

# Pledge of Shares

## Advantage Indian & Overseas Banks

The RBI has now delegated the power to authorized dealers to allow the pledge of shares of an Indian company by non-residents in favor of Indian and overseas banks. Ruchir Sinha and Arun Scaria, senior legal experts from Nishith Desai Associates, discuss ramifications of this major regulatory change:

**T**he regulatory change brought about by the RBI vide its Circular 57 recently permits non-resident shareholders of Indian companies to avail of loans from Indian and overseas banks using their shareholding in Indian companies as collateral subject to procuring the no-objection certificate (NOC) from the relevant authorized dealers (AD). Accordingly, the requirement to obtain prior approval of RBI for pledging the Indian shares held by non-residents is dispensed with subject to fulfillment of the conditions prescribed. All those major public sector and private banks as well as multi national banks which function as ADs in respect of FDI related transactions can act as AD relating to pledge of shares.

Under the extant exchange control laws, no person resident outside India is permitted to transfer any shares, except by way of a gift or sale. Since the term transfer is defined to include sale, purchase, exchange, mortgage, pledge, gift and loan, an exception was provided only for gift or sale; other forms of transfer such as pledge were deemed as not being permitted without prior RBI approval.

RBI's action is an endeavor to further liberalize, rationalize and simplify the processes associated with FDI flows to India. Ruchir Sinha, co-head,



**Arun Scaria** points out that non-resident shareholders/promoters of Indian companies can now facilitate bank financing of the Indian companies by pledging their shares

Real Estate Investments Practice, and Arun Scaria, senior member, Corporate and M&A Team, of law firm Nishith Desai Associates, outline wide ranging legal issues associated with the regulatory change:

### **NON-RESIDENT SHAREHOLDERS**

The regulatory change would be advantageous to both banks and non-resident shareholders of Indian companies, says Sinha, adding: "This is a welcome change and can be beneficial to all the stakeholders in such a loan or pledge. The change introduces a new source of funding for the non-resident shareholders of Indian companies including non-resident Indians. Non-resident shareholders can now leverage on their Indian shareholding to raise monies abroad for their general business purposes without having to procure any regulatory approval. Loans availed against the Indian shareholding by the non-resident shareholders can mitigate the liquidity crunch of the foreign shareholders, if any. Further, non-resident promoters can now facilitate funding of Indian companies from Indian banks using their shares in the Indian company as collateral."

He maintains that the relaxation in the process would also ease the time constraints associated with obtaining prior approval of the RBI, which generally took about 12-14 weeks and was a discretionary approval.

### **BANKS**

As per the circular, Indian banks are permitted only to extend loans to the investee Indian company against the shares held

by the non-resident shareholders in such company. Says Scaria: "If the loan against Indian shareholding is availed of by the non-resident shareholder or its group companies abroad, then such loan has to be necessarily procured from an overseas bank. Clearly, this regulatory change offers one more collateral that can be taken by banks to secure their loans. We understand that the banks generally prefer creating pledge on the shares in comparison to other assets of the borrower as pledge is a relatively liquid form of security especially in case of listed securities. To that extent, this regulatory change should be a favorable step for the banks."

Foreign banks are permitted to extend overseas loans to non-resident investors or their group companies against the pledge of shares of an Indian company held by the non-resident shareholders. "However, this facility will have to be strictly used outside India for business purposes. On the other hand, Indian banks are permitted to grant loans to Indian companies against shares held by non-residents which monies can be used for genuine business purposes by the Indian company. Therefore, we see that it is beneficial to both Indian and foreign banks," he adds.

The investee company also stands to gain. Scaria says the non-resident shareholders/ promoters of Indian companies can now facilitate bank financing for bona fide business purposes of the Indian companies by pledging their shares in favor of the lenders. It goes without saying that this can be a major source of funding for the Indian companies. He feels it is commendable that Indian companies are permitted to leverage on their non-resident shareholding without any regulatory approval, however, it would have been ideal if such liberty to pledge non-resident shareholding was extended also in favor of regulated financial institutions which play a pivotal role in such lending transactions.

