RBI Strengthens Norms for Lenders in AIFs

Source: IE

Why in News?

In a move aimed at curbing evergreening of stressed loans, the **Reserve Bank of India (RBI)** recently directed **Regulated entities (REs)** like **banks**, **non-banking financial companies (NBFCs)** and other lenders not to invest in any scheme of alternative investment funds **(AIFs)** which has downstream investments in a debtor company.

- **Regulated entities (REs)** make investments in units of AIFs as part of their regular investment operations. RBI, however, stated that certain transactions of REs involving AIFs, **raise regulatory concerns.**

What are the Recent RBI's Directives to REs Related to AIFs?

- RBI emphasized **"replacing direct loans given to borrowers with investments in AIF units by REs**, which indirectly links to the borrowers. This raised concerns about the practice of loan evergreening to avoid marking them as defaults.
  - **Evergreening of loans** is a process whereby a lender tries to revive a loan that is on the verge of default or in default by extending more loans to the same borrower.
- RBI's **directive explicitly prohibits REs from investing in AIFs schemes with downstream investments** in debtor companies related to the RE.
  - According to the directive, in instances where an AIF in which an RE is already an investor makes downstream investments in debtor companies, the **RE must liquidate its investment within 30 days.**
  - In case the REs are not able to liquidate their investments within the prescribed time limit, they will have to make a **100% provision on such investments.**
    - A provision is an amount set aside or reserved by a company or financial institution to cover anticipated future expenses or losses.

Note

- **Downstream investments** refer to the **actual investments made by AIFs in companies** using raised funds from investors.

What is an Alternative Investment Fund?

- **About**: An AIF refers to a fund established or formed in India, serving as a **privately pooled investment mechanism.**
  - It gathers funds from sophisticated investors, **whether domestic or international,** with the aim of investing according to a specific investment policy, ultimately benefiting its investors.
  - These investment vehicles adhere to the **SEBI (Alternative Investment Funds)**

Regulations, 2012.

        - As of **December, 2023**, 1,220 AIFs were registered with the **Securities and Exchange Board of India (SEBI).**

- **Types of AIFs in India:** SEBI has classified AIFs into three main categories:
    - **Category I:** AIFs that invest in **startups, early-stage ventures, social initiatives, SMEs, infrastructure,** or sectors deemed socially and economically beneficial by authorities.
        - This includes venture capital**,** social venture funds**, infrastructure funds,** and any other specified Alternative Investment Funds.
    - **Category II:** AIFs which **do not fall in Category I and III** and which do not undertake leverage or borrowing other than to **meet day-to-day operational requirements.**
        - These include **real estate funds, private equity funds (PE funds), distressed asset funds,** and similar types.
    - **Category III:** AIFs which **employ diverse or complex trading strategies** and may employ leverage including through investment in listed or unlisted derivatives.
        - Various types of funds such as **hedge funds, PIPE (private investment in public equity) Funds, etc.** are registered as Category III AIFs.
- **Legal forms:** An AIF can be established in the form of **a trust or a company or a limited liability partnership** or a **body corporate.**
    - Most of the AIFs registered with SEBI are in **trust form.**