More than ever, India today needs to attract foreign capital that can provide much needed respite to broken balance sheets of several bank / non-bank financiers, especially with wholesale real estate and corporate loan exposures

This note highlights major regulatory considerations impacting such investments

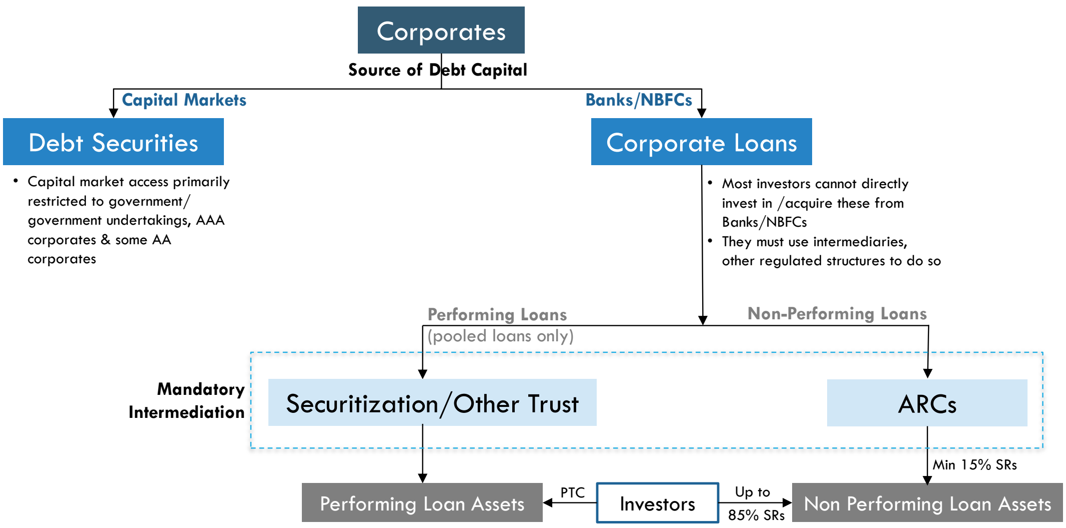
Background

In India, the primary source of debt capital for most corporates has been loans ("Corporate Loans" or "Wholesale Loans") from banks and non-bank finance companies[1] ("NBFCs"). Despite several attempts to deepen the debt capital markets, capital market access has remained restricted to the government, government undertakings, AAA rated companies and a limited set of AA rated companies. Corporate Loan AUM of banks alone amounts to ~INR 98Trn/US$1.3Trn[2], highlighting the importance of this category of debt for both investors and corporates. In the real estate (RE) context, between 2013 and 2018, NBFCs provided for 70%+ of the AUM growth in Wholesale RE Loans.

Despite the significance of Corporate Loans, regulations allow very limited type of institutions/investors that are eligible to provide or acquire such loans. Currently, only banks and NBFCs can deal in loans. Asset Reconstruction Companies (ARCs) are also allowed, but only to deal in non-performing loans. Most other category of investors such as Foreign Portfolio Investors (FPIs), Alternative Investment Funds (AIFs), Hedge Funds, Insurance Companies, Pension Funds, etc. are not allowed to directly participate in Corporate Loans transactions or acquire these loans from Banks / NBFCs. Therefore, these investors must partner with intermediaries such are ARCs (for non-performing loans) or undertake private trust / securitization structure (for performing loans) to acquire Corporate Loans.

Despite Corporate Loans being the predominant form of debt capital in India, most investors (foreign investors, pension funds, credit funds, etc) cannot directly participate in such loans or acquire them from banks and NBFCs

Below is a simplified schematic to illustrate the current situation:



[1] *For this note, non-banks include both Non-Bank Finance Companies and Housing Finance Companies (HFCs)*

[2] *Report of the Task Force on the Development of Secondary Market for Corporate Loans*

Over the last 18+ months since the default by IL&FS in Sep 2018 (onset of NBFC crises), most NBFCs have struggled to access liquidity from banks and mutual funds. Since then several other lenders have defaulted including DHFL, Altico Capital and Reliance Home Finance. This also had a direct flow through impact to the real estate sector as NBFCs were the primary source of sectors capital between 2013 and 2018. A report by Goldman Sachs[3] cited that NBFCs have an exposure of ~US$50Bn of loans to the real estate sector of which 20% are likely to be stressed.

