice to restrict the coupon that can be paid on CCDs to the same extent as dividends that can be paid on CCPS.

[17] SARFAESI Act facilitates enforcement of security interest without intervention of the courts.

The first challenge in opting for the NBFC route is the setting up of the NBFC. Obtaining a certificate of registration from the RBI for an NBFC is a time consuming process. This process used to take anywhere in the region of 12 – 14 months earlier, which wait period has now significantly reduced, but it may still take as much as 6 months, or in some cases, even longer.

The Working Group deliberated on whether NBFCs that fund their activities out of their owned funds should be exempt from registration with the regulator on the grounds that they do not pose any risk to any public funds. The Working Group felt that even entities that do not rely on public funds could pose systemic risks if the size of their operations are material especially in certain sensitive markets. Further, if excluded from registration requirements there could be a temptation to try to avoid regulatory oversight through the use of a variety of instruments that are ostensibly equity but could be quasi debt. Indeed, the Working Group is given to understand that there are a number of registered NBFCs that are apparently capitalised only with equity, but in fact the investment in their equity capital is based on funds borrowed offshore. These companies undertake investment and lending activity in India, thereby circumventing the capital controls on external borrowings. Besides, even if currently engaged in activities without any public funds in India, such large asset sized entities have the potential to take on such leverage at any point in time. NBFCs that are not leveraged or do not have any access to public funds up to a certain minimum size could however be considered for exemption from registration, but not regulation. As and when the regulator observes risks arising out of the activities of such exempted NBFCs, the exemption may be adequately modified to cover such risk generating NBFCs or may be withdrawn totally as the situation warrants. Based on these considerations, the Working Group recommended that NBFCs with asset size below Rs. 1000 crore and not accessing any public funds may be exempted from registration. Those NBFCs, with asset sizes of Rs. 1000 crore and above, need to be registered and regulated even if they have no access to public funds.

Working Group also proposed that small non deposit taking NBFCs with assets of Rs. 50 crore or less could be exempt from the requirement of RBI registration. Not being deposit taking companies and being small in size, no serious threat perception is perceived to emanate from them.

Due to the elaborate time period involved in setting up the NBFC, one of the alternatives adopted is to purchase an existing NBFC. Currently, there is a requirement of giving 30 thirty days' written notice prior to effecting a change of „control' (the term „control' has the same meaning as defined in the SEBI Takeover Code). The public notice needs to be published in one English and one vernacular language newspaper, copies of which are required to be submitted to the RBI. Unless the RBI restricts the transfer of shares or the change of control, the change of control becomes effective from the expiry of thirty days from the date of publication of the public notice.

The Working Group has recommended that all registered NBFCs, both deposit taking and non-deposit taking, should take prior approval from the Reserve Bank, where there is a change in control or transfer of shareholding directly or indirectly - in excess of 25 percent of the paid up capital of the company. „Control' may be defined as "right to appoint majority of the directors or to control the management or policy decisions exercisable by a person individually or persons acting in concert, directly or indirectly, by virtue of shareholding or shareholder agreements or by any other name. Prior approval of RBI should also be required for any mergers of NBFCs under Section 391-394 of the

Companies Act, 1956 or acquisitions by or of an NBFC, which are governed by the SEBI Regulations for Substantial Acquisitions of Shares and Takeover.

In addition to the requirement to give public notice, until November 4, 2011 any transfer of shares of a financial services company from a resident to a non-resident required prior approval of the Foreign Exchange Department of the Reserve Bank of India ("**FED**"), which took anywhere in the region of 2 – 4 months. However, as per a recent RBI circular dated November 4, 2011, the requirement to procure such an approval has been done away if:

a. "*No Objection Certificates ("**NOCs**") are obtained from the respective financial sector regulators/ regulators of the investee company as well as transferor and transferee entities and such NOCs are filed along with the form FC-TRS with the AD bank; and*
b. *The FDI policy and FEMA regulations in terms of sectoral caps, conditionalities (such as minimum capitalization, etc.), reporting requirements, documentation etc., are complied with.*"

However, there are a few ambiguities that need to be creased out. Since the Circular makes the reference to *„respective financial sector regulators',* it appears that such NOCs may be required to be obtained from the relevant regulator as against the FED. For instance, for transfer of shares of a non-banking financial services company, approval of the department of non-banking financial supervision may be required as against the FED.

