RSM Astute Consulting

# Regulatory Framework Governing Core Investment Companies Issued by RBI

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## INTRODUCTION

A Non-Banking Financial Company ('NBFC') is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.

NBFCs are classified into Asset Finance Company ('AFC'), Investment Company ('IC') and Loan Company ('LC').

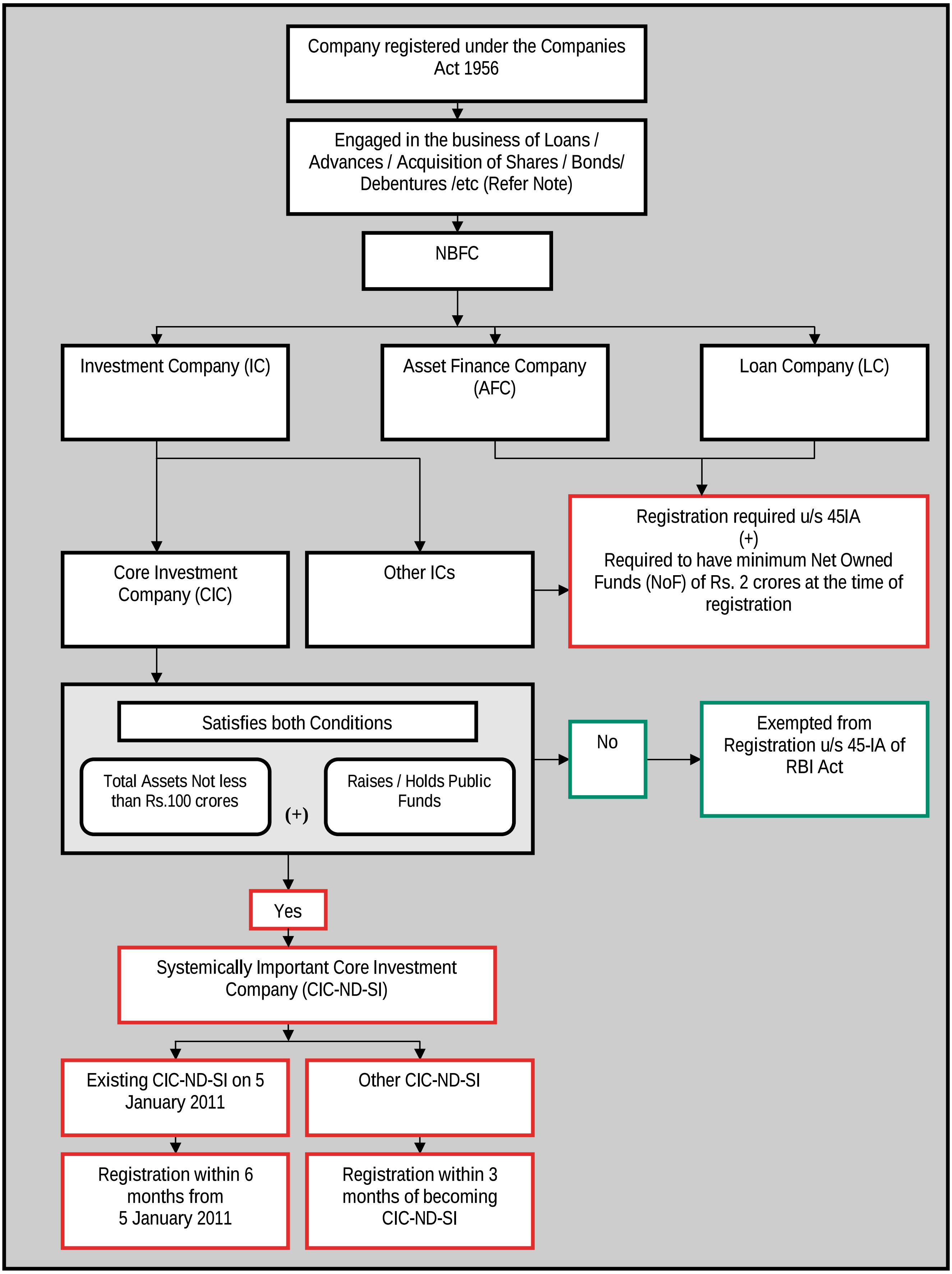
The Reserve Bank of India ('RBI') had announced in the Annual Policy 2010-2011 that companies which have their assets predominantly as investments in shares for holding stake in group companies but not for trading, and also do not carry on any other financial activity, i.e., Core Investment Companies ('CICs'), justifiably deserve a differential treatment in the regulatory prescription applicable to NBFCs which are non deposit taking and systemically important. In order to rationalize the policy approach for CICs as per the revised framework issued on 5 January 2011, such companies having an asset size of Rs.100 crores and above and accepting / holding public funds would be treated as systemically important core investment companies (CIC-ND-SI).