### CHALLENGES

Sinha says invoking a pledge can be challenging, since the law requires that a fund must immediately sell the shares upon



**Ruchir Sinha** feels this is a welcome change and can be beneficial to all the stakeholders in such a loan or pledge

invocation; funds are often faced with the dilemma of whether to invoke the pledge or not. "If they invoke the pledge, then they must ensure that the shares are sold, which may, apart from hammering the stock, earn a bad name for the fund. If they don't, and the share value falls, an argument can be made that they suffered the loss due to their failure to exercise their rights on time. The situation is even worse in a private company as there is generally no market for such shares. In fact, in a private company there is an additional degree of challenge as the closely held boards may even resist the pledgee from invoking the pledge on account of the transfer restrictions as contained in the charter of the company," says he.

### DISPUTE RESOLUTION

The dispute resolution mechanism in cases related with pledging of shares is getting complex. Scaria says: "Till recently, invocation of pledge on shares was considered to be an absolute contractual right of the pledgee akin to enforcement of a bank guarantee and courts were generally reluctant to come in way.

However, the enforceability of the pledge of shares has been called in to question after the recent Unitech case. Reports suggest that the promoters of Unitech stalled the move by the debenture trustee Axis Trustee Services to sell pledged shares by securing an injunction from the Delhi high court. The promoters of Unitech had raised funds from HNIs through the issue of non-convertible debentures and had pledged their shares in the firm as security to raise these funds. Subsequently, Unitech's stock price dropped drastically, marking a 38% decline since November 2009."

Since the default under the definitive agreements was triggered, Axis Trustee Services informed the promoters that it would sell the pledged shares on the next working day, as per their agreement. Unitech moved the high court, and secured injunction on the ground that the company would suffer irreparable loss if the stay was not granted.

He adds that even though the ruling in the Unitech matter is very specific to its facts and circumstances, the fear of being dragged to the court by the company against enforcement of pledged shares is common in the market lately. Further, in case of a private limited company, the company may refuse to register the transfer of shares on invocation of pledge to make things difficult for the pledgee.

### ARBITRATION

Scaria is of the opinion that more often than not banks have their standard dispute resolution clauses in the charge and loan documents which leave the parties with limited scope for negotiations in this regard. "In case of arbitration, the non-resident investors may insist on conducting the arbitration in their jurisdiction while Indian banks may want to conduct the arbitration in India. Despite the existence of arbitration clause, parties may seek interim measures from the courts in India to prevent irreparable damages like sale of shares while the arbitration process is continuing. Therefore, it has to be decided whether the application of

section 9 of the Indian Arbitration and Conciliation Act, 1996 which permits parties to seek interim measures from court should be specifically excluded contractually or not,” says he.

In a recent transaction that the company had worked on, the shares of an Indian listed company held by a company in Mauritius were pledged in favor of an overseas bank for availing loan abroad. Parties mutually consented for institutional arbitration by Singapore International Arbitration Centre and also identified a neutral venue for conducting the proceedings.

**ADDITIONAL FUNDING**

Sinha mentions that Circular 57 may not have a bearing on FDI as the loans availed of by the non-resident shareholders against their Indian shareholding cannot be used for any capital inflow into India. “We have significant number of clients looking at leveraging their Indian shareholding to borrow from foreign banks at much cheaper rates than they could have borrowed in India. However, this circular while allowing them to borrow from overseas banks, restricts them from investing such proceeds into India. This relaxation can be an added attraction for existing foreign investors and the investee companies.”

Pledge of shares in respect of FDI related transactions will be generated through foreign banks and overseas branches of Indian banks, so in effect they stand to gain more than any other banks. The banks which wish to corner business in this space have to strengthen their overseas presence, he maintains.

**FINANCIAL INSTITUTIONS**

With regard to the regulatory change vis-a-vis FIs which serve the overseas clients, Sinha says it has been restricted to only loans availed of from banks, Indian and overseas. Since, financial institutions contribute significantly in lending transactions and may also be fairly regulated entities, extending the relaxation to them, would certainly have been helpful.

“This would be even more helpful in cases where the banks have exhausted their limits under Section 19 of the Banking Regulation Act, 1949, which provides that a banking company cannot hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding thirty per cent of the paid-up share capital of that company or thirty per cent of its own paid-up share capital and reserves, whichever is less,” says he.

**PROPAGATE CHANGE**

Most banks have a separate divisions based in India to deal with their NRI customers. Banks which want to corner business in this space need to increase interactions with NRI customers. They should propagate this regulatory change to their NRI customers.

Says Sinha in this regard: “Indeed. This is a major source of business funding for the non-resident investors and also for Indian investee companies. Therefore, banks should bring this option to the attention of the non-resident shareholders who may be in the lookout for funding options without regulatory approval.”

