New regulatory framework for Core Investment Companies:

RBI means to exempt: will there be any takers?

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The issue as to whether non-depository companies, which are merely passive holding companies, meant for maintaining control over group companies, at all fall within the definition of an NBFC, is highly debatable. It is possible, for example, to contend that the business of "acquisition of shares" does not include those companies that are merely passively holding shares in group companies. Also, it is significant to note that the word "group company" has an extremely narrow definition in sec. 370 (1B) of the Companies Act. The sheer number of registered NBFCs in India - nearly 13000 as per latest available data - baffles anyone who is unaware of the fact that the largest component in the list is investment companies who have nothing to do with the financial market. World-over, a non-banking financial intermediary is an entity close to bank – it carries financial functions other than the business of banking. Hence, running an NBFC is almost like running a banking business. In fact, on several occasions, multi-lateral agencies have commented on the regulatory arbitrage that exists in case of NBFCs in India.

The clutter in the NBFC sector:

The issue is that the NBFC sector in India has a huge number of companies which the RBI has no business regulating, except for the sheer satisfaction of regulation. Unless regulation is an end by itself, there is no justification for placing a company which is husband-wife company, making investment in the stock market with self-owned funds, at par with a company that does para-banking business. There are at least few major downsides of the present approach of registering all investment companies: (a) regulatory focus gets diluted – those companies that need focus from viewpoint of the working of the financial system escape attention as the baby gets thrown with bath water; (b) those aware of the facts would confirm that in places like Kolkata, the business of forming, nurturing and selling "NBFC licenses" has become a business-model by itself – insiders say that NBFC license carries a value of nearly Rs 50 lacs; (c) there are costs on the system, as auditors give regular certificates that these companies which have nothing to do with the financial system are indeed eligible to carry on their licenses as NBFCs, and so on.

The distinction between systematically important (NBFC –SI) and other NBFCs was a step towards de-recognising the relevance of NBFCs that are not large enough to be important for the system. Even that distinction would not have much relevance for investment companies, since investment companies may merely be passive holding companies.

The Revised regulatory framework for Core Investment companies:

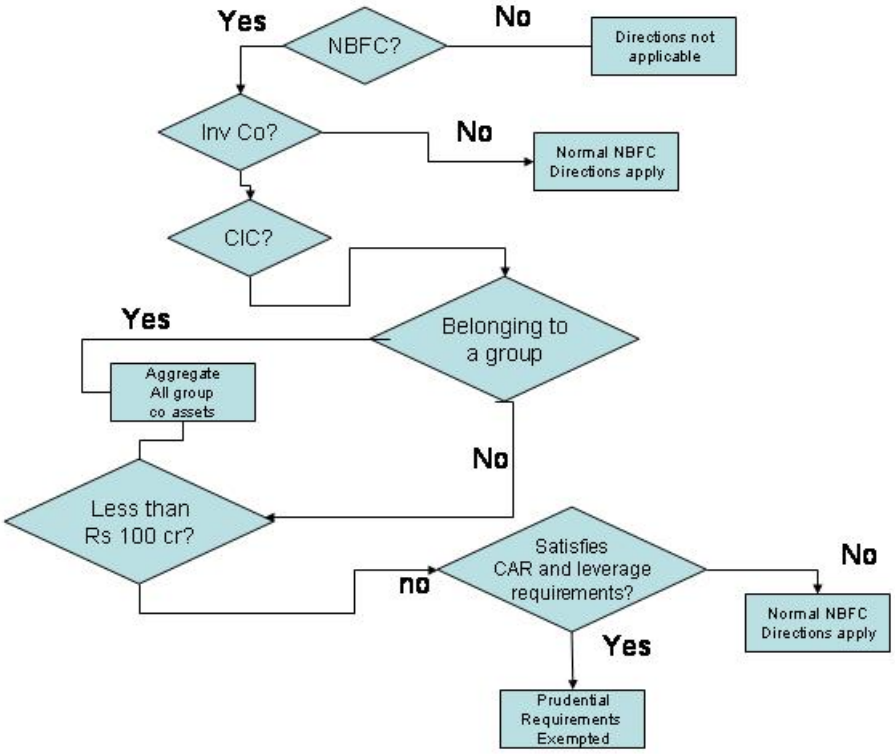
Though the NBFC-SI and non-SI distinction, the irrelevance of extending regulation to small-sized companies, particularly those who are not engaged in money-lending business, was realized, the RBI has not still been able to give up the idea of excluding investment companies completely from the regulatory purview. Not even after the revised regulatory framework for investment companies, discussed below, comes into place.

