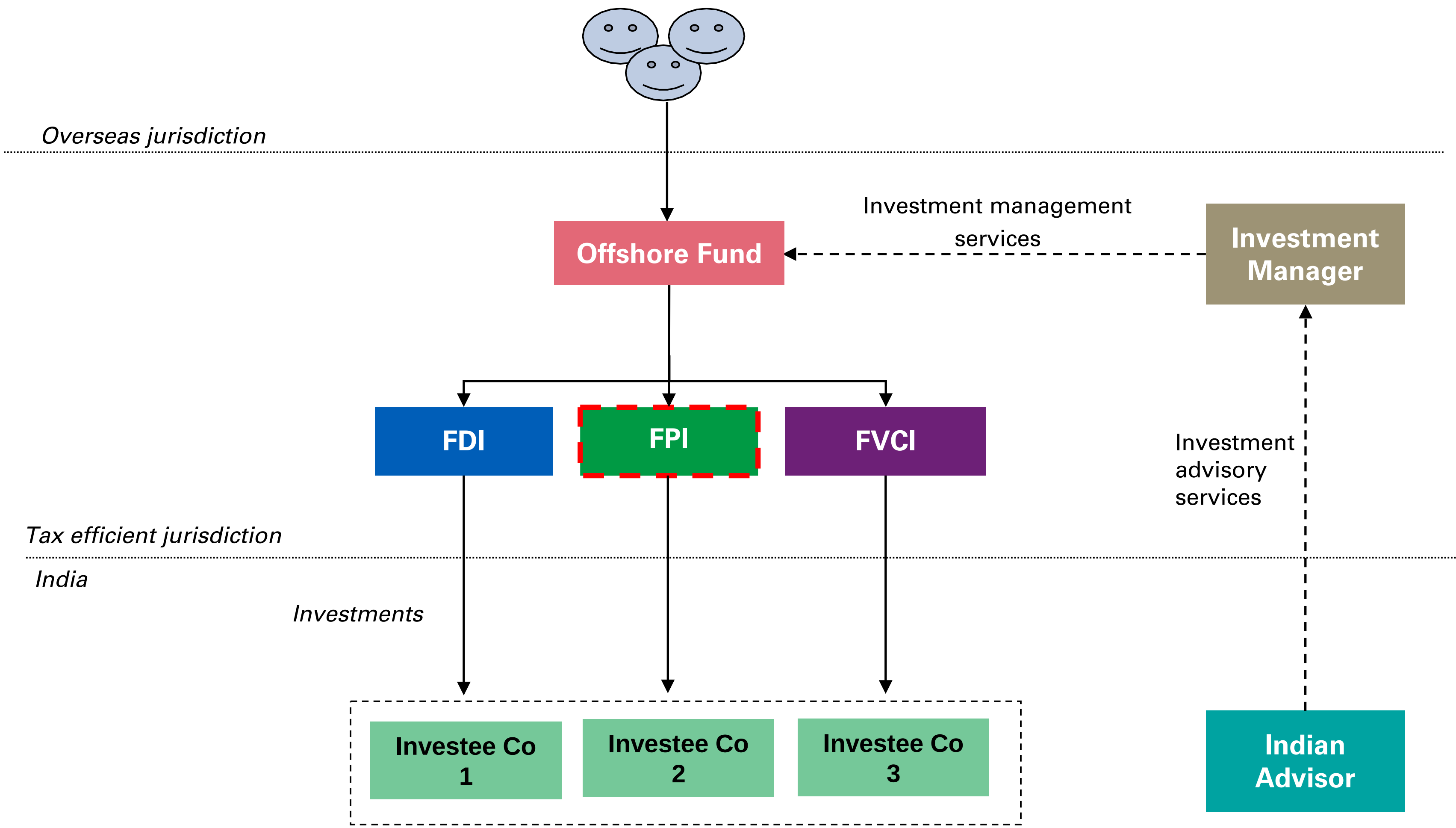
WIRC Training
Key aspects and issues for FPI & ARC

09 February 2019

Foreign Portfolio Investors

Foreign investments in India - Typical offshore fund structure



FPI - Categories

Category I – Low Risk

Government and Government related investors such as:

- Central Banks
- Governmental Agencies
- Sovereign Wealth Funds
- International or multilateral organizations or agencies

