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RBI Eases Regulations on Investments in AIFs by Regulated Entities

INTRODUCTION

The Reserve Bank of India (RBI) on 19 December 2023 issued a [circular](#) (Circular) imposing restrictions on (i) all commercial banks (including small finance banks, local area banks and regional rural banks), (ii) all primary (urban) co-operative banks/state co-operative banks/ central co-operative banks, (iii) all India financial institutions, (iv) all non-banking financial companies (including housing finance companies) (Regulated Entities or RE(s)) with respect to their investments in alternative investment funds (AIF(s)). The Circular aimed to curb the practice of round-tripping of funds through AIFs, which could lead to evergreening of loans. In a nutshell, the Circular has provided for the following:

- (a) REs are not permitted to make investments in the scheme of AIFs which has downstream investments either directly or indirectly in a debtor company in which RE currently has or previously had a loan or investment exposure anytime during the preceding 12 months (Debtor Company);
- (b) In case of fresh downstream investments in the Debtor Company by AIF, REs are required to liquidate its investment in the scheme within 30 days from the date of such downstream investment by the AIF. In case of existing downstream investment in the Debtor Company, the 30-day period for liquidation shall be counted from 19 December 2023;
- (c) In case REs are not able to liquidate their investments within the above-prescribed time limit, they are required to make 100 percent provision on such investments; and
- (d) In case of investment by REs in the subordinated units of any AIF scheme with a '[priority distribution model](#)', the full amount of that investment is required to be deducted from RE's capital funds.

Please refer to our previous [Ergo](#) in relation to our detailed views with respect to the Circular.

The Circular has had significant repercussions in the AIF and RE industry including: (i) losses to REs on account of provisioning in their Q3 results as most of the AIF investments are illiquid; (ii) REs were forced to sell their existing investments and REs became defaulting contributors since they were not able to contribute their commitments, even though there was no evergreening of the loans; and (iii) difficulties for AIFs in receiving commitments, contributions or raising of funds within the timelines, due to REs commitments were withdrawn or not honoured.

The RBI has released certain amendments and clarifications pursuant to the [circular](#) dated 27 March 2024 (Amendment) wherein it has provided certain relaxations to the restrictions imposed by it in the Circular, to address the concerns raised by the stakeholders and market players.

The RBI has provided the following clarifications under the Amendment:

- (i) The downstream investments will not include investments in equity shares of the Debtor Company, however, it will include all other investments, including investment in hybrid instruments;
- (ii) Provisioning in terms of paragraph (c) above, will be limited to the extent of investment by the RE in the AIF scheme which is further invested by the AIF in the Debtor Company, and not on the entire investment of the RE in the AIF scheme.
- (iii) In case of investment by REs in the subordinated units of any AIF scheme with a '[priority distribution model](#)', the full amount of the investment is required to be deducted equally from both Tier-1 and Tier-2 capital. Reference to investment in subordinated units of AIF Scheme will include all forms of subordinated exposures, including investment in the nature of sponsor units.
- (iv) Investments by REs in AIFs through intermediaries such as fund of funds or mutual funds are outside the scope of the Circular.

ANALYSIS

1. Scope of investment in equity shares

By way of the Amendments, the RBI has excluded the investment in equity shares from the scope of downstream investments, which was much needed since the intention is to curb the evergreening of the loans. However, a further clarification may be required to exclude the investments by way of compulsorily convertible preference shares (CCPs) or compulsorily convertible debentures (CCDs) in line with definition of 'equity instruments' under the Foreign Exchange Management (Non-debt Instruments) Rules, 2019. Further, AIFs typically invest in instruments such as CCPs and CCDs that are compulsorily convertible into equity shares.

2. Liquidation and provisioning

At the time of making investment in an AIF, the REs may not have the visibility in connection with the downstream investment to be made by the AIF, since the decisions in relation to such investments are solely made by the fund manager. Pursuant to the terms of the Circular and Amendment, the RE is required to liquidate its investment from the AIF scheme or make provision in proportion to the RE's funds utilised by the AIF to make downstream investment (other in the form of equity shares) in the Debtor Company. In such instance, (i) exit of the RE from the AIF scheme may be difficult as the investments in the AIF scheme are generally illiquid and may be subject to certain restrictive covenants including minimum lock-in restrictions; and (ii) making of provisioning may also not be easy by REs as REs would not be able to track exact downstream investments made by the AIF using RE's funds, since the money is fungible and all the investment decisions are made by the investment manager of the AIF. Ideally, the liquidation requirement or provisioning compliance should be applicable if the end use of the downstream investments is for refinancing or if the corporate debtor is in default or facing financial difficulties or if

there is any evidence of evergreening of a loan.

3. Write back of provisioning

The REs which have made provisioning in their 3rd quarter of Financial Year 2023 based on the requirements set out under the Circular, such REs will be able to write back the provisioning in the current financial year, based on the amended provisioning requirements as set out under paragraph (c) above.

4. End-use

While the Circular intends to curb evergreening of the loans, it will also restrict the RE from making investment in the AIF scheme, where such AIF is making downstream investment by way of debt in the Debtor Company for end uses which increase the growth of the Debtor Company, other than for refinancing RE loan. Further, no distinction is made for those structures which are at a genuine arm's length relationship between REs and the AIF, and the Debtor Company and such REs, in relation to working capital facility, term loans or other credit facilities. Additionally, there is no clarity provided under the Amendment in relation to the scenario wherein the Debtor Company raises the debt from the REs after REs has invested in the AIFs.

5. Sponsor fund

Even though the Amendment has excluded the investment by way of equity shares from the scope of downstream investments, it will be difficult for the RE to continue to be a sponsor in an AIF which is sponsored by the RE and where such AIF has made downstream investments in the form of hybrid instruments or debt instruments.

6. Deduction from the Tier 1 capital and Tier 2 capital

RBI treats Tier 1 Capital as the highest quality of regulatory capital. Pursuant to the Amendment, the RBI has clarified that in case of any investment by REs in the subordinated units of any AIF scheme with a 'priority distribution model', the

investment amount will not be deducted only from Tier 1 capital, but it should be equally deducted from both Tier-1 and Tier-2 capital. Further, it may also be noted that investment in subordinated units will include all forms of subordinated investments such as investments in the nature of sponsor units.

7. Fund of funds or mutual funds

The Amendment has made it very clear that the investments through intermediaries such as fund of funds or mutual funds will be exempted from the provisions of the Circular, which means that the REs will be able to invest in the AIF through fund of funds or mutual funds even if AIF has made equity investment in the Debtor Company. REs such as development finance institution including (NABARD, SRI, SIDBI, NHB, NIIF etc.) which may have objective of development of specific sectors and not have any intent of evergreening the assets are now not required to comply with the provisions of the Circular. This exemption will definitely improve capital investments in the AIFs.

CONCLUSION

Many AIFs have REs as their sponsor or one of their major investors, due to the restrictions imposed by the RBI, it will be tough for the AIFs to raise funding for their schemes including but not limited to the AIFs which are affiliated to the REs.

Since REs may not be able to monitor or control downstream investments made by AIFs and due to lack of clarity in the regulations, REs may discontinue investing in the AIFs scheme which primarily makes downstream investment by way of instruments (other than equity shares).

Having said that, the Amendment to the Circular is a step in right direction to bring clarity, to ease the regulations, and to demonstrate RBI's intention with respect to investments by REs in AIF. However, there are several other concerns which are still required to be addressed by the

- *Manisha Shroff (Partner), Vivek Mimani (Partner), Mohit Nad (Principal Associate) and Mansi Agarwal (Associate)*

For any queries please contact:
editors@khaitanco.com

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