NEWSFLASH

[About ARA LAW](#) | [ARA LAW in News](#) | [Legal Eye](#) | [Latest Deals](#) | [Contact Us](#)

May 18, 2016

PE/VC - FURTHER LIBERALIZATION OF FDI IN ASSET RECONSTRUCTION COMPANIES

In furtherance of its objective of tackling rising non-performing assets of banks, and in line with the Central Government's announcements in the Union Budget of 2016, the Department of Industrial Policy and Promotion ("**DIPP**") has, vide Press Note No. 4 issued on May 6, 2016 ("**PN 2016**") brought about significant changes to the Foreign Direct Investments ("**FDI**") policy relating to Asset Reconstruction Companies ("**ARCs**"). Brief details of the significant changes are set out below.

Key Amendments:

Particulars	Position prior to PN 2016	Revised Position
Percentage Cap on FDI in ARCs	100%	100%
Entry Route	Up to 49%: Automatic Route Beyond 49%: Government Route	Automatic Route
Sponsor's shareholding	Not more than 50% of the paid up capital either by way of FDI or routing it through FII/FPIs under one sponsor.	Will be as per the provisions of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("**SARFESI**").
FII/FPI's individual shareholding	Not more than 10% of the paid up capital of ARC.	Not more than 10% of the paid up capital of ARC.
Investment by FII/FPIs in security receipts of ARCs	Can invest up to 74% of each tranche of issuance of security receipts subject to limit of investment in corporate bonds by FII/FPIs and sectoral caps under the FDI Policy.	Can invest up to 100% of each tranche of issuance of security receipts subject guidelines/directions of Reserve Bank of India ("**RBI**") in this regard.

Analysis:

Allowing 100% FDI under the automatic route in ARCs would help in bringing in much needed foreign capital to deal with stressed and non performing assets in the banking sector. This would enable ARCs struggling for funds, especially due to the requirement under current RBI guidelines, of upfront payment of 15% of the new value of assets to banks for the purchase of bad loans.

PN 2016 also proposes linking of the investment limit of sponsors to the provisions of the SARFESI Act whereby a sponsor would be able to hold up to 100% stake in an ARC. Earlier, sponsors were not allowed to hold more than 50% in ARCs. As a combined effect of these amendments, more ARCs will be encouraged to set up business in India as the requirement of an Indian partner has been done away with. This will also enable ARCs to strengthen their capital base. Consequent amendments in the SARFESI Act will have to be made to reflect this change.

While there is no change in the cap on total holding by a foreign institutional investor/foreign portfolio investor in an ARC, which has been retained at 10% of the paid-up capital, foreign institutional investors/foreign portfolio investors will now be permitted to invest upto 100% in the issuance of security receipts by ARCs as against the earlier cap of 74%.

Further, in order to achieve the objective of attracting more FDI in ARCs, the Union Budget of 2016 had proposed complete pass through income tax status to ARC trusts that issue security receipts against the purchase of non-performing assets. With this, any income earned by an ARC trust will be exempt from payment of the income tax and income from investments in the trust will be directly taxed at the hands of investors. ARC trust will be liable to deduct tax at source from the income payable to investors. Consequent amendments in the Income Tax Act, 1961 will have to be made to reflect these amendments.

ARA LAW View

The changes under PN 2016 are expected to further open up the ARC sector, boost foreign investment in and provide relief to ARCs struggling for capital. However, concurrent amendments in the SARFAESI Act will have to be made to reflect the changes pertaining to permissible shareholding of sponsors in ARCs. Also, related changes pertaining to taxation of ARC trusts issuing security receipts will also have to be bought about in the Income Tax Act, 1961.

ARA LAW, Advocates & Solicitors.
Mumbai: The Capital | 10001 C | B Wing | Bandra Kurla Complex | Bandra (East) | Mumbai 400051 | India | T: (+91 22) 6619 8000
Bengaluru: 237 | Sumitra | 2'-Cross | 1st Main | II Stage | Domlur | Bengaluru - 560 001 | India| T: (+91 80) 41239800