Category II – Moderate Risk

- Regulated broad based funds such as mutual funds, investment trusts, insurance/reinsurance companies
- Regulated persons such as banks, asset management companies, investment managers/ advisors, portfolio managers
- Broad based funds* not appropriately regulated but whose investment manager** is appropriately regulated and registered as Cat II FPI
- University Funds, Pension Funds and University related Endowments already registered with SEBI

Category III – High Risk

- All others investors not eligible under Category I and II such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices

*Refer next slide for further elaboration
** Includes an investment advisor, trustee or equivalent role

KYC details for FPIs would depend upon the risk category

FPI - Key aspects

Key eligibility criteria

- Can be a person resident in India ('RI') or NRI subject to conditions
- Should be a resident in a country whose securities market regulator is a
  - signatory to IOSCOs MMOU (Appendix A signatory); or
  - signatory of a bilateral MOU with SEBI
- Should not be a resident in a country listed in the specified public statements issued by FATF
- Legally permitted to invest in securities outside its home country
- Authorized by its Constitution documents / agreement to invest on its own behalf or on the behalf of its clients
- Sufficient experience, good track record, is professionally competent, financially sound and has a generally good reputation of fairness and integrity

Broad based fund

- Should have atleast 20 investors – If investor is a pooling vehicle, underlying investors to be considered
- No investors should hold more than 49% of the shares / units of the Fund
  - An institutional investor can hold more than 49% of the shares / units of the Fund as long as it is a broad based fund

FPI - Eligibility for R / NRI

- NRIs/ OCIs/ Resident Indians (RIs) shall be allowed to be constituents of FPIs subject to the following conditions:
  - Contributions by NRI/ OCI/ RI including those of NRI/ OCI/ RI controlled Investment Manager should be below 25% from a single NRI/ OCI/ RI and in aggregate should be below 50% to corpus of FPI
  - Resident Indian’s contribution permitted is that made through LRS approved by RBI in global funds whose Indian exposure is less than 50%.
  - NRI/ OCI/ RI should not be in control of FPI
- FPIs can be controlled by investment managers (IMs) which are controlled and / or owned by NRI/ OCI/ RI if following conditions are satisfied:-
  - IM is appropriately regulated in its home jurisdiction and registers itself with SEBI as non-investing FPI; or
  - IM is incorporated or setup under Indian laws and appropriately registered with SEBI
- A non-investing FPI may be directly or indirectly fully owned and/ or controlled by a NRI/ OCI/ RI
- The restrictions in regard to eligibility conditions (viz. referred at point 3 above) will not be applicable to FPIs investing only in mutual funds in India
- Existing FPIs and new applicants shall be given a time period of 2 years from the date of coming into force of the amended regulations or from the date of registration, whichever is later in order to satisfy these eligibility conditions. Additional 90 days to be provided in case of breach

FPI - Key investment conditions

Key investment conditions

- Listed or to be listed securities in the primary and secondary markets including shares, debentures and warrants of companies – **Investment in unlisted shares not permissible**
- Listed or unlisted units of schemes floated by domestic mutual funds
- Units of schemes floated by a collective investment scheme
- Derivatives traded on a recognized stock exchange
- Treasury bills and dated government securities
- Rupee denominated credit enhanced bonds
- Perpetual debt instruments and debt capital instruments
- **Listed and unlisted NCDs / bonds issued by an Indian company**
- Listed NCRPS
- NCDs or bonds issued by NBFC - IFC
- Rupee denominated bonds or units issued by IDF
- Indian depository receipts

FPI - Key restrictions

Key restrictions

- Single FPI to hold less than10% of paid up capital of the company
  - o Total FPIs holdings not to exceed 24% of paid up capital – Can be increased to maximum sectoral cap through special resolution and intimation to RBI
- Investment through multiple FPIs having common ownership, directly or indirectly, of more than 50% or common control shall be treated as being part of the same investor group their investment limits will be clubbed
- No investment in liquid and money market mutual fund schemes and commercial papers permissible
- **Investments in debt securities permissible with minimum residual maturity of 1 year subject to $51 bn overall debt limit for FPIs**

FPI - NCD structure - Key benefits

- No minimum capitalization
- Pricing guidelines not applicable on investment as well as on redemption
- No restriction on regular coupon payments
- Regular coupon payments as well as redemption premium on NCDs available as deduction to Investee Co, subject to transfer pricing
- Lower withholding tax rate of 5% on interest received by FPI upto 30 June 2020
- Exit flexibility – easier cash extraction
  - No regulatory hurdles in making payment of regular coupon as well as redemption premium on NCDs
  - Ability to distribute higher coupon
  - Redemption of NCDs at premium to achieve commercially agreed IRR