Requirement of procuring an NOC from the financial services regulators of all the three – the investee company, the transferor and the transferee entities does seem elaborate and leaves a few ambiguities. For instance, it is not clear whether FED approval will be required or an NOC from the regulator of the investee company will suffice in cases where the transferor or transferee are unregulated entities (say, transfer between a resident and a non-resident individual shareholder). Also, since the Circular specifically provides for NOC from the "financial services regulator / regulators of *the investee company as well as transferor and transferee entities",* an NOC from the regulator of the transferor and transferee entities will be required even if such regulator is not a financial services regulator.

Another alternative of establishing foreign ownership in an NBFC could be to let an Indian resident / partner purchase the NBFC and diluting the resident shareholder by issue of shares (regulatory approval is not required for issue of shares to a non-resident) to the non-resident.

2. *Capitalization*:

The NBFC would be subject to minimum capitalization requirement which is pegged to the extent of foreign shareholding in the NBFC as set out in the FDI Policy.

Percentage of Holding in the NBFC	Minimum Capitalisation
Up to 51% FDI	USD 0.5 million, with entire amount to be brought upfront.
More than 51% FDI	USD 5 million with entire amount to be brought upfront.
More than 75% FDI	USD 50 million, with USD 7.5 million to be brought

	upfront and the balance in 24 months.

Considering the need for capitalization, it is not uncommon to see non – residents holding less than 75% stake in the NBFC even though a significant portion of the contribution comes from non-residents. Premium on securities is considered for calculating the minimum capitalization.

In addition to the above, every NBFC is required to have net owned funds[18] of INR 20 million (INR 2.5 million provided application for NBFC registration is filed on or before April 20,1999)[19].

3. *The Instrument:*

Before we discuss the choice of an instrument for the NBFC, let's discuss the instruments that are usually opted for investment under the FDI route.

The only available options under the FDI route are equity shares, compulsorily convertible preference shares ("**CCPS**") and CCDs. Typically, and naturally depending from case to case, a combination of equity and CCDs is usually preferred to capitalize the investee company. Equity usually forms a nominal part of the investment, and a large portion of the investment is made by subscription to CCDs.

CCDs essentially offer three important benefits. Firstly, any coupon paid on CCDs is a deductible expense for the purpose of income tax. Secondly, though there is a 40% withholding tax that the non-resident recipient of the coupon may be subject to, the rate of withholding can be brought to as low as 10%[20] if the CCDs are subscribed to by an entity that is resident of a favorable treaty jurisdiction such as Cyprus. Thirdly, coupon can be paid by the company, irrespective of whether there are profits or not in the company. Lastly, being a loan stock (until it is converted), CCDs have a liquidation preference over shares. And just for clarity, investment in CCDs is counted towards the minimum capitalization.

CCDs clearly standout against CCPS on at least the following counts. Firstly, while any dividend paid on CCPS is subject to the same dividend entitlement restriction (300 basis points over and above the prevailing State Bank of India Prime Lending Rate at the time of the issue), dividends can only be declared out of profits. Hence, no tax deduction in respect of dividends on CCPS is available. To that

[18] Net Owned Funds has been defined in the RBI Act 1934 as (a) the aggregate of paid up equity capital and free reserves as disclosed in the latest balance sheet of the company, after deducting there from (i) accumulated balance of loss, (ii) deferred revenue expenditure and (iii) other intangible asset; and (b) further reduced by the amounts representing (1) investment of such company in shares of (i) its subsidiaries; (ii) companies in the same group; (iii) all other NBFCs and (2) the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to and deposits with (i) subsidiaries of such company and (ii) companies in the same group, to the extent such amounts exceed ten percent of (a) above

[19] Although the requirement of net owned funds presently stands at INR 20 million, companies that were already in existence before April 21, 1999 are allowed to maintain net owned funds of INR 2.5 million and above. With effect from April 1999, the RBI has not been registering any new NBFC with net owned funds below INR 20 million.

[20] Tax credit of 10% is available in Cyrpus against the tax paid in India, which can be set off against domestic tax in Cyprus which is also 10%.

extent, the company must pay 30%[21] corporate tax before it can even declare dividends. Secondly, any dividends can be paid by the company only after the company has paid 15%[22] dividend distribution tax. In addition, unlike conversion of CCDs into equity, which is not regarded as a „transfer' under the provisions of the Income-tax Act, 1961, conversion of CCPS into equity may be considered as a taxable event and long term or short term capital gains may be applicable. Lastly, CCPS will follow CCDs in terms of liquidation preference.

