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28 December 2023

RBI Measures to Curtail Evergreening: Impact on Alternative Investment Funds

INTRODUCTION

A noteworthy trend has been observed in the investment landscape wherein certain entities namely (i) Commercial Banks (including Small Finance Banks, Local Area Banks and Regional Rural Banks), (ii) all primary (Urban) Co-operative Banks/State Co-operative Banks/ Central Co-operative Banks, (iii) all All-India Financial Institutions, (iv) all Non-Banking Financial Companies (including Housing Finance Companies) (Regulated Entities or REs) have increasingly invested their capital in Alternative Investment Funds (AIF(s)).

While this diversification strategy is commonplace, specific transactions involving AIFs have attracted regulatory attention. These transactions involve replacing REs' direct loan exposure to borrowers with indirect exposure achieved through AIF investments. This practice raises concerns regarding potential regulatory circumvention and risk management implications.

Scope of the RBI circular

Reserve Bank of India (RBI) vide its circular RBI/2023-24/90 DOR.STR.REC.58/21.04.048/2023-24 dated 19 December 2023 (Circular) attempts to address the concerns of indirect loan exposure of REs to its stressed borrowers. The framework provided by the Circular to address these concerns is elaborated below.

A. Prevention of Evergreening

To clarify and potentially restrict certain investments by REs in AIFs, the following guidance is provided:

1. Investment Restriction: REs are directed not to invest in AIF schemes that have any downstream investments, either directly or indirectly, in companies to which the RE has, or has had during the preceding 12 months, any loan or investment exposure (i.e., Debtor Companies).

   This restriction aims to avoid potential issues related to 'evergreening,' where loan obligations are continuously rolled over or masked through indirect investments.

   For situations where an AIF, in which an RE is already invested, makes a downstream investment in a Debtor Company, the following needs to be taken into account:

   i. *Liquidation Requirement:* The RE shall liquidate its investment in the AIF within 30 (thirty) days of the AIF's downstream investment in the Debtor Company.

   ii. *Applicability Timeline:* This 30-day period for liquidation applies both to existing investments with downstream debtor exposure as of the issuance date of the Circular and future investments where such exposure arises.

   iii. *Communication:* REs should promptly inform the relevant AIFs about this liquidation requirement.

2. Provisioning: In case where the REs fail to liquidate their investments in AIFs with downstream debtor exposure within the 30-day timeframe, they shall make 100% provision on such investments.

B. Subordinated Units with a Priority Distribution Model:

In case of investments in the subordinated units of an AIF with a priority distribution model, the full amount of that investment shall be deducted from the RE's capital funds.

Analysis and Impact:

1. By way of this Circular, RBI as a regulator of the REs, appears to have addressed the concern that in some cases REs may have used the AIF investment route to evergreen their loans i.e., close the existing loans (fully or partially) granted by such REs to its borrowers facing stress, to avoid impact of provisioning on the books of the RE in these stressed accounts by making investments through

an AIF scheme in the stressed borrower (directly or indirectly).

2. The Circular does not provide clarity on whether such evergreening is undertaken by way of fresh debt or equity infusion by AIFs in the Debtor Companies. Thus, the Circular does not differentiate between debt and equity and simply refers to "investments".

3. Further, where an AIF is sponsored by an RE, the Circular may make it difficult for the Sponsor to maintain its continuing interest in the Fund as prescribed under the AIF Regulations.

4. Since the Circular applies to all REs which could also include the DFIs (SIDBI, NABARD, NHB, NIIF, etc.) which may have development objective to support flows of capital to specific sectors and may not have the intent of evergreening of assets, may also get trapped within the ambit of the Circular which could be counterintuitive to their very purpose.

5. The Circular seems to presuppose that REs have direct or indirect control over the AIFs with an intent to undertake evergreening of their stressed assets. Further, no distinction has been made for those structures which are at a genuine arm's length relationship between REs and AIFs, and portfolio companies and such REs (working capital facility, term loans, trade credit, etc.).

6. While the Securities and Exchange Board of India (SEBI) has put an embargo on structures involving priority distributions (pending further deliberation)[1], the adjustment against the capital for any subordinated units held by RE as a general restriction could impact the ability of REs to participate in AIFs offering risk adjusted returns for different set of investors through different classes of units.

COMMENTS

With its framework on resolution of stressed assets and transfer of loan exposures, RBI has been regulating the mechanism available to REs for dealing with stressed assets including the risk weightage to be allotted to such assets. In this context, this Circular may be an attempt by RBI to restrict actions by REs to deal with their stressed assets through investments in AIFs and outside its stressed assets framework.

While RBI's concern regarding stressed asset management may be valid, it may be required for RBI to consider if putting a complete restriction on REs in this way to liquidate investments and make full provisions would curtail flow of funds to AIFs and thereby restricting funding and growth of credit to this sector.

While the representations from all the stakeholders who are impacted by the said Circular are being made, pending any clarity or dilution on the applicability of the circular, the stakeholders, including RBI, may want to give consideration to the following:

1. AIFs and REs may want to evaluate exercising their excuse rights as permitted by SEBI[2] to avoid situations where REs may be forced to completely exit from AIFs where AIFs intending to invest in Debtor Companies.

2. While the evergreening of loans is an issue which is a concern in the financial market space, a complete exit from the AIF where such REs (commercial banks/ NBFCs) have invested may not be a desirable option from an AIF's operations standpoint, therefore RBI may want to consider applying the provisioning condition pro rata to beneficial interest of the RE in the AIF which pertains to that specific Debtor Company.

3. It is imperative for RBI to consider situations where RE's loan to a Debtor Company pales in comparison to its overall investment in an AIF encompassing that Debtor Company. In

[1] Paragraph 11.2 of the SEBI Master Circular dated 31 July 2023 (accessible here)

[2] Guidelines with respect to excusing or excluding an investor from an investment of AIF dated 10 April 2023 (accessible here)

such scenarios, the RE may be afforded the option to terminate its loan agreement with the Debtor Company (by foreclosing the loan as agreed between the RE and the Debtor Company) within a pre-defined timeframe established by the RBI.

CONCLUDING REMARKS

The AIF industry has yet again faced a setback due to the Circular which could significantly impact their access to domestic institutional capital. While the REs were proving to be a significant balancing force to the AIF industry's dependence on offshore pools of capital, which time and again have been impacted by geopolitical considerations and economic cycles beyond one's control, the Circular may pose a challenge in maintaining this balance.

While one cannot deny the need for RBI to take necessary steps to curtail any abuse of regulations, however, in trying to address such abuse, it would be undesirable to use a broad brush approach as prescribed under the Circular since that could potentially destabilise and stunt the growth of the AIF industry which has been and is expected to be a significant contributor to the country's economic growth.

A more practical approach could be to put restrictions linked to performance/status of the underlying account of the REs with its customer rather than putting a complete restriction on REs to not invest in AIFs which may have exposure to borrowers of REs. This may possibly strike a balance between RBI's objective of stressed loan management in terms of its regulations so as to correctly capture the risk weightage on the balance sheet of REs and allowing REs to fund AIFs so that it doesn't impede/restrict their growth and innovation in the credit market.

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