RBI restriction on FPI Debt investment

FPI NCD route highly restricted for PE & M&A deals

50% limit

- Investment by any FPI, including by related FPIs, shall not exceed 50% of any issue of a corporate bond.
- In case an FPI, including related FPIs, has invested in more than 50% of any single issue, it shall not make further investments in that issue until this stipulation is met

20% limit

- No FPI shall have an exposure of more than 20% of its corporate bond portfolio to a single corporate (including exposure to entities related to the corporate)
- In case an FPI has, as on April 27, 2018, exposure in excess of 20% to any corporate (including exposure to entities related to the corporate), it shall not make further investments in that corporate until this requirement is met
- Investments made by existing FPIs post April 27, 2018 in new corporate (not existing one in which they have >20% exposure) shall be exempted from such 20% restriction only until 31 March 2019

Others

- Security Receipts not covered by the 20% and 50% limits
- Investments under process but not materialized as on 27 April 2018 shall be exempt from 50% and 20% requirements subject to assessment and satisfaction of custodian on parameter laid down (which inter alia includes that price/rate, tenor and amount of the investment have been agreed upon between the FPI and the issuer on or before April 27, 2018
- FPIs are permitted to invest in corporate bonds with minimum residual maturity of above one year, subject to the condition that short-term investments (i.e. investment with residual maturity of up to one year) in corporate bonds by an FPI shall not exceed 20% of the total investment of that FPI in corporate bonds.
- Short term investment by an FPI may exceed 20% of total investments only if such investments consist entirely of investments made on or before April 27, 2018.

A newly registered FPIs (i.e. FPIs registering after April 27, 2018) are permitted to comply with this requirement of 50% and 20% limit by March 31, 2019, or six months from the date of registration, whichever is later;

FPI - Draft Voluntary Retention Route ('VRR')

Objective

To attract long-term and stable FPI investments into debt markets

Key Exemptions

- Investments to be in addition to the overall FPI debt investment limits
- Exempt from:
  - Cap on short-term investments at 20% of portfolio size;
  - Concentration limits; and
  - Caps on exposure to a corporate group.

Auction Process

- Priority 1 – Retention period
- Priority 2 – Investment amount

Other key features

- Minimum Retention period – 3 years
- Income from investments through VRR may be reinvested (over and above committed investment amount
- Liquidation of investments prior to the VRR retention period under exceptional circumstances-
  - Sale permitted only to other FPI entities;
  - Buyer FPI to abide all the terms and conditions applicable to the seller under the VRR.

FPIs - Key tax aspects

- Securities held by FPI treated as capital assets and gains arising thereon taxable as capital gains
- Interest on rupee denominated bonds payable upto 30 June 2020 – Taxable @ 5% if interest within 13.95% (SBI Base Rate + 500 bps)
- Other interest income – 20%
- STCG on listed shares – 15% (w/o forex and indexation)
- LTCG on listed shares – 10% (w/o forex and indexation)
- Other STCG – 30%
- No withholding on capital gains arising to FPIs

FPI - NCD structure & Beneficial Ownership data

FPI – NCD structure

- Concentration norms (50%) and Diversification limits (20%) introduced
- Government to relax restrictions of diversification limits - Draft VRR scheme notified
- 5% tax if prescribed conditions are met
- Disclosure of Beneficial Ownership details by FPI
- Listed and unlisted NCDs

Beneficial Owner details

- Companies Act – Disclosure Timelines extended
- India Tax Return – Not mandatory field

