

August 2013

Reduction of Net-Worth Limit by Reserve Bank of India for Overseas Direct Investment by Indian Companies

Summary

The Reserve Bank of India (the “**RBI**”) has announced a significant change to the regime governing overseas investments by Indian companies. Under the earlier regime (which has been in place since 16 September 2007), an Indian company was permitted to make direct investments in and extend financial assistance to, overseas joint ventures companies or subsidiaries up to 400% of its net worth by way of direct equity investments, extending a loan or providing a guarantee without requiring prior approval of the RBI. The Indian company was then required to make a filing within 30 days, on the basis of which its “available net-worth” was calculated for future investments.

Through a notification issued on 14 August 2013 (the “**14 August Circular**”), the RBI reduced the 400% limit to 100% with immediate effect. In addition to the longer term impact on future overseas investments by Indian companies, this downward revision raises a few short-term questions that have not been dealt with completely in the 14 August Circular. In particular, it is unclear whether this revision means that prior approval of the RBI will now be required for transactions where an Indian company (i) has already acquired shares or provided financial assistance by way of a loan or a guarantee, as the case may be, and (ii) is within the 30 day filing time period, but (iii) has not yet made the required regulatory filings. Also, the ability of an Indian company to provide funds to its offshore joint venture or subsidiary to enable such entity to service its debts, as they fall due, may also be severely constrained.

Background

In common with certain other emerging market economies, the movement of capital in, or from India, is regulated. Indian corporates have to comply with restrictive Indian regulations while making overseas direct investment (“**ODI**”) in offshore joint ventures or subsidiaries, by way of owning shares in, making loans to, or giving guarantees.

ODI by an Indian corporate is governed primarily by the provisions of the Foreign Exchange Management Act, 1999 (“**FEMA**”) and the regulations issued thereunder, including the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 (the “**ODI Regulations**”). In addition, the Foreign Exchange Management (Guarantees) Regulations, 2000 regulate the issuance of guarantees by Indian residents.

Contents

Summary	1
Background.....	1
Reduction of the Net-Worth Limit for Overseas Direct Investment	2
Impact and Issues.....	3
Conclusion	5

The ODI Regulations permit Indian corporates to make ODI without requiring prior approval of the RBI up to a prescribed multiple of its net-worth (i.e., paid up capital and free reserves based on an Indian corporate's latest audited accounts) (the "**Net-Worth Limit**"). The RBI also permits Indian corporates to "use" the net-worth of its holding and subsidiary companies in India for the purposes of calculating the Net-Worth Limit. However, the Net-Worth Limit is not a consolidated test and counterparties intending to rely on ODI (e.g., the beneficiaries of guarantees which qualify as ODI) should ensure that there has been no double counting. In effect, the Net-Worth Limit links an Indian corporate's total "financial commitment" in relation to its ODI to its net-worth. Further, Indian corporates are also required to satisfy certain other conditions prescribed by the ODI Regulations in order to make ODI.

If the proposed ODI by an Indian corporate exceeds the prescribed Net-Worth Limit or if it does not satisfy the other conditions prescribed in the ODI Regulations, prior approval of the RBI is required.

The ODI Regulations define "financial commitment" of an Indian corporate to include the amount of the investment in shares or loan provided by an Indian corporate to an overseas joint venture or subsidiary. The Net-Worth Limit also includes 100% of any financial guarantees provided by the Indian parent or by an authorised dealer bank ("**AD**") in India to secure the payment obligations of an overseas subsidiary. However, only 50% of "performance guarantees" are considered towards the Net-Worth Limit.

The ODI Regulations require the Indian corporate to file "Form ODI" with the RBI within 30 days after making an ODI.

Reduction of the Net-Worth Limit for Overseas Direct Investment

Since 16 September 2007 and until 14 August 2013, the prescribed Net-Worth Limit was 400% of the net-worth of an Indian corporate. Through the 14 August Circular, the RBI reduced the Net-Worth Limit from 400% to 100% with immediate effect. As a result, any new ODI in excess of the reduced Net-Worth Limit (i.e., 100% of the net-worth of an Indian corporate) will require prior approval of the RBI. However, ODI by "Navratna" public sector undertakings and the Government of India owned ONGC Videsh Limited and Oil India Limited in overseas entities or in unincorporated ventures in the oil sector which have been approved by the Government of India, continues to be allowed under the automatic route without any Net-Worth Limit.