The RBI came out with its proposal for a revised regulatory framework for "core investment companies (CICs)", granting several exemptions for CICs. The problem is that the way the phrase CIC is defined, not too many investment companies would be able to avail of the exemption, and therefore, the niggardy hand of the regulator does not seem to be relinquishing much.

Crux of the revised regulatory framework:

The crux of the revised regulatory framework may be stated as follows:

- CICs, having an asset size of less than Rs 100 crores will be declared as exempted from all the requirements of NBFCs – including registration.
- Note that for this purpose, all CICs belonging to a group will be aggregated.
- CICs which have assets of Rs 100 crores or above will be considered as systematically important. Registration requirements will continue to apply to such companies. In addition, there are new requirements, including maintenance of 30% capital adequacy ratio and leverage restraints.
- The rest of the prudential requirements currently applicable to NBFCs will be exempted in case of systematically important CICs adhering to the above requirements.
- If the CIC in question does not adhere to the CAR and leverage requirements, it will be subjected to the complete prudential requirements as before.



Definition of CICs under the current Guidelines:

The Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 defines an "investment company" as,

(i) which has acquired shares/securities of its own group/holding/ subsidiary companies only and such acquisition is not less than ninety per cent of its total assets at any point of time;
(ii) which does not trade in such shares/securities; and
(iii) which does not accept/hold any public deposit :

The New definition for "Core Investment Company" under the current Guidelines is as under:

> Core Investment Company means an NBFC carrying on the business of acquisition of shares and securities which satisfied the following conditions:-
>
> (i) it holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;
> (ii) its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its Total Assets;

(iii) it does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;

(iv) it does not carry on any other financial activity referred to in Section 45I(c) and 45I(f) of the RBI act, 1934 except investment in bank deposits, money market instruments, government securities, loans to and investments in debt issuances of group companies or guarantees issued on behalf of group companies.

While under the earlier concept, investment companies were companies which has acquired shares/securities of its own group/holding/ subsidiary companies only and such acquisition is not less than ninety per cent of its total assets at any point of time, now there is bit of flexibility – loans to group companies also form part of investments in group companies, with a minimum 60% of total assets into equity.

The narrow ambit of CICs

Though the purpose of the new regulatory regime is benevolent – exempting CICs from several requirements of the Regulations, the problem is the definition of the word "group", because a CIC does not qualify for the exemption unless its assets are invested, to the extent of at least 90%, in "group companies".

What is a group company?

Under the NBFC Directions, words and expressions not defined therein shall borrow their meaning from the Companies Act. Besides, Explanation II to section 45-IA provides that "companies in the same group" shall have the same meanings assigned to them in the Companies Act, 1956.

Section 370 (1-B) of the Companies Act, 1956 defines "companies in the same group" as under:

> Two bodies corporate shall be deemed to be under the same management—
>
> (i) if the managing director or manager of the one body, is managing director or manager of the other body; or
>
> (ii) if a majority of the directors of the one body constitute, or at any time within six months immediately preceding constituted, a majority of the directors of the other body, or
>
> (iii) if not less than one-third of the total voting power with respect to and matter relating to each of the two bodies corporate is exercised or controlled by the same individual or body corporate; or
>
> (iv) if the holding company of the one body corporate is under the same management as the other body corporate within the meaning of clause (i), or clause (ii) or clause (iii); or
>
> (v) if one or more directors of the one body corporate while holding, whether by themselves or together with their relatives, the majority of shares in that body corporate also hold, whether by themselves or

together with their relatives, the majority of shares in the other body corporate.