FPIs - Key Challenges

RBI restriction of 50% & 20% highly restricts FPI NCD route for PE & M&A deals

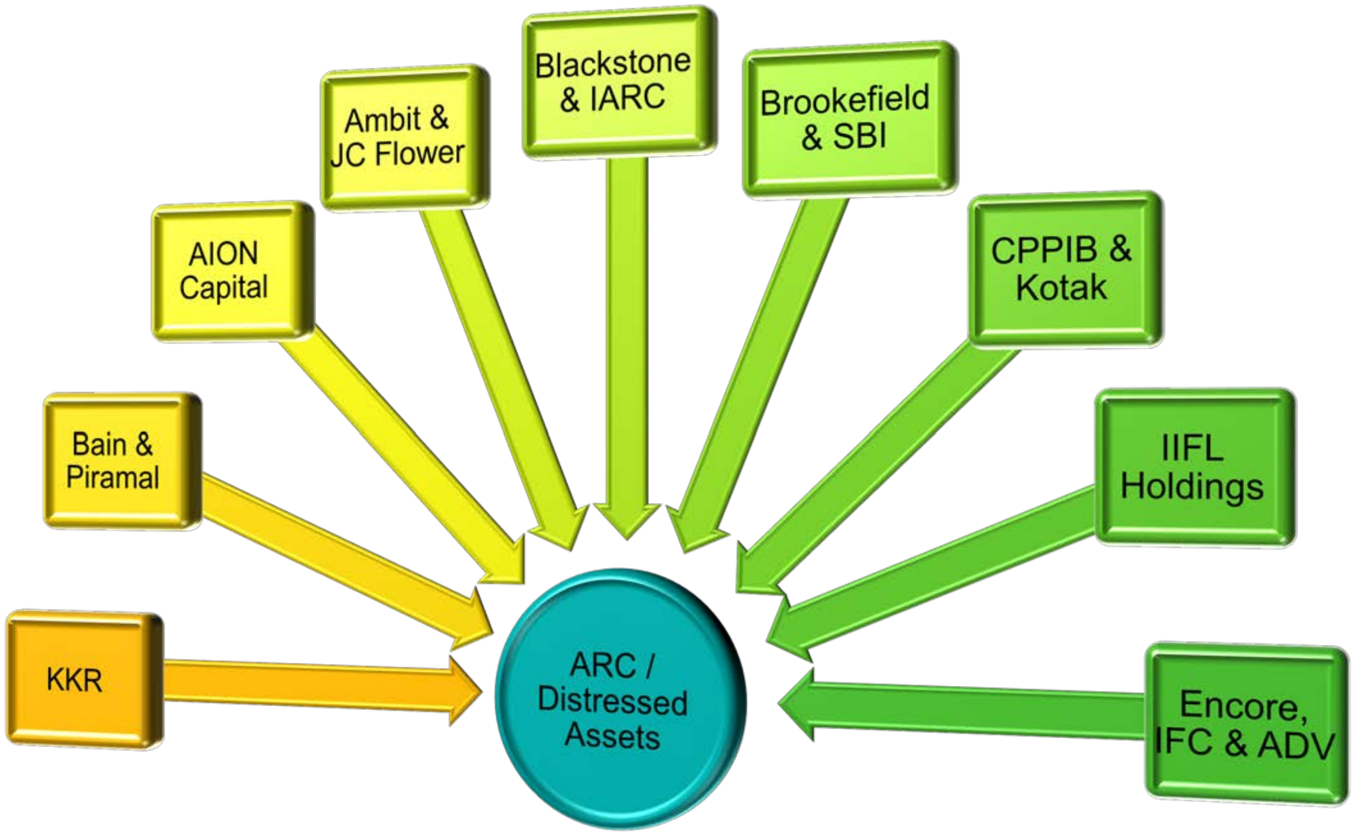
Investment by FPI in unlisted companies under FDI route

