Our Views

Core Investment Companies (CIC) guideline - Days of Leveraged Equity will be plugged

Whether it was the Global Financial Crisis 2008, the infamous Harshad Mehta scam 1992, the Non-Performing Assets (NPAs) issue faced by Indian Banks in early years of this decade, or the more recent IL&FS crisis - all of them have been driven by dangerously excessive leverage. One of the main causes of NPA challenges in our country has been due to very little real equity contribution by promoters in various projects.

Instead of promoter's own funds being invested in new projects, existing promoter equity was being leveraged through layers of holding companies or Core Investment Companies (CICs) as they are now known. Against the equity value of the operating company, the holding companies were borrowing more and investing it in new projects as promoter's own equity contribution. So, when a project was delayed or derailed, they had no real economic interest tied to it to revive the same. Ideally, an appropriate capital structure that is linked to the residual risks of the project is required to ensure that genuine promoter equity and not borrowed equity is being invested.

Reserve Bank of India (RBI) realized the magnitude of the problem and post the IL&FS situation set up a Working Group led by Mr. Tapan Ray to review the framework for CICs. The Working Group identified the potential risks and suggested measures to limit the same, basis which RBI amended its guidelines for CICs on August 13, 2020.

In earlier days, CICs were strategic investment companies whose only business was to invest in group companies for the purpose of holding a stake and not for trading in the securities held. Regulation defines a CIC as an NBFC which carries on the business of acquiring shares or securities and its investments in group companies must constitute 90% or more of its net assets. Further, investments in equity shares of group companies must constitute at least 60% of its net assets.

Some of the earlier key issues leading to excessing leveraging and the commendable resolutions provided by RBI are as follows:

Possibility of Multiple Gearing - Under the earlier guidelines, any number of CICs could exist in a Group, and they could invest in each other's capital without deduction of their own capital. They could borrow up to 2.5x of their Adjusted Net Worth. This provided room for multiple gearing and caused excess leverage at the group level. The CICs capital could be leveraged up to 11.25x if there were two CICs in a Group. The scope of leverage at group level could increase exponentially with addition of more CICs in a Group. The Working Group constituted by RBI observed that the standalone leverage of IL&FS was within the regulatory limits at March 2018; however, when calculated at consolidated level it was considerably higher. To potentially avoid the issue of multiple gearing, RBI altered the method for calculation of Adjusted Net Worth (ANW). Under the revised methodology to compute ANW, the amount representing any direct / indirect capital contribution made by one CIC in another, to the extent such amount exceeds 10% of Owned Funds of the investing CIC, is deducted.

Opacity of structure and ownership - CICs are often a part of large business conglomerates having multiple companies and business lines spread across India and abroad. This kind of complex structure often lead to opacity in terms of ownership, control, and related-party transactions. The Working Group noted the complex structure of IL&FS which had 4 level of companies below the main CIC as NBFCs were exempt from Companies' Act 2013 provision which restricts the Group Structure to a maximum of 3 layers (including the top layer). To address this, RBI has restricted the number of layers of CICs within a Group (including the parent CIC) to two. Also, if a CIC makes any direct or indirect equity investment in another CIC, it will be deemed as a layer for the investing CIC.

Corporate Governance - Since the Corporate Governance guidelines were not explicitly applicable to CICs, RBI has directed CICs to adhere to the corporate governance requirements as per the Companies Act, 2013. Further, the CICs are now required to maintain a functional website containing basic information about itself and its Group, annual reports, corporate governance reports along with any other significant information. They have also been asked to prepare consolidated financial statements to provide a clear view of the financial standing of the Group as a whole.

With the above, we hope that going forward promoter equity will be real equity and not borrowed equity.

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