Several banks/NBFCs are actively looking to sell down their loan portfolios to institutional investors to access liquidity as well as pair down risk. There had been few successes (examples), but most closures had remained elusive, despite significant investor interest.

Over the last 18 months, we reviewed close to US$5.0Bn of Wholesale RE loans seeking sell-down or project level recapitalisation. Drawing from that experience, we highlight foremost regulatory impediments in consummating these transactions.

Major regulatory considerations

Reflecting on our review of ~US$4.7Bn+ of Wholesale RE loans over the last 1.5 years, we highlight five critical regulatory considerations for investors looking to participate in secondary credit opportunities:

1. **Transaction structuring:** Investors other than banks, NBFCs (including HFCs) and ARCs cannot directly hold loans and can only invest in debentures, pass-through-certificates (PTCs) or Security Receipts (SRs). Investment implications:
    - *Non-performing loans:* Acquisition will require partnering an ARC. Investors will need to consider ARC fees and expenses. Further ARCs need to invest 15% of the cash consideration and this can sometimes be a hindrance in large transactions. Investor and ARC will also need to lay down a governance / decision mechanism among themselves
    - *Performing Loans:* Generally, acquisition of performing loans requires pooling of few such loans (making it difficult to transact a single loan) and setting up a trust (typically a Securitization Trust) to acquire the pooled loans. The trust then issues pass-through-certificates (PTCs) that are subscribed by the investor. These PTCs will typically need to be rated and listed
2. **Eligibility for Securitization (required for performing loan transfers):** Securitization Regulations were designed for transfer of homogenous retail loans and sometimes eligibility restrictions make it difficult to transfer Corporate Loans. An early assessment of the underlying pool's compliance with these regulations should be considered
3. **Tax Considerations:** The with-holding rate on NCDs / PTCs / SRs can vary significantly ranging from 5% to 40%, depending on tax treaties, investing structures (FPI or AIF or other) and the nature of underlying exposure
4. **Regulatory restrictions in holding more than 50% of a debt issuance:** Foreign exchange regulations prohibit FPIs to subscribe more than 50% of any debenture or

[3] *Goldman Sachs Equity Research report dated 9th July 2019: India Diversified Financials - Takeaway from industry expert call: Developer stress lingers, significant haircuts likely*

PTC issuance. Hence, for a private debt issuance, they must find a partner for the balance. However, they may use Voluntary Retention Route to avoid this restriction. This restriction is also not applicable to investments through an AIF or Security Receipts (SRs) issued by ARCs

5. **Recognition of security waterfall under insolvency regulations:** Currently, Insolvency and Bankruptcy Code (IBC), does not properly recognize the seniority of distributions for a super-senior / last mile investor ahead of incumbent / junior lenders. Review of this is under consideration, but in the meanwhile, contractual agreements / inter-creditor agreements is one of the ways to mitigate this issue

In September 2019, an RBI constituted task force made some path-breaking recommendations. If implemented, these can fundamentally alter India's secondary Corporate Loan market, providing it the much-needed boost

Many a times, the above considerations are not show-stoppers and appropriate solutions can be found to consummate the transaction, but finding these solutions can often take significant time, effort, and cost.

Conclusion:

There is an immediate need to attract significant amount of foreign capital to shore up the capital base of banks and provide liquidity for non-banks. There is significant investor interest as the underlying fundamental opportunity is attractive. However, sometimes transactions can get stuck in avoidable regulatory impediments.

Last year, Reserve Bank of India (RBI) had set up a task force to review the impediments in sale/transfer of Corporate Loans and make recommendations to facilitate the development of a robust secondary market for the same. RBI task force submitted its report in Sep 2019 and made some excellent recommendations, several of which dealt with above-mentioned hurdles too. These recommendations, if passed, would significantly ease investment in secondary loan markets, see faster turnaround and ultimately facilitate much needed flow of capital to the battered Indian financial sector.

Additional Resources:

- **RBI Task Force Report:** https://m.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=940
- **CNBC Panel Discussion covering the above subject**: https://certuscapital.in/Ashish-Khandelia-discusses-secondary%20debt-markets-and-related-regulatory-issues-on-CNBC.php

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