

Financial Service Update

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RBI TIGHTENS CONTROL OVER OUTBOUND INVESTMENT BY CICs

The Reserve Bank of India ("RBI") vide a notification¹ has issued a separate set of guidelines² ("CIC-OI Directions") for overseas investments by core investment companies ("CICs") which inter alia require all CICs intending to make overseas investments in the financial sector³ to obtain certificate of registration ("CoR") from RBI. These directions are in addition to the already existing guidelines prescribed by the Foreign Exchange Department of RBI for overseas investments.

BACKGROUND

Earlier, CICs were not necessarily required to be registered with RBI if certain specified conditions were satisfied⁴. However, in August 2010, systematically important CICs⁵ ("CICs-ND-SI") were brought under regulatory supervision⁶. Such CICs-ND-SI were also subjected to rules and regulations applicable to outbound investments by non-banking financial companies ("NBFCs") vide the 'NBFC (Opening of branch/subsidiary/joint venture/representative office or undertaking investment abroad by NBFCs) Directions, 2011' ("NBFC-OI Directions"), which laid down the conditions subject to which an NBFC may make an investment outside India. However, in May 2012, in view of the unique nature of business of CICs and their need (being holding companies) to invest in both financial and non-financial activities, RBI had released draft guidelines for regulating overseas investment by all CICs. These draft guidelines have now been formalized and introduced as the Core Investment Companies - Overseas Investment (Reserve Bank) Directions, 2012.

CIC-OI DIRECTIONS

All CICs which intend to invest in financial sector overseas will now be required to hold a CoR and seek prior approval from RBI. Therefore, non-CIC-ND-SIs which were earlier exempt from registration ("Exempted CICs") will now have to seek RBI's registration and comply with all directions/regulations/instructions issued by RBI from time to time if they intend to invest in financial sector abroad.

However, for an outbound investment in non-financial sectors, neither Exempted CICs will require registration nor registered CICs would need prior approval from RBI. However, registered CICs will be required to report such investment with the relevant regional office of the department of non-banking supervision ("DNBS") of RBI within 30 days of making the overseas investment. The overseas investment by CICs is, of course, subject to the conditions prescribed by RBI under FEMA (Transfer or Issue of any Foreign Security) Regulations, 2004, as amended from time to time (the "ODI Regulations"), as explained herein below.

ELIGIBILITY CRITERIA

The RBI has prescribed the following eligibility criteria for CICs intending to invest abroad:

1. The adjusted net worth ("ANW") of the CIC 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 as at the end of the financial year. The CIC shall continue to meet the requirement of minimum ANW, post overseas investment⁷;
2. The level of net non-performing assets of the CIC should not be more than 1% of the net advances as on the date of the last audited balance sheet;
3. The CIC should generally be earning profit continuously for the last three years and its performance should be satisfactory during the period of its existence.

CONDITIONS PRESCRIBED

Overseas investments by CICs are subject to several general and specific conditions prescribed by RBI in this regard. All CICs are required to comply with regulations issued under ODI Regulations from time to time and no overseas investment could be made in activities prohibited under FEMA. Further, the total overseas investment should not exceed 400%, and investment in financial sector should not exceed 200%, of the owned funds of CIC.

The RBI has also prescribed that in case of issuance of guarantees / Letter of Comfort, if the investment structure requires non-operating holding company, there should not be more than two tiers in the structure. Further, CICs requiring more than one non-operating holding company in the investment structure are required to report the same to RBI for its review.

As CICs are non-operating entities, they will not, in the normal course, be allowed to open a branch office overseas.

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Further, a representative office can be opened overseas with the prior approval of RBI. Such a representative office can undertake liaison work, market study and research, but not any activity which involves outlay of funds. Further, any wholly owned subsidiary ("**WOS**") or joint venture ("**JV**") established overseas should not be a shell company⁸. The WOS/JV abroad can also not be used as a vehicle for raising resources for Indian operations.

RBI has also laid down other regulations and several reporting and disclosure requirements for CICs making overseas investments, including for issuance of guarantees and letters of comfort.

ANALYSIS

Overseas investments by Indian companies, including in the financial sector, were regulated by RBI inter-alia under the ODI Regulations. NBFC-OI Directions were issued to specifically regulate overseas investments by NBFCs. However, within CICs, only CICs-ND-SI's were regulated under NBFC-OI Directions and not Exempted CICs. Therefore, RBI has now tightened its grip on CICs and brought all CICs investing in the financial sector overseas under its regulatory supervision. Further, the NBFC-OI Directions prohibited any investment in non-financial services sector whereas the CIC-OI Directions seems to permit investments in non-financial sectors by all CICs by providing that no registration or prior approval is necessary in case of investment by CICs in non-financial sectors. Further, it is pertinent to note that in order to effectively monitor and control overseas investment structures of CICs, RBI has specifically imposed restrictions on having complex structures. These restrictions do not apply in case of other NBFCs.

With the introduction of the CIC-OI Directions, RBI has brought Exempted CICs investing in the financial sector overseas at par with CICs-ND-SI in all respects. The RBI seems to have also recognized the peculiar nature of the business of CICs and their need to invest in both financial and non-financial sector. In the wake of various liberalization reforms that are being introduced in the financial sector, these changes, though restrictive in their intent, should in the long run prove to be beneficial (especially from a systemic risk control perspective) to the numerous conglomerates in India that in many cases are organized under a CIC holding structure.

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You can direct your queries or comments to the authors

¹ Notification No. DNBS (PD) 252/CGM (US) - 2012, dated December 6, 2012
² Core Investment Companies - Overseas (Reserve Bank) Directions, 2012
³ Financial Sector for this purpose is defined as a sector/service regulated by a Financial Sector Regulator
⁴ RBI did not earlier consider CICs as carrying on the business of acquisition of shares and securities (which require compulsory registration as a non-banking financial company), 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.
⁵ CIC-ND-SI is defined under the CIC (Reserve Bank) Directions, 2011 as a CIC having total assets of not less than INR 1 billion either individually or in aggregate along with other Core Investment Companies in the Group and which raises or holds public funds.
⁶ Holding company structures under regulatory scanner
⁷ For this purpose, the risk weights are as laid down in the Notification No.219 dated January 05, 2011
⁸ Shell Company has been defined to mean a company that is incorporated, but has no significant assets or operations. However companies undertaking activities such as financial consultancy and advisory services shall not be considered as shell companies.

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