Ecosystem for Investment in Stressed Assests in India

cyril amarchand mangaldas
ahead of the curve

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The formal insolvency system requires an ecosystem of support for it to succeed. A robust market for stressed assets with domestic and international investors is among the most critical of these. International investors in stressed assets got a level playing field with domestic investors with the Insolvency and Bankruptcy Code, 2016 ("**IBC**") in terms of trigger; voting; and equitable distribution. This has fostered confidence and credibility in the distressed debt market in India.

However, India is an exchange controlled jurisdiction with capital account controls, but over the last several years, there has been a progressive opening up of the market for distressed debt with equity, external debt and bond holders being permitted to invest. Certain restrictions continue, particularly on corporate bonds which are permitted only subject to either overall caps or caps along with requirements to remain invested in India for a prescribed period, currently 3 years. The Indian regulatory regime provides for limits on both equity holding as well as debt investments into Indian entities.

Along with the qualified early successes of the IBC, alternative options like asset sales and infusion of foreign capital have gained importance in addressing this problem. The importance of foreign capital in resolving India's stressed debt problem thus is significant. They are participants in the formal insolvency process as well as important complements to it, providing alternative resolution and capital remedies when the insolvency code underwent a moratorium on account of COVID and when struggling with institutional capacity constraints. A range of avenues for investment in equity, debt and assets at various stages- before; during and after formal insolvency processes exist which address various investment strategies and objectives and present opportunities as well as limitations. A 3 X 3 matrix as below sets out the various investment opportunities in various asset classes and the limitations or rigidities that continue to exist.

Entry Routes for Stressed Assets by Foreign investors

Type of investment / Characteristic	Eligible investor	Investment Strategies	Opportunities	Limitations
PRE FORMAL INSOLVENCY PROCEEDINGS				
Equity	Foreign Portfolio investors[1] Foreign Direct Investors [2] Alternative Investments Funds	Pre IBC capital infusion at sensible valuations Investment in Asset Reconstruction Companies	Promoters may seek equity / sell assets prior to formal insolvency proceedings to avoid the spectre of Section 29a Investors in stressed companies can trigger insolvency proceedings as "corporate applicants" under the code	Sectoral FDI caps[3] Initiating IBC proceedings by the investor is untested and difficult given Board resolution requirements

[1] Foreign Institutional Investors (FIIs) and Foreign Portfolio Investors (FPIs) may invest in the capital of an Indian company. Earlier, FIIs were subject to the 'Portfolio Investment Scheme', which limited the individual holding of an FII to below 10% of the capital of the company. The aggregate limit for FII investment was 24% of the capital of the company. However, with effect from 1 April 2020, specific sector caps have been prescribed for FPIs in terms of investment limits by way of the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (issued by the Ministry of Finance on 17 October 2019). Companies may alter the investment limits in increments of certain prescribed slabs subject to a maximum of the respective sector cap through a board resolution and a special resolution of the general body. In a sector where FDI is prohibited, however, the aggregate limit is 24%.
Note: On account of geopolitical tensions and the threat of "opportunistic takeovers / acquisitions of Indian companies due to the COVID-19 pandemic", the Indian Government has prescribed that entities from countries which share a land border with India can only invest under the approval route (including if the beneficial owner of the investment is situated in or is a citizen of such country).

[3] Depending on the sector and the mode of investment, investment can either be under the 'automatic' or 'approval route'. Investments under the automatic route do not require regulatory approvals

Type of investment / Characteristic	Eligible investor	Investment Strategies	Opportunities	Limitations
PRE FORMAL INSOLVENCY PROCEEDINGS				
Debt	Foreign Portfolio Investors[4] Alternate Investment Funds, including recently introduced Special Situation Funds External Commercial Borrowings through recognised lenders[5]	Secondary debt purchases Lower cost lending to refinance higher cost Rupee lending[6]	Purchases at discounted value Lenders can renegotiate 'in the shadow of IBC' – restructuring/ acquirer funding	Caps on FPI investment VRR route requires investors to stay invested in India for a minimum of 3 years[7] Investments by FPIs or AIFs possible only in bonds or security receipts; a significant part of Indian debt is bilateral loans which can only be sold to financial institutions, and when from Indian state owned banks; subject to Swiss challenge processes End use restrictions for ECBs[8]

[4] The RBI has now also exempted FPI investment in bonds under default from the minimum residual maturity requirements, short-term investment limits and investor limits that they were earlier subject to. These exemptions have also been extended to certain other types of 'exempted securities', including security receipts and debt instruments issued by asset reconstruction companies, and debt instruments issued under a resolution plan under the Insolvency Code.

