

ALTERNATIVE INVESTMENT FUND: ECONOMY

NEWS: RBI caps investment by banks, NBFCs at 20% of corpus of AIF scheme

WHAT'S IN THE NEWS?

The RBI has issued new restrictions on investments by Regulated Entities (REs) in Alternative Investment Funds (AIFs) to prevent indirect exposure to borrower companies and ensure financial discipline. Meanwhile, the Union Budget 2025–26 clarified the taxation of Category I & II AIFs, treating their income as capital gains taxed at 12.5%.

Alternative Investment Funds (AIFs) – Overview & Recent RBI Guidelines

What is an Alternative Investment Fund (AIF)?

- **Definition:**
An AIF is a **privately pooled investment vehicle** that collects money from sophisticated investors and invests in **non-traditional assets** such as venture capital, private equity, hedge funds, infrastructure, and real estate.
- **Target Investors:**
Designed mainly for **High Net-worth Individuals (HNIs)** due to **high minimum investment requirements**.
- **Regulatory Body:**
Securities and Exchange Board of India (SEBI) regulates and categorizes AIFs under the **SEBI (Alternative Investment Funds) Regulations, 2012**.

Types of AIFs in India

1. Category I AIFs – Development-Oriented Investment

- Invest in:
 - **Start-ups**
 - **Small and Medium Enterprises (SMEs)**
 - **Infrastructure projects**
 - **Social ventures**
- **Objective:** Promote economic growth, job creation, innovation, and social impact.
- **Government Support:** Receive **incentives or concessions** due to their national development focus.

2. Category II AIFs – Growth-Oriented Investment

- Invest in:
 - **Private equity**
 - **Debt funds**

- **Distressed assets**
- **Characteristics:**

Do not get government incentives.

Play a vital role in corporate financing and business restructuring.

- **Stability:** Typically **medium to long-term** investment strategies.

3. Category III AIFs – High-Risk, High-Return Investment

- Invest using:
 - **Advanced and complex trading strategies** (like derivatives, arbitrage, etc.)
- **Objective:** Short-term return maximization.
- **Risk Profile:** High-risk, high-volatility instruments.
- Often used by hedge funds or portfolio managers.

Taxation on AIFs (Union Budget 2025–26)

- **Before Budget 2025–26:**
 - No clear provision on how **Category I & II AIF incomes** were taxed under the Income Tax Act.
- **After Budget 2025–26:**
 - Income from **Category I and II AIFs** is now:
 - Treated as **capital gains**.
 - **Taxed at a uniform rate of 12.5%.**
 - The **definition of “capital asset”** under the Income Tax Act has been **expanded** to include **gains made by AIFs**.

Recent RBI Guidelines on AIF Investments (2024)

Applicability:

- Applies to **Regulated Entities (REs)** including:
 - Commercial Banks
 - Cooperative Banks
 - Non-Banking Financial Companies (NBFCs)
 - Housing Finance Companies (HFCs)

- All-India Financial Institutions (AIFIs)
- Effective from **1 January 2026** or **earlier adoption** by entities.

Investment Caps:

- **Single Regulated Entity (RE):**
 - Cannot invest **more than 10%** of an AIF scheme's **corpus**.
- **Collective Cap (All REs combined):**
 - Cumulative investments by REs in a particular AIF scheme cannot exceed **20% of the corpus**.

Exposure to Debtors via AIFs:

- If an RE **invests over 5%** in an AIF that has **downstream investment** in the **RE's debtor company** (*other than equity*):
 - The RE must make a **100% provision** for its **proportional exposure**.
 - This aims to **avoid indirect lending risks**.

Capital Fund Deduction:

- Investments in **subordinated units** of AIFs (i.e., lower-ranked in payout hierarchy):
 - Will require **full deduction** from the RE's **regulatory capital**, reducing their core capital base.

Benefits of Investing in AIFs

- **High Return Potential:**
Opportunity to earn **higher returns** than traditional mutual funds, especially in niche and emerging sectors.
- **Portfolio Diversification:**
Access to **non-traditional assets** like:
 - Private equity
 - Infrastructure
 - Start-ups
 - Real estate
- **Low Correlation with Markets:**
Due to lesser dependence on equity markets, AIFs offer **reduced exposure to stock market volatility**.

Risks & Limitations of AIFs

- **High Entry Barrier:**
Requires **high minimum investment**, typically ₹1 crore and above, making them inaccessible to retail investors.
- **Liquidity Constraints:**
AIFs have **lock-in periods** and **limited exit options**, making them **illiquid** compared to mutual funds or stocks.
- **Regulatory Impact:**
Changes in **SEBI/RBI regulations** may impact the fund's performance or permissible investment strategies.

Conclusion

- **Alternative Investment Funds (AIFs)** are best suited for **wealthy investors** seeking **diversified and high-growth opportunities** beyond traditional investment avenues.
- With classification into **three categories** based on risk-return profiles and strategies, investors must choose the AIF **aligned with their goals and risk appetite**.
- Understanding recent **RBI investment caps, tax implications, and liquidity constraints** is vital before investing.

Source: <https://www.thehindu.com/business/rbi-caps-investment-by-banks-nbfcs-at-20-of-corpus-of-aif-scheme/article69870668.ece>