RBI issued draft regulatory framework for CICs in April 2010 and solicited suggestions from stakeholders. After considering the representations received from the stakeholders, RBI has announced the regulatory framework for CICs on 12 August 2010. As per the regulatory framework CICs were distinguished from the regulatory guidelines applicable to NBFCs in general. Further, in continuation with the above regulatory framework, revised framework has been issued on 5 January 2011 which modified and further provided clarification to the earlier regulatory framework applicable to CIC-ND-SI.

In this Newsflash, we have endeavored to provide a broad framework considering the updated regulations governing the CICs. These regulations have far reaching implications for all investment companies and non-compliance with the registration requirements under section 45-IA of the Reserve Bank of India, 1934 ('RBI Act') shall result into imprisonment for a term in the range of 1 year to 5 years and with fine in the range of Rs. 1,00,000 to Rs. 5,00,000.

The registration requirement as per the regulatory framework for CICs has been depicted in the diagram on the next page.

## DIAGRAMMATIC REPRESENTATION




Note: The diagrammatic depiction is not a complete representation of the NBFC framework, but is restricted to the relevant applicable regulations in case of CICs.

## SIGNIFICANT HIGHLIGHTS OF THE REGULATORY FRAMEWORK

- Core Investment Companies

  Core Investment Company (CIC) means a non-banking financial company carrying on the business of acquisition of shares and securities and which satisfies the following conditions as on the date of the last audited balance sheet:

  - it holds not less than 90% of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies;
  - 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 net assets

> Net assets, for the purpose of this provision, would mean total assets excluding
> i. cash and bank balances;
> ii. investment in money market instruments and money market mutual funds
> iii. advance payments of taxes; and
> iv. deferred tax payment.

  - it does not trade in its investments in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;
  - it does not carry on any other financial activity referred to in Section 45 I (c) [i.e. Definition of 'Financial Institution'] and 45 I (f) [i.e. Definition of 'Non-Banking Financial Company'] of the Reserve Bank of India Act, 1934 except:
    a. investment in
       i) bank deposits,
       ii) money market instruments, including money market mutual funds
       iii) government securities, and
       iv) bonds or debentures issued by group companies;
    b. granting of loans to group companies; and
    c. issuing guarantees on behalf of group companies.

  Explanation of 'Companies in the Group' as provided in the revised regulatory framework

> "Companies in the Group", shall mean an arrangement involving two or more entities related to each other through any of the following relationships:
> i. Subsidiary – parent (defined in terms of Accounting Standard (AS) 21),
> ii. Joint venture (defined in terms of AS 27),
> iii. Associate (defined in terms of AS 23),
> iv. Promoter-promotee (as provided in the SEBI (Acquisition of Shares and Take-over) Regulations, 1997) for listed companies,
> v. a related party (defined in terms of AS 18),
> vi. Common brand name, and
> vii. Investment in equity shares of 20% and above

Note: The explanation of the meaning of 'companies in a group' has provided clarity to the computation of 90% investment by a CIC in the net assets as specified of the group companies.

In view of the above conditions prescribed in terms of net assets not less than 90% investment in instruments of group companies and further 60% of such investment in group companies to be in the form of equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue), many investment companies shall not be treated as CICs and as such, it shall require registration as required by section 45-IA of the RBI Act.

- Systemically Important Core Investment Company (CIC-ND-SI)

  Systemically important core investment company (CIC-ND-SI) to mean a Core Investment Company which fulfils both the conditions vis-à-vis

  – having total assets of not less than Rs. 100 crores, individually or with group companies in aggregate, and

  – raises or holds public funds.

Explanation of ‘Public Funds’ as per the Regulatory framework:

“Public funds" shall include funds raised either directly or indirectly through public deposits, Commercial Papers, debentures, inter-corporate deposits and bank finance but excludes funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue.

Note: Considering the above, if any of the above conditions are not fulfilled, then such CICs would not be CIC-ND-SI and hence would be exempted from registration u/s 45-IA of the Reserve Bank of India Act, 1934 (‘RBI Act’).

- Registration

  Every Systemically Important Core Investment Company (CIC-ND-SI) is required to apply within a period of 6 months from the date of the notification (i.e. 5 January 2011) for grant of Certificate of Registration (CoR), irrespective of any advise in the past, issued by RBI to the contrary.

  – Further, every Core Investment Company shall apply to the RBI for grant of CoR within a period of 3 months from the date of becoming a CIC-ND-SI.

