Revised Norms on FDI in Asset Reconstruction Companies - A Game Changer?

The Department of Industrial Policy & Promotion, vide a press note dated 6th May 2016 (the **"Press Note"**) has allowed 100% foreign direct investment (**"FDI"**) under automatic route in Asset Reconstruction Companies (the **"ARCs"**), subject to certain key conditions. This FYI provides a brief overview of the changes and their impact.

1) ***Position prior to the Press Note***

Prior to the issuance of the Press Note, FDI in ARCs was permissible up to 49% under automatic route and beyond 49% under Government route, subject to the following conditions:

(a) No sponsor could hold more than 50% of the shareholding in an ARC, either under the FDI route or by routing it through a Foreign Institutional Investor (the **"FII"**)/Foreign Portfolio Investor (the **"FPI"**) controlled by single sponsor;

(b) No FII/FPI could invest more than 74% in each tranche of the scheme of Security Receipts (the **"SR"**) issued by an ARC; and

(c) Investment in SRs by FII/FPI was to be within the limits of corporate bonds prescribed from time to time.

2) ***Position following the Press Note***

100% FDI under the automatic route in ARCs and 100% FII/FPI investment in SRs has now been allowed, subject to certain key conditions:

(a) *Sponsor Investment Limit*

The investment limit of the sponsor[1] will be governed by the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (the **"SARFAESI Act"**).

Currently, the SARFAESI Act restricts a sponsor from being a holding company of an ARC (i.e., holding more than 50% of shareholding) or from holding a controlling interest in an ARC. The Budget Speech of 2016 included the proposal of making necessary amendments in the SARFAESI Act to enable the sponsor of an ARC to hold up to 100% stake in the ARC.

The provisions of this Press Note will currently not pave the way for 100% FDI by a sponsor in an ARC, unless the SARFAESI Act is amended in this regard.

(b) *100% Investment by FII/FPI in SRs*

Pursuant to the provisions of the Press Note, an FII/FPI is allowed to invest upto 100% in each tranche of the scheme of SRs issued by an ARC, subject to the RBI guidelines. The RBI regulations governing ARCs, currently mandate an ARC to hold a minimum of 15% of the SRs issued by it on an ongoing basis.

[1] Sponsor is defined under the SARFAESI Act to mean, any person holding not less than 10% of the paid-up equity capital of an ARC.

3) *Impact:*

Given the current situation of stressed assets and the volume of non performing assets, the Press Note is a welcome move and a step taken in consonance with facilitating dealing of stressed assets.

For the provisions of the Press Note to be effective (vis-à-vis investment by a sponsor and investment in SRs) as also to effect other proposals contemplated in the Budget, necessary amendments would be required to be made to the Foreign Exchange Management Act, 1999, the SARFAESI Act and the relevant RBI regulations (currently prescribing 15% mandatory investment by an ARC in SRs).

However, as mentioned above, it seems that the government is already working towards ironing out these creases and, hopefully, it is just a matter of time that 100% FDI in an ARC and 100% FII/FPI investment in SRs will be completely allowed.

This move may be considered as a part of a coordinated effort, including by passage of new legislations and amending the relevant legislations / regulations being undertaken by the Government, to create an effective framework for dealing with resolution of stressed assets - the latest of which is in the form of the passage of the Insolvency and Bankruptcy Code, 2016.

The market was already witnessing interest from key players to set up new ARCs and for acquisition of existing ARCs. Structured deals are already being contemplated and / or are being acted upon for foreign investments to happen in the distressed asset space. With these developments (and in anticipation of the aforemnetioned amendments to the SARFAESI Act and the relevant RBI guidelines), the activity in this space is likely to see an increase, with possibility of strategic players coming in as well.

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