However, unlike other companies, a combination of nominal equity and a large number of CCDs may not be possible in case of NBFCs. Though all non-deposit accepting NBFCs are subjected to NBFC (Non-Deposit Accepting or Holding) Companies Prudential norms (Reserve Bank) Directions (the "**Prudential Norms**"), once such NBFC has „total assets' in excess of INR 1 billion (USD 20 million approximately)[23], the NBFC is referred to as a „systemically important NBFC'. Unlike other NBFCs, a systemically important NBFC is required to comply with Regulation 15 (Auditor's Certificate), Regulation 16 (Capital Adequacy Ratio) and Regulation 18 (Concentration of Credit / Investment) of the Prudential Norms. The choice of instrument is largely dependent on the capital adequacy ratio required to be maintained by the NBFC for the following reason.

Regulation 16 of the Prudential Norms restricts a systemically important NBFC from having a Tier II Capital larger than its Tier I Capital.

"Tier I Capital" = *Owned funds*[24] + *Perpetual debt instruments (upto15% of Tier I Capital of previous accounting year) -Investment in shares of NBFC and share/ debenture/bond/ loans / deposits with subsidiary and Group company (in excess of 10% of Owned Fund)*

"*Tier II* Capital" = *Non-convertible Preference shares / OCPS + Subordinated debt + General Provision and loss reserves (subject to conditions) + Perpetual debt instruments (which is in excess of what qualifies for Tier I above) + Hybrid debt capital instruments + revaluation reserves at discounted rate of fifty five percent;*

Thus, CCDs being hybrid debt instruments which fall in Tier II cannot be more than Tier I Capital. This disability in terms of capitalization is very crucial for the NBFC and its shareholder as it not only impedes the ability of the NBFC to pay out interests to the foreign parent in case of inadequate profits, but is also tax inefficient. There is currently an ambiguity on whether NCDs are to be included in Tier II Capital no as they do not qualify in any of the heads as listed above for Tier II Capital.

4. *No ability to make investments:*

[21] Exclusive of surcharge and cess.

[22] Exclusive of surcharge and cess.

[23] Note that an NBFC becomes a systemically important NBFC from the moment its total assets exceed INR 100 crores. The threshold of INR 1 billion need not be reckoned from the date of last audited balance sheet as mentioned in the Prudential Norms.

[24] "Owned Fund" means *Equity Capital + CCPS + Free Reserves +Share Premium + Capital Reserves –(Accumulated losses + BV of intangible assets + Deferred Revenue Expenditure)*

Having discussed the funding of the NBFC itself, let's discuss how the NBFC could fund the investee companies. Under the FDI Policy, an NBFC with foreign investment can only engage in certain permitted activities[25] under the automatic route, and engaging in any financial services activity other than such activities will require prior approval of the Foreign Investment Promotion Board ("**FIPB**"), an instrumentality of the Ministry of Finance of the Government of India.

While lending qualifies as one of the permitted categories („leasing and finance'), „investment' is not covered in the list above. Therefore, any FDI in an NBFC that engages in „investments' will require prior approval of the FIPB. Such an approval though discretionary is usually granted within 3 months' time on a case to case basis. Therefore, an NBFC with FDI can only engage in lending but not in making investments.[26]

We are given to understand that in a few cases where the redemption premium of the NCDs was linked to the equity upside, RBI qualified such instruments to be in the nature of investments rather than just loan instruments. Once the nature of the instrument changed, then nature of the NBFC automatically changed from lending to investment, and FIPB approval was immediately required in respect of foreign investment in an NBFC engaged in investment activity.

CORE INVESTMENT COMPANIES

A core investment company ("**CIC**") is a company which satisfies the following conditions as on the date of the last audited balance sheet (i) it holds not less than 90% of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies; (ii) its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its net assets ; (iii) it does not trade in its investments in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment; and (iv) it does not carry on any other financial activity referred to in Section 45 I (c) and 45 I (f) of the Reserve Bank of India Act, 1934 except for granting of loans to group companies, issuing of guarantees on behalf of group companies and investments in bank deposits, money market instruments etc.

