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RBI RESTRICTS INVESTMENT IN NBFCS FROM FATF NON-COMPLIANT JURISDICTIONS

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The Reserve Bank of India (RBI) issued a circular on 12 February 2021 (Circular) to impose restrictions on investments in non-banking finance companies (NBFC) by investors from Financial Action Task Force (FATF) non-compliant jurisdictions. The restrictions are applicable with immediate effect from 12 February 2021 onwards.

The jurisdictions on the FATF blacklist include Iran and North Korea, and the ones on the grey list include Albania, Barbados, Botswana, Cambodia, Ghana, Jamaica, Mauritius, Myanmar, Nicaragua, Pakistan, Panama, Syria, Uganda, Yemen, and Zimbabwe. The listing serves as a signal to the global financial and banking system about increased risks in transactions with the listed countries and may negatively impact the economy of such countries.

Background

These restrictions come in the wake of the increased scrutiny of NBFCs post the recent collapse of certain entities and with a view to restricting money laundering. The RBI had started closely examining investments from Mauritius last year itself and had returned multiple applications by various NBFCs due to their connection with Mauritius. This was because Mauritius was put under the grey list by FATF in February 2020 due to certain systemic deficiencies. These systemic deficiencies included lack of access to accurate beneficial ownership information by competent authorities, absence of capacity to prevent money laundering, and inability to conduct financial investigations.

These steps of the RBI resulted in lack of clarity for the fund managers who were concerned about whether to consider Mauritius while setting up fund structures and how to work with the existing legacy structures. However, this confusion is significantly reduced due to the Circular. The specifics of the same are set out below.

New Investors

New investors from or through FATF non-compliant Jurisdictions will be prohibited from directly or indirectly acquiring '*significant influence*' in the existing investee NBFC as well as companies seeking Certification of Registration. The term '*significant influence*' is defined as having more than 20% of the actual and potential voting power. This consequentially prohibits new investors from FATF non-compliant jurisdictions from acquiring more than 20% of the voting rights in NBFCs.

The Circular requires considering the aggregate of the actual and potential voting power. The potential voting power includes rights on account of instruments that are convertible into equity, other instruments with contingent voting rights, contractual arrangements, contingent voting rights, etc.

Existing Investors

The restrictions under the Circular will not apply to existing investments in NBFCs from FATF non-compliant jurisdictions. They have also been permitted to bring in additional investment to support their continuity of business in India. However, such additional investment should be in accordance with the extant regulations.

The permission for further investments by existing investors seems to be misaligned with the objective of the Circular. The existing investors are permitted to freely make additional investments as per extant regulations and only new investors are subjected to a restriction of 20% of the voting rights.

The Circular could lead to practical issues in ensuring compliance by listed NBFCs and specific mechanism may need to be developed to facilitate the same. The listed NBFCs will have to be mindful of investments by already registered foreign portfolio investors from jurisdictions that were subsequently classified as FATF non-compliant. Such foreign portfolio investors can invest up to the sectoral limit i.e., 100% in NBFCs, thus breaching the limit set under the Circular.

Conclusion

Earlier in the year 2020, RBI had returned a few applications from private equity and venture capital funds domiciled in Mauritius for greenfield investments or acquisitions of NBFCs on account of its FATF compliance status.

The Circular of the RBI is a welcome step. It clarifies the position of law, clearly sets out the restrictions, permits non-controlling investments, and exempts existing investments including additional investment in such NBFCs to support continuity of business in India. Further, clarity on potential voting rights is also helpful in confirming the position of the Indian regulatory system.

This clarity regarding the restrictions is likely to benefit investors in structuring their India entry, especially in the financial services sector.

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