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RBI AMENDS CIC MASTER DIRECTIONS – OVERHAULS REGULATIONS FOR COMPLEX CIC STRUCTURES

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Background

On 13 August 2020, the Reserve Bank of India (RBI) issued the "Review of Guidelines for Core Investment Companies" (Review Guidelines) incorporating majority of the recommendations from the report of the Working Group to Review the Regulatory and Supervisory Framework for Core Investment Companies (CICs) published on 6 November 2019 (Report).

The working group was set up to identify and suggest measures for limiting the risks posed by CICs. The trigger for constitution of the working group and review of the existing regulatory framework was the insolvency of Infrastructure Leasing and Financial Services Limited (IL&FS, a CIC with a complex group structure involving several layers of subsidiaries). The aftermath of IL&FS' insolvency saw a systemic liquidity crisis and loss of investor confidence in the shadow banking sector in India. While the reasons for IL&FS' insolvency are many, the regulatory front also invited some introspection. The review suggested that some of the leeway provided to CICs from corporate governance norms and restrictions on investment layers resulted in over leveraging, reduced regulatory oversight and abuse of exemptions provided to CICs for encouraging simpler corporate holding structures for large businesses.

To address the concerns, the Report identified 6 major areas of reform for CICs, which included (i) reducing the opaqueness in large conglomerates in terms of ownership, controls and related party transactions by restricting investments layers; (ii) regulating excessive leveraging by CICs by restricting numbers of CICs in a group; (iii) formulating a group risk management committee (GRMC) entrusted with the responsibility to maintain oversight on the emerging risks for the group; (iv) adopting corporate governance related measures such as constitution of board committees on audit and directors' remuneration, induction of independent directors, consolidation of financial statements and ring fencing of boards of CICs; (v) removing ambiguity in nomenclature for exempt CICs; and (vi) lastly, designing offsite returns, annual certifications by statutory auditors and periodic onsite inspection of the CICs.

Structural Changes

Taking recommendations of the working group on board, the Review Guidelines have mandated the following two structural changes:

- the number of layers of CICs within a group (including the parent CIC) to be restricted to two (including direct or indirect holding/ control exercised by a CIC in the other CIC). If a CIC makes any direct/ indirect equity investment in another CIC, it will be deemed as a layer for the investing CIC.

- amounts representing any direct or indirect capital contribution made by one CIC in another CIC exceeding ten per cent of owned funds of the investing CIC to be deducted for computing the adjusted net worth (ANW).

This takes away the current exemption available to CICs i.e. their ability to have more than two layers of investment vehicles. This also disincentivises intra-group CIC investments as a tool for improving leverage and capital adequacy position calculated against the ANW of CICs.

Additional Compliances

In addition to the structural changes, CICs will also be required to comply with the following:

- constitution of a GRMC by the parent CIC in the group or the CIC with the largest asset size (in case there is no identifiable parent CIC in the group) with at-least 5 members. Two out of the five members are required to be independent directors, one of which needs to be the chairperson. The GRMC's responsibilities entail analysis and assessment of risk strategies and systems for effective risk oversight, intra-group conflicts and corporate governance framework and risk management, articulating and monitoring group level leverage and periodic review of the group structure and internal controls.

- appointment of a chief risk officer in all CICs with asset size of more than INR 50 billion with clearly specified roles and responsibilities (as applicable to systemically important non deposit taking non-banking financial companies).

- submission of a quarterly statement of deviation certified by the chief executive officer/ chief financial officer, indicating deviations in the use of proceeds of any funding obtained by the CIC from creditors and investors from the objects/ purpose stated in the application, sanction letter or offer document for such funding.

- compliance with corporate governance requirements as per the Companies Act, 2013 including applicability and monitoring of "fit and proper" criteria for directors of CICs.

- specific disclosures relating to financial statements and investments.

- preparation of consolidated financial statements for the group as a whole and where exemptions are available to certain entities within a group, appropriate disclosures on non-inclusion of such entities within the consolidated financial reports in the prescribed disclosure formats.

Ancillary Modifications

Besides the above, the Review Guidelines have also:

- modified the nomenclature of systemically important CIC to "Core Investment Company" and exempt CICs to "Unregistered CICs". The exempt CICs are the CICs with an asset size of (a) less than INR 1 billion; or (b) with an asset size of INR 1 billion and above and not accessing public funds;

- allowed CICs to invest in money market instruments, including mutual funds which make investments in money market instruments/debt instruments with a maturity of up-to 1 year; and

- required all CICs to become members of all credit information companies and submit information as the systemically important non-deposit taking non-banking financial companies are required to submit.

Timelines

While the Review Guidelines are effective from the 13 August 2020, all existing CICs are required to reorganise their business structure and adhere to the Review Guidelines latest by 31 March 2023.

Comments

The need for these reforms was necessitated due to the apprehension of the risks that CICs (in the financial services sector) pose to the Indian economy - mainly arising out of the disparity in regulatory treatment of regular non-banking financial companies (NBFCs) and CICs. The Review Guidelines ensure that overleveraging strategies and practices are deflated and CICs adhere to corporate governance norms. Having said that a majority of the CICs today are companies operating as investment vehicles and engaged in non-financial sectors. CIC registration has been sought by them to ensure efficient centralised corporate holding structures without having to subject themselves to arduous regulatory requirements applicable to NBFCs, which may not be relevant to them from a risk or reward perspective. With the Review Guidelines, the classic debate on requirement of CIC regime for non-financial services sector in the first place is likely to be revived. A more nuanced approach to applicability of these reforms to CICs in specific sectors would have been appropriate and even desirable. For now, intra-group CICs are likely to move towards consolidation, and others may consider reorganization towards deregistration.

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