Cat III FPIs not entitled to exemption from indirect transfer

Category III FPI does not qualify as a Qualified Institutional Buyer

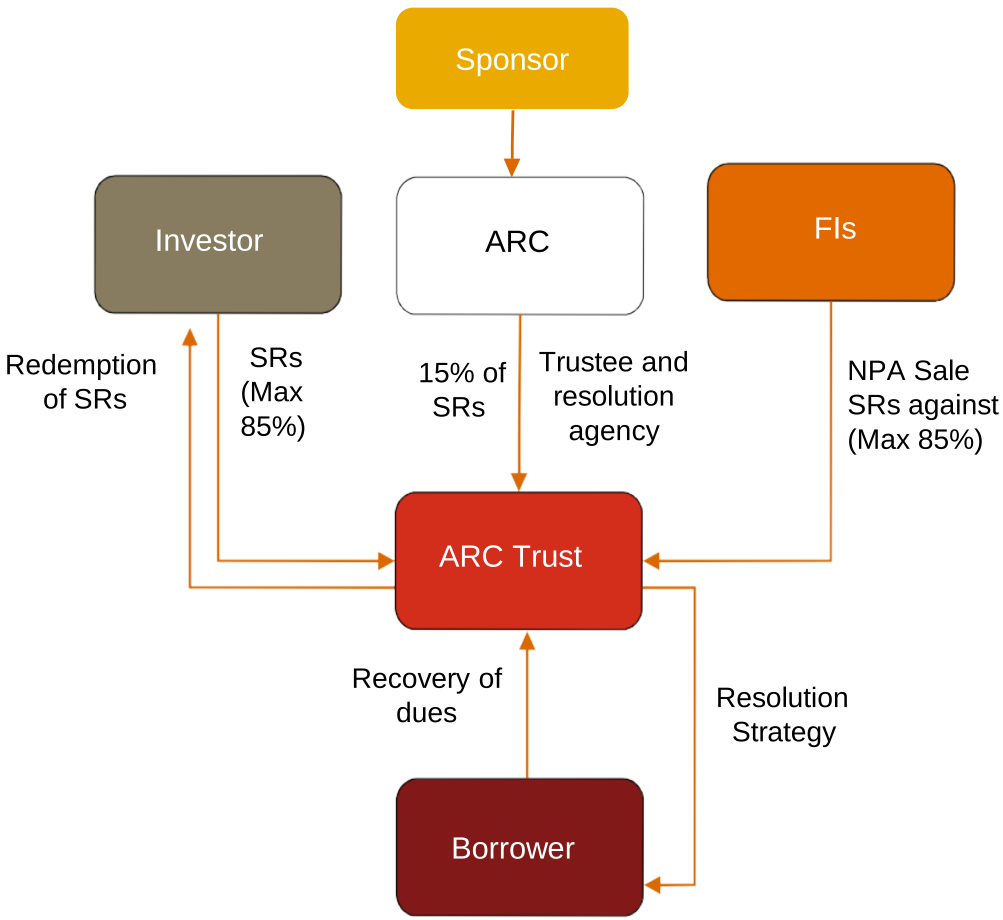
Asset Reconstruction Company

Distressed Space - Growing interest



US$150 bn - Stressed Assets in the Indian Banking System as on September 2017

Typical ARC model



- ARC acquires NPAs from FIs through a trust
- The Selling FIs transfers the asset to a trust floated by the ARC
- The Trust issues SRs to the Selling FIs / Investors
- ARC plays the role of a trustee and resolution agency
- Typically, 85% SRs are held by selling FIs and 15% are held by the ARC
- SRs are pass through certificates where the issuer does not guarantee repayment but is obligated to pay as recovered from borrower

ARC - Application Process

1. Incorporation of the Company with minimum NOF
2. Collating relevant documents / information and **Business Plan**
3. Application to RBI
4. Clarifying queries raised by RBI from time to time and on-going discussions
5. RBI Executive Committee to discuss Business Plan and application
6. Disposal of application / issuance of Certificate of Registration

Time Frame for ARC License – Minimum 8-12 months & FOCC ARC may take around 12+ months

ARC - Key Regulatory Aspects

ARC	• Should be a company incorporated in India for the purpose of asset reconstruction and have obtained valid license from RBI
Net Owned Fund	• Having net owned fund of atleast INR 100 crores • Existing ARCs to achieve NOF of atleast INR 100 crores by 31 March 2019 • Equity shares + CCPS counted towards NOF; CCDs not included
Sponsor	• Sponsor should be a fit and proper person in accordance with the criteria specified by RBI
Foreign Investment in the capital of ARCs	• Less than10% of the total paid-up capital of ARC by an individual FII / FPI • 100% of the total paid-up capital of ARC (FDI+FII/FPI) under automatic route
Eligible Investors for SRs	• Qualified Buyers (QB) such as Banks, Mutual Funds, AIFs, FPIs, Insurance Co, etc
FPI investment in SRs	• 100% investment in SRs issued by ARC Trust – Practically 85% only possible
Investment in SRs by ARC	• ARC to mandatorily hold at least 15% of each tranche / class of SRs of each scheme on an on-going basis
Other key aspects	• ARC with assets acquired of > INR 500 crore can utilize maximum 25% of amount raised from QBs for reconstruction purpose • ARC shall undertake only securitization activity – Lending activity may not be permitted ? • CRAR - >15%