A CIC is not required to register with the RBI, unless the CIC accepts „public funds' AND has total financial assets in excess of INR 1 billion.

„Public funds' for the purpose of CIC include funds raised either directly or indirectly through public deposits, Commercial Papers, debentures, inter-corporate deposits and bank finance but excludes

[25] The activities permitted under the automatic route are: (i) Merchant Banking, (ii) Under Writing, (iii) Portfolio Management Services, (iv)Investment Advisory Services, (v) Financial Consultancy, (vi) Stock Broking, (vii) Asset Management, (viii) Venture Capital, (ix) Custodian Services, (x) Factoring, (xi) Credit Rating Agencies, (xii) Leasing & Finance, (xiii) Housing Finance, (xiv) Forex Broking, (xv) Credit Card Business, (xvi) Money Changing Business, (xvii) Micro Credit, (xviii) Rural Credit and (xix) Micro Finance Institutions

[26] The FDI Policy however under paragraph 6.2.24.2 (1) provides that: *"(iv) 100% foreign owned NBFCs with a minimum capitalisation of US$ 50 million can set up step down subsidiaries for specific NBFC activities, without any restriction on the number of operating subsidiaries and without bringing in additional capital.*

(v) Joint Venture operating NBFCs that have 75% or less than 75% foreign investment can also set up subsidiaries for undertaking other NBFC activities, subject to the subsidiaries also complying with the applicable minimum capitalisation norms."

funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue.

5. *Credit concentration norms:*

A systemically important NBFC is not permitted to lend or invest in any single company exceeding 15% of its owned fund[27], or single group[28] of companies exceeding 25% of its owned fund. If however the systemically important NBFC is investing and lending, then these thresholds stand revised to 25% and 40% respectively.

Exemption from such concentration norms may be sought and has been given in the past where the NBFC qualified the following two conditions – firstly, the NBFC did not access public funds[29], and secondly, the NBFC did not engage in the business of giving guarantees. Interestingly, „public funds' include debentures, and to that extent, if the NBFC has issued any kind of debentures (including CCDs), then such relaxation may not be available to it. In the absence of such exemption, it may be challenging for loan or investment NBFCs to use the leverage available to them for the purpose of making loans or investments.

6. *Enforcing Security Interests*:

NBFCs, unlike banks, are not entitled to protection under the SARFAESI Act. This is a major handicap for NBFCs as they have to undergo through the elaborate court process to enforce their security interests, unlike banks which can claim their security interests under the provisions of SARFAESI Act without the intervention of the courts. Representations were made by industry associations seeking inclusion of NBFCs within the ambit of SARFAESI Act, especially in the current times when NBFCs are fairly regulated.

We understand that the then RBI Governor D. Subbarao responded to the exclusion of NBFCs on the ground that their inclusion under the SARFAESI Act would distort the environment for which Securitisation Companies (SCs)/ Reconstruction Companies (RCs) were set up by allowing more players to seek enforcement of security rather than attempting reconstruction of assets.
Subbarao mentioned that SARFAESI Act was enacted to enable banks and financial institutions to realise long-term assets, manage problem of liquidity, asset liability mis-matches and improve recovery by exercising powers to take possession of securities, sell them and reduce nonperforming assets by adopting measures for recovery or reconstruction, through the specialised SCs/RCs, which would be registered with the RBI and purchase the NPAs of the banks and FIs. According to him, two methodologies were envisaged - first, the strategy for resolution of the assets by reconstructing the NPAs and converting them into performing assets, and second, to enforce the security by selling the assets and recovering the loan amounts

[27] *Supra* Note 24

[28] The term „group' has not been defined in the Prudential Norms

[29] "Public funds" includes funds raised either directly or indirectly through public deposits, Commercial Papers, debentures, inter-corporate deposits and bank finance.

Subbarao further mentioned that SARFAESI Act is not merely a facilitator of security enforcement without the intervention of Court. It is a comprehensive approach for restructuring the assets and make it work and only when it does not work, the recovery mode was envisaged.

He was apprehensive that since NBFCs have followed the leasing and hire purchase models generally for extending credit and they enjoy the right of repossession, the only benefit SARFAESI Act would extend to the NBFCs will be for enforcement of security interest without the intervention of the court, which may distort the very purpose for which SCs/RCs were created, namely, reconstruction and the inclusion would simply add a tool for forceful recovery through the Act.