- Capital Requirements

  Adjusted Net Worth of a CIC-ND-SI shall at no point of time be less than 30% of its aggregate risk weighted assets on balance sheet and risk adjusted value of off-balance sheet items as on the date of the last audited balance sheet as at the end of the financial year.

- Leverage Ratio

  Outside liabilities of a CIC-ND-SI shall at no point of time exceed 2.5 times its Adjusted Net worth as on the date of the last audited balance sheet as at the end of the financial year.

- Exemptions

  RBI may if it considers it necessary for avoiding any hardship for any other just and sufficient reason, grant extension of time to comply with or exempt any CIC-ND-SI from all or any of the provisions of the directions either generally or for any specific period, subject to such conditions as RBI may impose.

- Exemptions from Maintenance of Minimum Net Owned Funds (i.e. Rs. 2 Crores)

  A CIC-ND-SI which adheres to the requirements regarding capital requirements (i.e. 30% of aggregate risk weighted assets on balance sheet and risk adjusted value of off-balance sheet items) and leverage ratio (i.e. outside liabilities not to exceed 2.5 times its Adjusted Net worth), may to the extent necessary, be exempted from compliance with:

  – maintenance of statutory minimum Net Owned Fund (NoF) and

  – requirements of "Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007" including requirements of capital adequacy and exposure norms.

- Submission of Annual Statutory Auditors Certificate

  Every CIC-ND-SI is required to submit an annual certificate from its statutory auditors regarding compliance with the requirements of these directions within a period of 1month from the date of finalization of the balance-sheet.

- Effect of Non-Registration

  As per section 58B(4A) of the RBI Act, if any person contravenes the provisions of sub-section (1) of section 45-IA regarding the requirement for registration, he shall be punishable with imprisonment for a term which shall not be less than 1 year but which may extend to 5 years and with fine which shall not be less than Rs. 1,00,000 but which may extend to Rs. 5,00,000.

## CERTAIN OTHER IMPORTANT DEFINITIONS

- Owned Funds

  In the Non Banking Financial (Non Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007, "Owned Fund" is defined as under

  "Owned fund" means paid up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, as reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure, if any.

- Net Owned Funds

  Paid-up capital and free reserves, minus accumulated losses, deferred revenue expenditure and other intangible assets,
  Less,
  - Investments in shares of subsidiaries/companies in the same group/ all other NBFCs.
  - The book value of debentures/bonds/ outstanding loans and advances, including hire purchase and lease finance made to, and deposits with, subsidiaries/ companies in the same group, in excess of 10% of the owned funds.

- Adjusted Net worth

| "Adjusted net worth" means the aggregate, as appearing in the last audited balance sheet as at the end of the financial year, of Owned Funds as defined in Non Banking Financial (Non Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;** | |
|---|---|
| (i) as increased by | A. 50% of the unrealized appreciation in the book value of quoted investments as at the date of the last audited balance sheet as at the end of the financial year (such appreciation being calculated, as the excess of the aggregate market value of such investments over the book value of such investments); and<br>B. The increase, if any, in the equity share capital since the date of the last audited balance sheet. |
| (ii) as reduced by | A. the amount of diminution in the aggregate book value of quoted investments (such diminution being calculated as the excess of the book value of such investments over the aggregate market value of such investments ) and<br>B. The reduction, if any, in the equity share capital since the date of the last audited balance sheet. |

** Prior to the revised regulatory framework issued in January 2011, "Adjusted Net worth" also included 45% of the amount standing to the credit of the Revaluation Reserve arising from revaluation of investments in quoted investments, if any. In the revised framework the same has been excluded.

- Outside liabilities

  "Outside liabilities" means total liabilities as appearing on the liabilities side of the balance sheet excluding 'paid up capital' and 'reserves and surplus', instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue but including all forms of debt and obligations having the characteristics of debt, whether created by issue of hybrid instruments or otherwise, and value of guarantees issued, whether appearing on the balance sheet or not.

  Note: The revised regulatory framework has also excluded from the definition of "Outside Liabilities", the instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue.

For further information please contact:

RSM Astute Consulting Group
13th Floor, Bakhtawar,
229, Nariman Point,
Mumbai - 400 021.

**T:** (91-22) 6696 0644 / 6121 4444
**F:** (91-22) 2287 5771 / 2820 5685
**E:** emails@astuteconsulting.com
www.astuteconsulting.com

Offices: Mumbai, New Delhi - NCR, Chennai, Kolkata, Bengaluru, Surat, Ahmedabad, Hyderabad and Gandhidham.



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