The 14 August Circular clarifies that the reduced Net-Worth Limit would apply to "*all fresh ODI proposals on a prospective basis*". As a result, ODI made prior to 14 August 2013 will not be affected. However, the 14 August Circular does not provide any transitional measures for arrangements or commitments which have already been entered into by Indian corporates but not completed.

Impact and Issues

The reduction in the Net-Worth Limit is expected to significantly affect the ability of Indian corporates to make future outbound investments or support existing offshore investments. In addition, the 14 August Circular does not presently contain any transitional measures. This could cause a certain amount of uncertainty (or worse) for transactions potentially affecting transactions in any of the following scenarios:

- > where the ODI had in fact not been completed prior to 14 August 2013 even though the Indian corporate may have entered into binding commitments or arrangements to do so. Absent lack of clarity from the RBI on transitional arrangements, the August 14 Circular is likely to adversely affect such existing binding arrangements or commitments, including those where Indian corporates have promised to support debt incurred by their offshore subsidiaries or joint ventures by injecting funds in such overseas entities. Under the ODI Regulations, the available net-worth of an Indian corporate is utilised for an ODI only when it acquires shares in, makes loans to or issues a guarantee for the obligations of, an overseas subsidiary or joint venture. The Net-Worth Limit is not tested under the ODI Regulations in respect of an obligation of an Indian corporate to make such investment, loan or issue a guarantee in the future and hence, such obligations would not fall within the pre-approved category of investments, loans or guarantees and will be treated as fresh proposals under the 14 August Circular;
- > where any put (or other) option structures are in existence which involve an offshore investor having a right to put the shares or debentures issued by an offshore subsidiary or joint venture of an Indian corporate or an offshore lender to such offshore subsidiary or joint venture having a right to put the loan to the Indian corporate, and the exercise of such option after 14 August 2013 will require the Indian corporate to exceed its Net-Worth Limit;
- > where a letter of comfort or an undertaking has been issued by an Indian corporate providing its commitment to provide funds to its offshore subsidiary, and which commitment has not been discharged by 14 August 2013. While guarantee commitments previously given by Indian corporates to support the obligations of their offshore subsidiaries or joint ventures will remain unaffected by this change, however, what is not pre-approved (because it might result in double counting) is loans made or equity injected to meet debt service obligations (effectively, equity or debt injected to meet debt service obligations of an offshore entity as they fall due, and which payments, if not made, would be within the scope of a guarantee issued by an Indian parent). Indian corporates or creditors facing such a scenario where an equity injection or a loan would result in the Indian corporate exceeding its Net-Worth Limit should urgently seek a clarification/ approval from the RBI, or risk the underlying loan going into payment default (with consequent cross default implications for an Indian guarantor);

- > where Form ODI has not been filed by 14 August 2013 for ODI made prior to 14 August 2013. In a scenario where ODI by an Indian corporate through an equity investment in, or a loan provided to, its offshore subsidiary has already been made through an AD, the AD will allow Form ODI to be filed for such an investment. The Indian corporate may be required to discuss with its AD to check whether the reduced Net-Worth Limit will be applied to test whether a guarantee issued prior to the 14 August Circular is under the automatic route or can the guarantee be issued under the previous Net-Worth Limit. Clarity is also required from the RBI as to which Net-Worth Limit will apply to guarantees issued prior to the 14 August Circular but in respect of which Form ODI has not been filed. The Indian corporate issuing such guarantees will need to determine its Net-Worth Limit after discussions with its AD, or otherwise, the RBI; and
- > where an extension of existing guarantees or a change in the Net-Worth Limit previously approved for an existing guarantee is proposed. The ODI Regulations require the period for which a guarantee is issued and the Net-Worth Limit up to which a claim can be made under a guarantee to be specified in the Form ODI filed by the Indian parent. A change in such period or the Net-Worth Limit will require a new Form ODI to be filed. Presumably, the new Net-Worth Limit will apply when such change is sought to be made.