Working Group recognized the anomaly that unlike banks and PFIs, most NBFCs (except those registered as PFIs under Section 4A of the Companies Act) do not enjoy the benefits deriving from the SARFAESI Act even though their clients and/or borrowers may be the same. Working Group has recommended that NBFCs may be given the benefit under SARFAESI Act, 2002

7. *Exit:*

Exit for the foreign investor in an NBFC is the most crucial aspect of any structuring and needs to be planned upfront. The exits could either be by way of liquidation of the NBFC, or buy-back of the shares of the foreign investor by the NBFC, or a scheme of capital reduction (where the foreign investor is selectively bought-back), or the sale of its shares in the NBFC to another resident or non-resident, or lastly, by way of listing of the NBFC. [30]

Unlike most countries, liquidation in the Indian context is a time consuming and elaborate process in India, sometimes taking in excess of 10 years.

Buyback of securities is another alternative, however, CCDs cannot be bought back. CCDs must be converted into the underlying equity shares to be bought back. Buy-back of securities is subjected to certain conditionalities as stipulated under Section 77- A of the Companies Act, 1956. A buyback of equity shares can happen only out of accumulated profits, or proceeds of an earlier issue or out of share premium[31]. In addition to the limited sources that can be used for buy-back, there are certain other restrictions as well that restrict the ability to draw out the capital from the company. For instance, only up to a maximum of 25%[32] of the total paid up company can be bought in one financial year, the debt equity ratio post buy-back should not be more than 2:1 etc. Buy-back being a transfer of securities from a non-resident to a resident cannot be effected at a price higher than the price of the shares as determined by the discounted cash flows method, as explained in *Annexure I*.

[30] The forms of exit discussed here are in addition to the ability of the foreign investor to draw out interest / dividends from the NBFC up to 300 basis points over and above the State Bank of India prime lending rate.

[31] As a structuring consideration, the CCDs are converted into a nominal number of equity shares at a very heavy premium so that the share premium can then be used for buy-back of the shares.

[32] Draft Companies Bill does not provide for including securities premium in afore-mentioned limit of 25%

As an alternative to buy-back, the investor could approach the courts for reduction of capital under the provisions of section 100 of the Companies Act, 1956; however, the applications for such reduction of capital need to be adequately justified to the court. There have been certain cases such as Century Enka where the court approved a scheme for selective buy-back of 30% of its shareholding from its non-resident shareholders.

Sale of shares of an NBFC or listing of the NBFC could be another way of allowing an exit to the foreign investor; however, sale of shares cannot be effected at a price higher than the price of the shares determined by the discounted cash flow method. Listing of NBFCs will be subject to the fulfillment of the listing criterion and hinges on the market conditions at that point in time.

Conclusion

Archimedes had once quoted – "*Give me a lever long enough and a fulcrum on which to place it, and I shall move the world.*" While leverage is crucial for any sector, it has always held special importance for the realty sector. Real estate has been one of the sectors most impacted by the global downturn, and with the global capital being somewhat constrained, the need for mezzanine funding structures for the sector has accentuated.

With CCDs and NCDs having their respective set of challenges, and banks getting increasingly apprehensive of funding real estate, NBFCs play a crucial and niche role in funding real estate projects. There is an immediate and significant need for funding the sector, and we have seen keen and growing interest from players to setup realty specific NBFCs to cater to such needs.

Whilst the Working Group recommendations are likely to go a long way in developing NBFCs and make them more attractive for sector specific funding, Working Group recommendation to limit the exposure of NBFCs to commercial real estate may act as a dampener for realty focused NBFCs. Working Group's recommendation to allocate higher risk weightage to real estate, even in cases of standalone NBFCs (which do not take bank finance) will impede the ability of NBFCs exposure to CRE. However, looking at the increased demand for debt from the developers and the corresponding investor preference, NBFC structure is likely to be explored by an increasing number of offshore realty players.

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Annexure I

Debt Funding under the FDI Route

Per the FDI Policy, no Indian company that has FDI can engage in "**Real Estate Business**", which has been defined to mean „*dealing in land and immoveable property with a view to earning profit or earning income there from*.' FDI in real estate is however permitted under the automatic route in (i) housing, built-up infrastructure and construction-development projects (which would include, but not be restricted to, housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure); and (ii) serviced housing plots, subject to fulfillment of certain entity level and project level requirements as set out in the FDI Policy and detailed in our previous „***Realty Check on Funding Real Estate Projects – Exit Challenges***'[33]. Few such conditions are listed herein below.