[5] 'Recognised lenders' are those that are resident in Financial Action Task Force (FATF) or International Organisation of Securities Commissions (IOSC) compliant countries, including on transfer of External Commercial Borrowing (ECB). Further, the following have also been specifically categorised as recognised lenders under the ECB framework:

a) Multilateral and Regional Financial Institutions where India is a member country;
b) Individuals are permitted as lenders if they are foreign equity holders or for subscription to bonds / debentures listed abroad; and
c) Foreign branches / subsidiaries of Indian banks are permitted as recognised lenders only for foreign currency ECB (with certain exceptions).

[6] 'investment in financial year (automatic route) is USD 750 million.
All-in-cost, minimum average maturity and general reporting requirements have also been specific

[7] Voluntary retention rout for FPI investment in debt exempts compliance from macro-prudential and other regulatory norms ordinarily applicable to FPI debt investments (including any minimum residual maturity requirements, concentration limits or single / group investor-wise limits applicable to corporate bonds), provided such FPIs voluntarily commit to retain a required minimum percentage of their investments in India for a period of time. The overall investment cap applicable to the VRR route is INR 1,50,000 Crores.

[8] General end use restrictions:
a) Investment in capital markets / acquisitions of Indian companies.
b) Real estate activities.
c) General corporate purpose, working capital purpose or repayment of existing rupee loans (with certain exceptions).
d) On-lending for the abovementioned purposes (with certain exceptions).
(For (c) and (d) above, there is no blanket end-use restriction but only a requirement for compliance with longer minimum maturity requirements)

Type of investment / Characteristic	Eligible investor	Investment Strategies	Opportunities	Limitations
PRE FORMAL INSOLVENCY PROCEEDINGS				
Asset purchases	NBFCs (though equity or debt investment) Asset Reconstruction Companies ("**ARCs**")[9] (though equity investments) FDI investors or their portfolio companies	Purchase assets being sold as liquidity enhancements measures through the securitization or asset sale route	Securitisation or asset purchases at a discount Non-financial asset sales through hive off or business transfer route	Only SSF AIFs NBFCs and ARCs may purchase loans. Depending on thresholds, hive off or business transfer will require approvals from Competition regulator and / or courts (if done through a scheme under the Companies Act
DURING IBC				
Equity	Foreign Strategic and financial investors through the FDI route, singly or in arrangement with Indian strategics (usually the latter)	Investors may propose resolution plan to buy out company, singly or with other strategic bidders	Valuation likely to be rationalised in insolvency "Clean" buyout possible, since promoters barred	For publicly listed companies, open offer and floor pricing Limited time and information for due diligence Traditional M&A covenants, including post buyout "adjustments" may not be possible (despite the limited due dillgence) as lenders may seek an "unconditional plan"

[9] ARCs are permitted to issue security receipts linked to the recovery of underlying loan assets and to form trusts to acquire NPAs from banks and financial institutions. The regime for investment into ARCs was liberalised in 2016 and FDI is now permitted up to 100% under the automatic route, and FPIs can hold up to 100% of each tranche of security receipts issued by ARCs.28 However, the total equity shareholding of an individual FPI in an ARC is still subject to the maximum limit of 10%. ARCs are also required to maintain the lower of either: (i) a minimum owned fund amount of at least INR 100 crores, or (ii) at least 15% of the total financial assets acquired / to be acquired on an aggregate basis. It is also relevant to note that ARCs can provide support finance to borrowers only to the extent of 25% of the monies raised from investors for that borrower. While there is no restriction if the ARC is providing funding to the borrower from its own funds, many of the ARCs find it hard to raise funds for such loans

Type of investment / Characteristic	Eligible investor	Investment Strategies	Opportunities	Limitations
DURING IBC				
Debt	FPI eligible ECB lenders AIFs	Interim finance- statutory super priority Lending to bidders – acquisition finance Recent ECB liberalisation permits borrowing abroad to repay domestic debt Secondary sales during IBC process permitted by regulation Purchases by ARCs Loan to own structures possible	Secondary transfers during the IBC present opportunities for significant upside Loan to own structures have been used with varying success in recent times	50% investment limit for single bond issuance for FPIs Can only acquire security receipts, not loans (majority of Indian debt is through loans) For AIFs if special situation funds, no diversification requirement; permitted to invest in loans as well as bonds. If not special situation funds, Maximum investment limit – 25% net committed funds (mandatory diversification) Restricted leverage at the level of the fund
Asset Sales		Asset sales and demergers are possible during insolvency, but the focus is on "resolution as a going concern" and therefore rarely undertaken		

Type of investment / Characteristic	Eligible investor	Investment Strategies	Opportunities	Limitations
POST IBC				
Equity	FDI or FPI investors Alternate Investments Funds	Where a company cannot be resolved, in liquidation, opportunity to: Buy assets piecemeal schemes of arrangement for "going concern" purchase of business	Valuations likely to be most attractive Promoter barred	Liquidation reluctance continues on the part of courts as well as creditors
Debt	FPI investors Alternate Investment Funds Eligible ECB lenders	Successful bidders of companies seeking exit financing, including offshore lending opportunities Secondary sales by existing creditors	Secondary sales during liquidation permitted and continue Opportunities for upside	Investments restrictions for FPIs and AIFs as above Recoveries from avoidance transactions slow and subject to litigation
Assets		Purchase assets in auctions during liquidation	Valuations sensible	

