

Regulatory Hotline

August 12, 2016

REGULATORY ALERTS

UNION CABINET APPROVES:

- Foreign investment in other financial services beyond the 18 specified NBFC activities under automatic route provided the activities are regulated by financial sector regulators.
- Elimination of minimum capitalization norms as mandated under FDI Policy for foreign investment in NBFCs considering the financial regulators prescribe their own set of capitalization norms.

In continuation of its endeavour to liberalise the existing foreign direct investment ("FDI") regime in India, the Government has announced important policy related clarifications / directives relating to the FDI in financial services sector. Nishith Desai Associates, continuing with its practice of highlighting important regulatory changes, is bringing you this alert which provides a brief overview of certain key regulatory announcements with our comments.

FOREIGN INVESTMENT IN FINANCIAL SECTOR UNDER AUTOMATIC ROUTE

In order to induce FDI and spurt economic activities in financial services sector, the Union Cabinet ("Cabinet") chaired by the Hon'ble Prime Minister Shri Narendra Modi has given its approval to amend regulations pertaining to foreign investment in the Non-Banking Finance Companies ("NBFC") to allow FDI in other financial services beyond the 18 specified NBFC activities under the automatic route provided the activities are regulated by financial sector regulators such as Reserve Bank of India ("RBI"), Securities and Exchange Board of India ("SEBI"), Pension Fund Regulatory and Development Authority ("PFRDA"), Insurance Regulatory Authority of India ("IRDA") etc. Further, foreign investment in NBFCs not regulated by any financial sector regulators ("Unregulated NBFCs"), will require prior government approval.

It is a welcome change brought in spirit of the announcement made by the Hon'ble Minister of Finance during the Union Budget (2016-2017) speech on February 29, 2016 that the FDI in NBFCs will be allowed beyond the 18 specified NBFC activities under the automatic route provided the activities are regulated by financial sector regulators. Investment in financial services sector has been taking a hit due to lack of clarity on the definition of 18 NBFC activities in which FDI is currently permitted under the automatic route.

Currently, an NBFC having FDI under automatic route is permitted to engage in only the following 18 financial activities and FDI in financial activities other than those mentioned below require prior approval of the Government.

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|-----------------------------|---------------------------|-----------------------------------|
| (1) Merchant Banking | (2) Under Writing | (3) Portfolio Management Services |
| (4) Stock Broking | (5) Asset Management | (6) Venture Capital |
| (7) Custodian Services | (8) Factoring | (9) Leasing & Finance |
| (10) Housing Finance | (11) Credit Card Business | (12) Micro Credit |
| (13) Rural Credit | (14) Investment Advisory | (15) Financial Consultancy |
| (16) Credit Rating Agencies | (17) Forex Broking | (18) Money Changing Business |

ELIMINATION OF MINIMUM CAPITALISATION NORMS FOR FDI IN NBFCs

Another long awaited change proposed by the Cabinet is elimination of minimum capitalization norms prescribed under the Consolidated FDI Policy for foreign investment in NBFCs engaged in 18 specified NBFC activities given that the financial regulators prescribe their own set of capitalization norms. For example, SEBI under SEBI (Mutual Funds) Regulations, 1996 (as amended) require the Asset Management Companies setup in India to have network of not less than INR 500 million and RBI under the Master Circular on Memorandum of Instructions Governing Money Changing Activities require the Authorised Money Changers to have minimum net owned funds of INR 2.5 million or INR 5 million depending on the number of branches.

As per the extant Consolidated FDI Policy, fund based NBFCs having FDI are required to comply with the minimum capitalization norms, as mentioned below:

- USD 0.5 million for FDI up to 51%, to be brought upfront;
- USD 5 million for FDI more than 51% and up to 75%, to be brought upfront;
- USD 50 million for FDI more than 75% out of which USD 7.5 million to be brought up front and the balance to be brought in within 24 months.

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Similarly, non-fund based activities such as Investment Advisory Services, Financial Consultancy, Forex Broking, Money Changing Business and Credit Rating Agencies are required to comply with the minimum capitalization of US \$0.5 million upfront irrespective of the level of foreign investment.

ANALYSIS

The proposed amendments to the Consolidated FDI Policy and subsequently to the Foreign Exchange Management (Transfer or Issue of Security by the Person Resident Outside India) Regulations, 2000 provide much awaited clarity in terms of investment by foreign investors in activities such as, proprietary trading, infrastructure debt fund and investments NBFCs. These sectors regardless of being appropriately regulated remained economically unviable due to lack of clarity on the definition of 18 NBFC activities in which FDI is currently permitted under the automatic route. Further, the proposed change is likely to provide a level playing field to all foreign owned and controlled entities who typically had to determine the legal validity of their investments in unspecified NBFC activities under the Consolidated FDI Policy even though sectoral regulators allowed such activities to be performed by a foreign owned and controlled entity.

Similarly, elimination of minimum capitalisation norms under the Consolidated FDI Policy would provide boost to foreign investors planning to invest in financial services that require less minimum capital under the relevant regulations than what is mandated under the Consolidated FDI Policy based on the shareholding of the company seeking investments. Further, it is a big relief for companies involved in investments and fund management activities, as they would no longer be required to bring in the minimum capitalisation as prescribed under the Consolidated FDI Policy, if their business model does not require such amounts.

– Prashant Prakhari, Kishore Joshi & Pratibha Jain

You can direct your queries or comments to the authors

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