- *Minimum area*: Minimum built-up area[34] to be developed under each project should be at least 50,000 square meters[35] or 10 hectares in case of serviced housing plots;

- *Minimum capitalization*: Company seeking foreign investment for construction development projects must be capitalized to a certain (US $10 million for wholly owned subsidiaries and US $5 million for joint ventures with Indian partners) by the foreign investor. Also, such capitalization should be brought in within six months of commencement of business[36] of the company.

- *Lock-in*: Original investment[37] was not permitted to be repatriated before a period of three years from the date of completion of minimum capitalization. If the foreign investor sought to make an early exit[38], he was required to obtain prior approval of the FIPB.

[33] Available on www.nishithdesai.com

[34] The concept of „built-up area' is not clearly defined nor is the term standardized within the industry so as to allow for clear guidance. In particular, the ambiguity pertains to whether the area includes only floor-space index (FSI), as licensed by a relevant local authority, or whether it also includes garage and other below grade areas, which are not considered FSI. In either case, a clear system of measurement on how the minimum area should be calculated is important to refine the process of vetting potential projects for FDI compliance.

[35] Majority of realty players have had difficulty finding land parcels that meet the 50,000 square meter built-up area requirement, especially in the Tier I metro cities such as Mumbai and Delhi. Also, since valuation of land in these cities is very high, acquiring such land parcels is critically dependent on the ability of the acquirer to raise money. Consequently, this requirement acts as a severe stumbling block in attracting FDI. Conversely, salability of a 50,000 square meter project in a Tier II or Tier III city may not be feasible, especially if the plot is for commercial use.

[36] The policy document does not clarify whether the term „commencement of business' is to be reckoned from the date of incorporation of the company; the date of commencement of business of the Indian company; the date of the investment agreement signed by the investor; or from the date the funds are credited into the account of the company. However, based on regulatory advice received in specific cases, commencement of business for the purpose of infusion of FDI has been interpreted to mean the infusion of first tranche of investment into the company, or the date of execution of the investment agreement for the infusion of FDI into the company, whichever is earlier.

[37] FDI Policy has clarified that each tranche of investment made by the foreign investor shall be subject to the three year lock-in from the date it was invested. This has created tremendous issues for offshore realty funds that are willing to fund the project at a later stage, or in cases where the funding is construction linked as their investment may happen to be locked-in for a time span that exceeds the life of the fund itself. There is news that the term original investment is being reconsidered to mean the amount of minimum capitalization; however that proposal seems to be under discussion as of date.

Projects that meet the above requirements are referred to as "**FDI Compliant**", and are eligible to receive FDI[39]. In 2007, the RBI mandated that all FDI must come through only equity shares; preference shares compulsorily convertible into equity shares ("**CCPS**"); or debentures fully and compulsorily convertible into equity shares ("**CCD**") (together "**FDI Instruments**"). It further provided that investments using instruments other than FDI Instruments were to be regarded as ECB, which is prohibited for real estate. In addition to the project level, entity level and instrument restrictions, a non-resident can acquire an FDI Instrument only above a certain floor price and sell it only below a certain ceiling price ("**Pricing Norms**")[40].

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[38] The term used here is „exit' and not „repatriation'. Accordingly, there have been cases where the regulator has taken a position that any sale by a foreign investor to another foreign investor amounts prior to the expiry of the lock-in period amounts to an exit, and to that extent, such sale cannot be consummated prior to the lock-in period without prior approval of the FIPB.

[39] Note that provisions of FDI Policy listed above are only applicable in cases where the Indian company receiving FDI proposes to engage in development of immoveable property and earn profits or income therefrom. Where the purchase or sale of land is ancillary to the main business activity, and the intent is to undertake certain developmental or other business activities on the immoveable property, then the purchase or sale of land in furtherance of the business should not qualify as Real Estate Business. For instance, where the intent to develop the real estate is to develop and operate a hotel, special economic zone, hospital, old age homes etc.

[40] The floor and the ceiling price is the price determined by a chartered accountant or a category I merchant banker as per the discounted cash flows method.