Recommendations for Reform

Foreign Portfolio Investors (FRI) regime

The restrictions on FPI investments, including the overall, company / issue specific and minimum investment period requirements are perhaps that last remaining vestige of the "license permit Raj" or centrally controlled investments. While there is some justification for some of these measures, including historic concerns about 'hot money" in debt investments, as the market is maturing and deepening, these restrictions can and should be steadily liberalized. The Government should also consider revising the restrictions on Category II FPIs from issuing or subscribing to overseas derivative instruments (ODIs). Although this restriction has been defended on the basis that money being routed through India in a manner that circumvents the regulatory framework should be discouraged, it acts to further disincentives foreigners from looking towards India as a destination for investment. The Government must not resort to pre-liberalisation era patterns of policy making if it intends to ensure a constant uptick in the Indian economy,

while simultaneously combating the deeply entrenched stressed assets problem. It must also simultaneously make clear-cut policy decisions in order to resolve India's ease-of-doing-business concerns, like the permitting of assured returns and exit by foreign equity investors.

Asset Reconstruction Company (ARC) regime

Despite the recent moves towards liberalisation of the framework applicable to ARCs, the competitiveness and flexibility of ARCs is hampered by a requirement that they have to pay up to 15% of total risk weighted assets purchased by them upfront, and only the balance amount can be paid by way of security receipts. This has led to a situation wherein ARCs are unable to live up to their potential and contribute to the reduction of stress in the economy. In the first two quarters of the financial year 2016-17, for instance, ARCs purchased loans worth only INR 20,000 crore, one-fifth of what was put-up for sale in the market.72 Although the sale of loans to ARCs has picked up since, it has not increased drastically. It is imperative that the Government recognises that this requirement is one that is self-defeating and works towards revising it at the earliest. Further, the Government must also bring about policy reforms to ensure that ARCs are unable to recoup their investments without security receipt holders having first received their face value, in order to protect the interests of foreign investors. The RBI is seized of this and has recently brought out a report setting out several recommendations for reform and industry inputs to the committee included some of these. Formal amendments are still to be made, but if adopted, they could position ARCs as an important tool for resolving NPAs. The proposed reform of Arcs by RBY includes widening the ambit of their capital base, asset pool, debt resolution avenues as well as including elements of clarity, transparency, uniformity and governance, the objective to equip ARCs to operate in a commercially effective manner so as to achieve their debt resolution/revival/recovery goals.

Strengthening the ARC ecosystem will also complement the IBC ecosystem as the IBC has become a pre-dominant tool for stress resolution leading to a huge backlog of cases and stretching the institutional capacity.

Alternative Investment Funds (AIF) regime

The AIF framework also needs some reconsideration. The Securities and Exchange Board of India (**'SEBI'**), introduced to introduce a new sub-category of Category I Alternative Investment Funds, namely Special Situation Funds ('**SSFs**'), which will invest only in 'stressed assets'- which include loans (subject to RBI regulations applicable to the seller in order to avail of prudential and capital retention exemptions, a massive liberalization as AIFs were previously permitted to invest in bonds and security receipts. SSFs will also have several exemptions including on concentration norms in a single investee company, minimum corpus, etc. There are also additional restrictions on certain categories of AIFs, for instance Category II AIFs (primarily private equity and debt funds) are prohibited from participating in large-pooled domestic savings, precluding even pension funds and insurance companies from such investments. 'Category III' AIFs have also been excluded from being accorded 'pass-through' status despite recommendations to the contrary made by industry and policy bodies. These restrictions indicate protectionism and their rationalization would open up important avenues for foreign investors and allow alterantives for the stressed asset ecosystem in India.

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Key Contacts

Cyril Shroff
Managing Partner
cyril.shroff@cyrilshroff.com

L. Viswanathan
Partner (Chair – Finance, Projects & Bankruptcy)
l.viswanathan@cyrilshroff.com

Dhananjay Kumar
Partner
dhananjay.kumar@cyrilshroff.com

Gaurav Gupte
Partner
gaurav.gupte@cyrilshroff.com

Richa Roy
Partner
richa.roy@cyrilshroff.com

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Peninsula Chambers, Peninsula Corporate Park, GK Marg, Lower Parel, Mumbai 400 013, India
T +91 22 2496 4455 **F** +91 22 2496 3666 **E** cam.mumbai@cyrilshroff.com **W** www.cyrilshroff.com
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