

# Financial Service Update

October 16, 2012

## NBFCs SETTING UP STEP DOWN SUBSIDIARIES: DISPARITY REMOVED

The Department of Industrial Policy and Promotion, Ministry of Commerce and Industry ("DIPP") by Press Note No. 9 of 2012 dated October 4, 2012 (the "**Press Note**") has finally amended the foreign direct investment policy to remove the current disparity between 100% foreign owned NBFCs and NBFCs with foreign investment above 75% but below 100% with respect to setting up any number of (operating) subsidiaries, without the requirement of bringing in additional capital beyond the initial USD 50 million. This change puts all NBFCs having foreign investment of 75% or more on the same footing with respect to the foreign direct investment policy.

### BACKGROUND AND EXISTING POSITION

Prior to issuance of the Press Note, the FDI policy consolidated and updated by Circular 1 of 2012, issued by DIPP and as effective from April 10, 2012 (the "**Consolidated FDI Policy**") provided that where an NBFC was 100% foreign owned and had met the minimum capitalization requirement of USD 50 million, it could set up step down subsidiaries to carry out specific NBFC activities (i.e. the 18 activities that an NBFC with foreign investment is permitted to conduct under the terms of the Consolidated FDI Policy) without any restriction on the number of operating subsidiaries and without any requirement to bring in additional capital to capitalize such subsidiaries. It also provided that where an NBFC operated through a joint venture having 75% or less than 75% foreign investment, it may setup subsidiaries for undertaking other specific NBFC activities, subject to the subsidiaries bringing in additional capital to comply with the applicable minimum capitalization norms for NBFCs.

Considering that an NBFC having foreign investment of more than 75% but less than 100% and an NBFC which was 100% foreign owned were both required to be capitalized to the extent of at least USD 50 million and in both cases effective control would lie with the foreign investors, the reasons for the disparity between the two with respect to setting up of subsidiaries were not very clear. In fact a number of representations had been made to the regulators by market participants, including by Nishith Desai Associates, requesting an alignment in the treatment of such NBFCs.

### CHANGE IN LAW

The Press Note now allows NBFCs with foreign investment above 75% but below 100% and having a minimum capitalization of USD 50 million, to also set up step down subsidiaries to conduct specific NBFC activities without any restriction on the number of operating subsidiaries and without any requirement of bringing in additional capital to separately capitalize such operating subsidiaries. Accordingly, such step down subsidiaries setup to conduct specific NBFC activities would only have to be capitalized to the extent required for all NBFCs, which in most cases is INR 20 million<sup>1</sup> (approx. USD 377.5 thousand).

### RATIONALE FOR CHANGE AND ANALYSIS

Though no specific rationale has been provided for the introduction of this change, it appears that the same could possibly be attributed to the following:

- **No rational for different treatment of 100% foreign owned NBFCs and NBFCs with foreign investment above 75% but below 100%:** Under the Consolidated FDI Policy all NBFCs with foreign investment equal to or exceeding 75% were necessarily required to be capitalized with a minimum of USD 50 million of foreign investment and accordingly, there was no distinction drawn between an NBFC that was 100% foreign owned and an NBFC that had foreign investment of 75% or more, whether with respect to the minimum capitalization requirement or any other condition. Accordingly, it may have appeared prudent for the regulators to also align the requirements applicable to both the above type of NBFCs for setting up (operating) subsidiaries as well.
- **Control issues :** The discussion paper titled FDI Policy - Rationale and Relevance of Caps issued by DIPP on June 23, 2011 mentioned that the rationale for the 74% foreign investment caps in some sectors was to give the Indian equity holders, acting in unison, the power to block a special resolution which requires a favourable vote from 75% of the shareholders under the dictate of the Companies Act, 1956. Considering that a minimum capitalisation threshold of USD 50 million has been set for all NBFCs having foreign investment of 75% or more, there is no difference between an NBFC having 75% percent foreign investment or an NBFC having 100% foreign investment from the perspective of the foreign investors having effective control over the NBFC. This may be another reason why there should not be any difference between both these type of NBFCs.

As discussed above, prior to issuance of the Press Note, an NBFC operating as a joint venture with more than 75% foreign investor stake was restricted in its activities to the extent that if it intended to set up step down subsidiaries for conducting specific NBFC activities then each such subsidiary would have to be capitalized in accordance with the FDI policy akin to an NBFC having direct foreign investment. This Press Note is a welcome move, and should pave the way for more joint ventures in the NBFC sector in the near future and possibly help provide the necessary impetus to foreign investments in the Indian financial sector.

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<sup>1</sup> Reserve Bank of India Act, 1934, section 45-IA. provides, Requirement of registration and net owned fund  
*“(1) Notwithstanding anything contained in this Chapter or in any other law for the time being in force, no non-banking financial company shall commence or carry on the business of a non-banking financial institution without—  
(a) obtaining a certificate of registration issued under this Chapter; and  
(b) having the net owned fund of twenty-five lakh rupees or such other amount, not exceeding two hundred lakh rupees, as the Bank may, by notification in the Official Gazette, specify.”*

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.

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