ARCs - Key Tax Aspects

Income of securitization trust ('SRT') pass through and exempt
- Taxable in the hands of investors in same and like manner as if investments made directly by such investors
- Taxable in same nature and proportion as in the hands of the SRT

No clarity on characterisation of income of SRT; possible to contend that such income should be characterised as business income – If business income, taxability as under:
- Resident investors – 30%
- Non-resident investors – Not taxable so far no PE in India; otherwise taxable @ 40%

Tax withholding by the SRT as under:
- Resident individuals / HUF - @ 25%
- Other Residents - @ 30%
- Non-resident investors - @ applicable rates in force

Withholding tax not to apply on payments received by SRT

Investors can apply for nil / low withholding certificate from tax authorities

Income not distributed, deemed to be credited to investors at the end of the financial year

ARC - Other Key Aspects

- ARC can acquire Financial Asset only from Financial Institution
- ARC can acquire debt from other ARC subject to conditions like aggregation of debt, cash settlement, etc
- ARC can convert debt into 100% equity shares of the borrower company
- ARC cannot acquire NPA from its sponsor bank on bilateral basis
- Change in or takeover of management of borrower by ARC to be intimated to RBI
- Financial Assets should be realised within 8 years of acquisition
- ARC to acquire Financials Assets through trusts
- An ARC may as a sponsor and for the purpose of establishing a joint venture, invest in the equity share capital of another ARC formed for the purpose of asset reconstruction
- Prior RBI approval for change in Sponsor or >10% of capital of ARC

RBI Guidelines on sale of NPAs to ARC - Key aspects

Sale possible on re-course or without re-course basis

Banks / FIs not to assume any operational / legal / any other risks related to NPA sold

Sale for contingent price not permitted whereby in the event of shortfall in the realization by the ARC, the banks / FIs would have to bear part of the shortfall

Consideration in form of cash / bonds / debentures / SRs / PTC permitted (subject to prescribed conditions such as max 6 years, interest rate of 1.5% over Bank Rate, secured against assets, etc) and shall be recorded as Investments - Commitment to redeem bonds / debentures to be unconditional and not linked to recovery of assets

When Banks / FIs invest in the security receipts/ pass-through certificates issued by ARC in respect of the financial assets sold by them to the ARC, the sale shall be recognised in books of the Banks at the lower of:

the redemption value of the security receipts/ pass-through certificates; or

the Net Book Value of the financial asset.

For specific asset sold, Banks and ARC permitted to enter into agreement to share any surplus realised by ARC on such asset in agreed ratio

Cat I & II AIFs - Investments in SRs

Under SARFAESI guidelines, only Qualified Buyers (**'QB'**) are permitted to invest in Security Receipts (**'SRs'**) of ARC Trust which *interalia* includes Banks, NBFCs, ARC, Mutual Funds, FPIs, etc

SEBI vide Circular dated 03 August 2012 (issued under SARFAESI Act) permitted AIFs **set up as body corporate** to invest in SRs of ARC Trust

- Only AIFs set up as Company / LLP could invest in SRs – AIFs set up as Trusts not permitted

RBI vide Notification dated 16 May 2018 (issued on 05 July 2018 under SARFAESI Act) specified that Cat II and III AIFs will be categorized as QB for investing in SRs, subject to the following conditions:

- AIF which has invested in ARC shall not invest in the SRs issued by that ARC;
- AIF shall not invest in SRs issued on the underlying loans of any of its associate or group company; and
- AIF shall not invest in SRs backed by NPAs of banks which hold equity of more than 10% in that AIF

Corresponding amendment in AIFs Regs pending till date

ARC - Key Regulatory Issues

Valuation mismatch between ARC and FIs

INR 2 cr v 100 cr NOF as on date of application

Funding for 15% SRs in every deal

Capital structure at ARC level beyond INR 100 cr - Owned funds vs. debt funds through onshore and/or offshore funding routes

Primary or secondary acquisition of shares by ARC

ARC cannot acquire financial assets from non-financial institutional lenders

Comfort of RBI on ARC owned trough PE Fund structure

ARC - Key Tax Issues

Income from SRs – Capital gains v Business Income v Other Income

Taxability on account of waiver of loan in the hands of borrower

Timing of taxation of income to investors

Lapsation of tax losses if ARC acquires / converts > 49%

Section 56 tax implications if debt converted into equity at less than book value

Thank You

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