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**NEWS**

**RBS**

**RBS initiative against cluster bomb makers**

The Royal Bank of Scotland has announced it will stop investing in firms that make deadly cluster bombs. The bailed-out bank said it would work with other finance groups and the government to draw up guidelines to stop future investments in such companies. More than 10,000 people emailed RBS chief executive Stephen Hester in an Amnesty International campaign. The bombs deploy many smaller explosives designed to kill and maim civilians.

**RBS not to support Belarus**

Royal Bank of Scotland said it will no longer do fundraising work for the Belarus government following a campaign by human rights groups. Free Belarus Now and Index on Censorship argued that companies such as RBS were helping to support the regime of ‘Europe’s last dictator’. Index said RBS and other banks had sold \$1.85 billion worth of government bonds over the past year. RBS said given the sanctions, the deteriorating political situation in Belarus and the fact that it has reneged on key elements of the IMF program, RBS has ceased any type of capital-raising for or on behalf of the Belarus Republic.

**Customer complaints rise**

Royal Bank of Scotland suffered a sharp rise in customers complaining about its core banking services in the first half of the year despite its continued efforts to improve standards. The bank received 96,205 grievances from customers with NatWest current accounts, 10% more than in the previous six months and 40% more than the first half of 2010. Complaints about RBS accounts rose at a similar rate to 33,660 in the first six months compared with 30,218 six months earlier. The trend stands in contrast to Lloyds Banking Group and Barclays, which both saw complaints from current account customers fall by about a third in the first half of the year.

**This is Our Life**

**Rajneesh Kapoor**

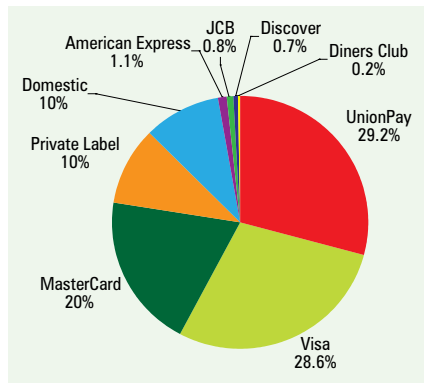


# UnionPay Overtakes Visa

The global card market is poised for a major growth through 2015 and prepaid cards are becoming popular - RBR research study:

**R**BR has undertaken a study of 66 payment cards markets worldwide, titled 'Global Payment Cards Data and Forecasts 2010-2015'. Several findings stand out in this study such as the number of cards worldwide surpassing a phenomenal 8 billion, a fall in the number of cards in North America and more than 10% growth in the prepaid and debit

Share of Payment Cards Worldwide by Scheme, 2010



card sectors. The most startling finding, however, is that China's UnionPay is now the largest payment card scheme in the world, its brand appearing on 3 in every 10 cards worldwide.

Executives at Visa, the card scheme that has been usurped at the top of the rankings, can console themselves with the news that cards with their branding are still well ahead in terms of usage and spending and the fact that most UnionPay cards are found within China.

The new RBR research shows that there is still plenty to play for, with 20% of cards worldwide belonging to domestic bank card or private label schemes. This share is falling however, so competition for these cards plus efforts to persuade large issuers to change their scheme

alliances will only intensify.

## GROWTH DRIVERS

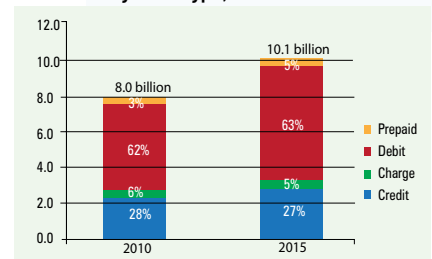
The global card market is projected to expand from 8 billion in 2010 to 10.1 billion by 2015, as a slowdown in card issuance in the mature North American and western European regions is more than offset by rapid growth elsewhere. The prepaid and debit card sectors each grew by more than 10% in 2010, whilst the credit card sector contracted by 6%.

Prepaid cards currently represent just 3% of the global total, but their numbers are increasing rapidly. They are perhaps most commonly viewed as a payment instrument for those with little or no interaction with banks and as a means of paying salaries and benefits – as for example in Colombia and Brazil. This type of card has also found favour with foreign workers in countries such as Saudi Arabia and the UAE, where they are used to make remittances back to family members in foreign countries. Prepaid cards have also been rolled out in significant numbers in some countries where bank account holding is high, and this trend looks set to continue. For example, in New Zealand, hosting the 2011 Rugby World Cup has given rise to the issuance of prepaid cards for use at stadiums during the competition. The share of prepaid cards is expected to rise to 5% by 2015.