Further, it is not entirely clear how the Net-Worth Limit would be determined where the ODI includes unpaid performance guarantees issued prior to 14 August 2013. The ODI Regulations requires the Net-Worth Limit to be tested at the time when the Indian guarantor is required to make a payment under a performance guarantee issued by it. Unless the RBI clarifies otherwise, it remains unclear whether the Net-Worth Limit in respect of a performance guarantee that was issued prior to 14 August 2013 will be that which existed at the time the performance guarantee was issued or the Net Worth Limit revised pursuant to the 14 August Circular.

Banks in India are permitted to issue guarantees in respect of the obligations of the offshore subsidiaries of an Indian corporate up to the Net-Worth Limit of the Indian corporate. The available net-worth of the Indian parent is blocked when such guarantees are issued. Such banks now risk calls on their guarantees, particularly where an Indian parent's ability to inject funds into its offshore subsidiary (to enable it to service the guaranteed debts, as they fall due) is diminished or reduced.

Conclusion

The reduction in the Net-Worth Limit is expected to significantly affect the ability of Indian corporates to make future outbound investments or support existing offshore investments. It remains to be seen whether the RBI will provide clarity on some of the issues highlighted above. Meanwhile, Indian corporates who wish to honour their commitments or agreements to support their offshore subsidiaries or to make an ODI under the previous regime will, absent sufficient Net-Worth Limit, be required to obtain prior approval from the RBI. This is also an issue for the creditors providing debt to an offshore subsidiary or joint venture of an Indian corporate with the expectation that the Indian parent will inject funds sufficient to enable the offshore entity to service its debts, as they fall due.

Authors: Aditya Shroff, Sonali Mahapatra and Jitesh Shahani

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

© Linklaters Singapore Pte. Ltd. All Rights reserved 2013

Linklaters Singapore Pte. Ltd. (Company Registration No. 200007472C) is a qualifying foreign law practice, incorporated with limited liability in Singapore. Linklaters Singapore Pte. Ltd. is affiliated with Linklaters LLP, a limited liability partnership registered in England and Wales with registered number OC326345. Linklaters LLP is a law firm authorised and regulated by the Solicitors Regulation Authority. The term partner in relation to Linklaters LLP is used to refer to a member of Linklaters LLP or an employee or consultant of Linklaters LLP or any of its affiliated firms or entities with equivalent standing and qualifications. A list of the names of the members of Linklaters LLP together with a list of those non-members who are designated as partners and their professional qualifications is open to inspection at its registered office, One Silk Street, London EC2Y 8HQ, England or on www.linklaters.com and such persons are either solicitors, registered foreign lawyers or European lawyers.

Please refer to www.linklaters.com/regulation for important information on our regulatory position.

We currently hold your contact details, which we use to send you newsletters such as this and for other marketing and business communications.

We use your contact details for our own internal purposes only. This information is available to our offices worldwide and to those of our associated firms.

If any of your details are incorrect or have recently changed, or if you no longer wish to receive this newsletter or other marketing communications, please let us know by emailing us at marketing.database@linklaters.com or marketing.database@tta.in.

Contacts

For further information please contact:

Linklaters

Philip Badge

Partner, Singapore

(+65) 6692 5731

philip.badge@linklaters.com

Aditya Shroff

Counsel, Singapore

(+65) 6692 5705

aditya.shroff@linklaters.com

One George Street #17-01

Singapore 049145

Tel: (+65) 6692 5700

Narayan Iyer

Partner, London

(+44) 207 456 6699

narayan.iyer@linklaters.com

Savi Hebbur

Partner, London

(+44) 207 456 3388

savi.hebbur@linklaters.com

One Silk Street

London EC2Y 8HQ,

United Kingdom

Tel: (+44) 20 7456 2000

Linklaters.com

tt&a

Kunal Thakore

Partner, Mumbai

(+91) 22 6613 6961

kunal.thakore@tta.in

Sonali Mahapatra

Partner, Mumbai

(+91) 22 6613 6988

sonali.mahapatra@tta.in

3rd Floor, Kalpataru Heritage

127, MG Road

Mumbai, 400 001

Tel: (+91) 22 6613 6900