Annexure II

Setting up an FII / Sub account

Foreign Institutional Investment is a preferred route of investment for foreign investors who do not wish to take control in the management of Indian companies. The genesis of foreign institutional investments into listed Indian companies lay in the Government of Indian Guidelines in the year 1992 to allow reputed foreign investors such as Pension Funds, Investment Trusts, Asset Management Companies, Incorporated/Institutional Portfolio Managers etc., to invest in Indian capital markets. This was followed by the SEBI (Foreign Institutional Investors) Regulations, 1995 ("**SEBI FII Regulations**"), which presently govern the registration of foreign institutional investors ("**FIIs**") desirous of making portfolio investments into listed Indian securities.

Eligibility Criteria

For the purposes of making investment in India as FII one should hold a certificate of registration granted by SEBI under the FII Regulations. There are several eligibility criteria such as applicant's track record (of at least one year), professional competence, financial soundness, experience, general reputation of fairness and integrity, whether the applicant is regulated by a appropriate foreign regulatory authority, etc. SEBI has clarified that where the FII applicant is a newly set up fund, the track record of its fund manager may be considered for the purpose of ascertaining the track record, subject to such fund manager providing its disciplinary track record details.

The following categories of foreign investors are eligible for FII registration:

a) an institution established or incorporated outside India as Pension Fund or Mutual Fund or Investment Trust or insurance / reinsurance company;
b) an International or Multilateral Organization or an agency thereof or a Foreign Government Agency, Sovereign Wealth Fund or a Foreign Central Bank;
c) an Asset Management Company or Bank or Institutional Portfolio Manager, Investment Manager or Advisor, established or incorporated outside India and proposing to make investments in India on behalf of broad based funds and its proprietary funds, if any; and
d) a Trustee of a trust established outside India and proposing to make investments in India on behalf of broad based funds and its proprietary funds, if any;

Additionally, foreign investors that are university funds, endowments, foundations, charitable trusts or charitable societies can seek registration as FII without the need of being „regulated' by an appropriate foreign regulatory authority. University fund, endowments, foundations, charitable trusts or charitable societies should be serving public interest. Thus, it gives a wide discretionary power to SEBI to consider applications from such investors based on whether they are serving any public interest or not.

Certain categories of FII applicants can register funds, corporate or individual as sub-accounts. Sub account has been defined to mean "*any person resident outside India, on whose behalf investments are proposed to be made in India by a foreign institutional investor and who is registered as a sub-account under these regulations*". The different categories of sub-accounts are set forth below.

Types of Sub Accounts

The various kinds of sub accounts are as follows:

1. Broad-based sub-account

For a fund to be regarded as „broad based fund', it should have at least 20 investors and none of the single individual investor should hold more than 49% of the units or shares of the fund. However, if the fund has institutional investors then it shall not be necessary for the fund to have 20 investors. Further, if any institutional investor holds more than 49% of the units or shares of the fund, then the said institutional investor must itself be a „broad based fund'. Thus, the definition of „broad based fund' applies on a look through basis in case any institutional investor holds more than 49% interest in the fund.

2. Proprietary sub-account

A proprietary sub-account can be used by the FII to invest its own funds. No client monies can be invested by the FII through the proprietary sub-account.

3. Foreign Corporation

As per the SEBI (FII) (Amendment) Regulations, 2008, a foreign corporate means a body incorporated outside India which has its securities listed on a stock exchange outside India, has an asset base of not less than US$ 2 billion and had an average net profit of at least US$ 50 million during the three financial years preceding the date of application. However, these conditions should not apply to an entity registered as a „foreign corporate' sub-account prior to the commencement of the abovementioned amendment regulation which came in to force from May 22, 2008.

4. Foreign Individual

SEBI (FII) (Amendment) Regulations, 2008 defines a „foreign individual' as a foreigner who holds the passport of a foreign country for a period of at least five years preceding the date of the application, has a net worth of at least US$ 50 million and holds a certificate of good standing from a bank. He must also be a client of the FII or any other entity which belongs to the same group as the FII, for a period of at least three years preceding the date of the application.

Further, under the amendment regulations, SEBI has also removed the restriction imposed on Overseas Corporate Bodies ("**OCBs**") from registering as FIIs and sub-accounts. Thus, now only Non Resident Indians ("**NRIs**") are restricted from registering as sub-accounts.

The FIIs are not permitted to invest their own monies through any of their clients registered as sub-accounts except through their proprietary sub-account.

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