Although debit cards make up 62% of the card base worldwide – a share that has risen by 4 percentage points since 2009 – there is still considerable potential for further growth. Government campaigns to promote financial inclusion and the increasing tendency for employers to pay salaries electronically will drive bank account holding, boosting debit

card issuance. The share of debit cards is forecast to increase by one percentage point by 2015.

Number and Share of Payment Cards Worldwide By Card Type, 2010 & 2015



Source: Global payment Cards Data & Forecasts 2010-15

## CREDIT CARD PROSPECTS

The share of credit cards declined by 4 percentage points to 28% in 2010, principally because of the large fall in numbers in the USA, where many accounts with overdue debt were closed and large numbers of inactive cards were taken out of circulation. Credit cards are expected to see a revival over the next few years as confidence is restored following the financial crisis. Greater regulation of the sector, such as in Brazil and Mexico, will lead to a rise in transparency and therefore make customers more comfortable with holding and using such cards.

There are nevertheless various factors which will continue to restrict growth in credit card numbers. In immature markets, there is a scarcity of central credit bureaux and a reluctance of banks to issue credit cards as they consider the risk too great. Even though credit card numbers are likely to rise over the next 5 years, their share of payment cards is forecast to fall by 1 percentage point to 27% by 2015, as the prepaid and debit card sectors will see faster growth.

# Reviving Real Estate

The Confederation of Indian Industry and global real estate services firm Jones Lang LaSalle brought out a research report, 'Indian Real Estate - Charting a Global Course', analyzing market forces and discussing the dynamics of the Indian real estate ecosystem:

**T**he past decade has witnessed a period of economic transformation of the Indian real estate industry. With a vision to drive the transformation of the country's real estate best practices to the next level, the Confederation of Indian Industry (CII) and global real estate services firm Jones Lang LaSalle (JLL), published a research paper that aims at gaining perspective on factors that could turn India into a global real estate powerhouse in the next decade. The report feels that while the industry participants are key to ensure fair business practices of their respective firms, it is important for the government to roll out regulatory policies through a national structured framework which can be enforced at a state or city level.

It also says a typical real estate ecosystem comprises different stakeholders that include architects, developers, government/regulatory authorities, banks, private equity players, other funding agencies, buyers, brokers, and property consultants. For any such ecosystem to remain successful over a long term, it is imperative that all its key industry participants are on a level playing ground despite changing dynamics.

## **AFFORDABILITY**

The report points out that income pyramid in India is heavy at the bottom, with over 60% of the households earning averagely less than ₹80,000 per year. Nearly 19% of the households (at the bottom of the pyramid) cannot afford any type of housing through their income. Another 0.6% of the households in the lower middle income group cannot afford a house in tier I or II cities. Due to lack of available land parcels within the cities, suburbanization has accelerated in several metropolitan areas during the past decade. Several office, retail and residential developments have dotted the suburban landscape. Unaffordable land prices have resulted in leapfrogging of residential development to even suburbs of suburbs or exurbs.

The residential construction activity is even more skewed in the metropolitan cities, with over 95% of the housing projects being constructed at suburban locations. With rapidly expanding city limits due to increased suburbanization of Indian cities, the focus of affordability should not only consider the market value of the products, but also the travel costs to the workplaces, retail and recreational centers.

## **IT/ITES DIVIDENDS**

The emergence of information technology industry in India during the past two decades has contributed significantly to the growth of real estate in several top metropolitan cities in India, finds the report. The increasing presence of international real estate developers, investors and occupiers especially in the tier II and III cities has acted as a catalyst for the increase in transparency outside the tier I cities. Data on office market fundamentals is now more comprehensive in the tier II cities such as Hyderabad, Pune and Kolkata, as they develop into IT/ITES and manufacturing hubs. Data availability for the retail and residential sectors has improved across all tiers due to the rapid development of the residential sector and modern retail formats.

## **TRANSPARENCY**

The report highlights that transparency is the key to improve efficiencies in the system, which benefits all stakeholders, particularly buyers. While developers should avoid misrepresentation and unfair practices, government needs to be unbiased and participative. There is an absence of national indices on real estate sectors, due to lack of market data.