The key question is – is the Companies Act definition of "group companies" at all relevant to the regulatory regime for CICs? Simple enough, the purpose of the CIC exemption is that as long as investment companies are making investments within the group, they do not have any significance for the external world, much less to the RBI, as the investment activity is purely a domestic concern.

The definition in the Companies Act is intended to be narrow – as its purpose is to put curbs on investments within the group. It is commonplace knowledge that the sec 370/372 of the Companies Act as they existed strongly discouraged companies giving loans or making investments in group companies. As it was disciplinary measure, the definition was narrowly cast. Practitioners would agree that it is very easy to fall outside the definition, and very difficult to fall within it.

If the whole objective of the new regime for CICs to leave out investment companies that do not have regulatory relevance, is it at all proper that the definition be latched to the Companies Act definition which a completely different purpose. There is no stretch of argument whereby the RBI might be wanting to discourage companies from making investments within the group.

Other conditions for CICs:

The predominant condition for CICs is that 90% of its assets (note – it is assets and not net worth) must have been invested in "group companies". The range of flexibility is extremely strangulating, as one may note from the following:

- 90% of the assets must be in equities, debt and loans to group companies;
- Out the 90%, at least 60% must be in form of equities. That leaves a scope for only 30% for non-equity investments, that too, within the narrowly-defined concept of "group";
- Since 90% investments have to be within the group, we are left with a breathing margin of 10% - can we breathe with the 10%? The regulators, yes, you can but there are conditions for breathing. That is, the remaining 10% investments also cannot be directed towards any activity other than deposits in banks, investments in government securities, etc.

The word "total asset" has also been defined with a sweeping definition that includes all items on the asset side of the balance sheet, with only a few named exceptions. For example, if deduction of tax at source is not an exempted asset, it will form a part of total assets.

There is also a limitation on selling of shares – that the CIC cannot sell its holdings except by way of block deals. It is common understanding that though group investment companies intend to hold shares for the purpose of retaining control, but then there are times when they buy additional shares and they sell their holdings in part.

In short, the apparently liberal mood of the RBI in granting the exemption to CICs has completely been scuttled by the very narrow definition of CICs, latching to an even more narrow definition of "group companies".

Additional Requirements to be complied with by CIC having asset size of 100 crores or more:

CICs having an asset size of Rs 100 crores or more will be considered as Systemically Important Core Investment Companies (CICs-ND-SI). These companies will continue to require Certificate of Registration from RBI under Section 45-IA.

While that is only a continuity, these companies have also been subjected to additional requirements, which, on implementation, may be quite difficult to achieve. There are 2 major requirements – leverage restraint and a capital adequacy ratio.

It is notable that investment companies do not raise their investible capital solely by means of equity or capital. They raise it by way of loans. Loans are not necessarily loans from banks – there are loans from group companies again. This is simply a practical requirement since capital is not available for buyback; loans are flexible.

So, the rule imposing a capital requirement of 30% of risk-weighted assets is a huge capital to be kept. Notably, as most of the investments would anyway have to be in equity shares, the risk weight is unlikely to be less than 100%. So, if 30% of the risk-weighted assets have to be in form of "net owned funds", it is only the balance 70% that may be in form of debt, subject to the overall leverage limit of 2.5 times.

Conclusion:

It is doubtful if many companies would be able to avail of the exemption from the registration requirements. The restraints and costs of availing the exemption, and retaining it, would more than outweigh the costs of maintaining an NBFC registration. After all, what does it cost in terms of compliance for a non-depository, systemically unimportant company to comply with the NBFC registration requirements? Hence, if the objective of the new regime was to clean up the messy NBFC scenario with 13000 names, the objective is hardly going to be achieved.