PROPOSED REGULATORY FRAMEWORK FOR NBFCS

Enterslice

Foreword from Enterslice

Non-Banking Finance Companies (NBFCs) in India have been playing a significant role in the Indian financial system. These entities have been bringing in more efficiency, inclusion and diversity into financial landscape of the country. NBFCs have also redesigned their operations, quality of asset and offerings, and risk management framework.

NBFCs have also noticeably enjoyed a more lenient and flexible regulatory framework as compared to banks, allowing them to operate more freely. Further, the Reserve Bank of India has time and again introduced regulations to improve the functioning of NBFCs and streamline the sector to a larger extent.

In this report, we're summarizing the Reserve Bank of India's discussion paper on 'Revised Regulatory Framework for NBFCs - A Scale-Based Approach' dated January 22, 2021. Through this discussion paper, the Bank has introduced a scalar-based approach to regulate Non-Banking Financial Companies in a more rationalized manner.

INTRODUCTION TO THE NBFC SECTOR IN INDIA

In the past decade, Non-Banking Financial Companies (NBFCs) have emerged as more approachable and cost-efficient alternatives to mainstream banking. These financial service providers have become a fundamental part of the Indian Financial System, and have been contributing commendably towards the Indian government's initiative of financial inclusion in the country.

NBFCs provide credit to the underserved and unserved segments, extending innovative solutions to an otherwise traditional sector. With their innovative products and focus on niche services, they are addressing the financial needs of masses that otherwise await financial assistance. NBFCs have been a supplementary role to the organised banking sector in India, bridging the service gap and increasing financial service penetration.

NBFC SECTOR STATISTICS

The NBFC sector continues to witness steady growth and transformation, backed by a developing economy and financial awareness.

The various macro-level regulatory efforts and restructuring changes have also had a positive effect on the sector.

9.7%

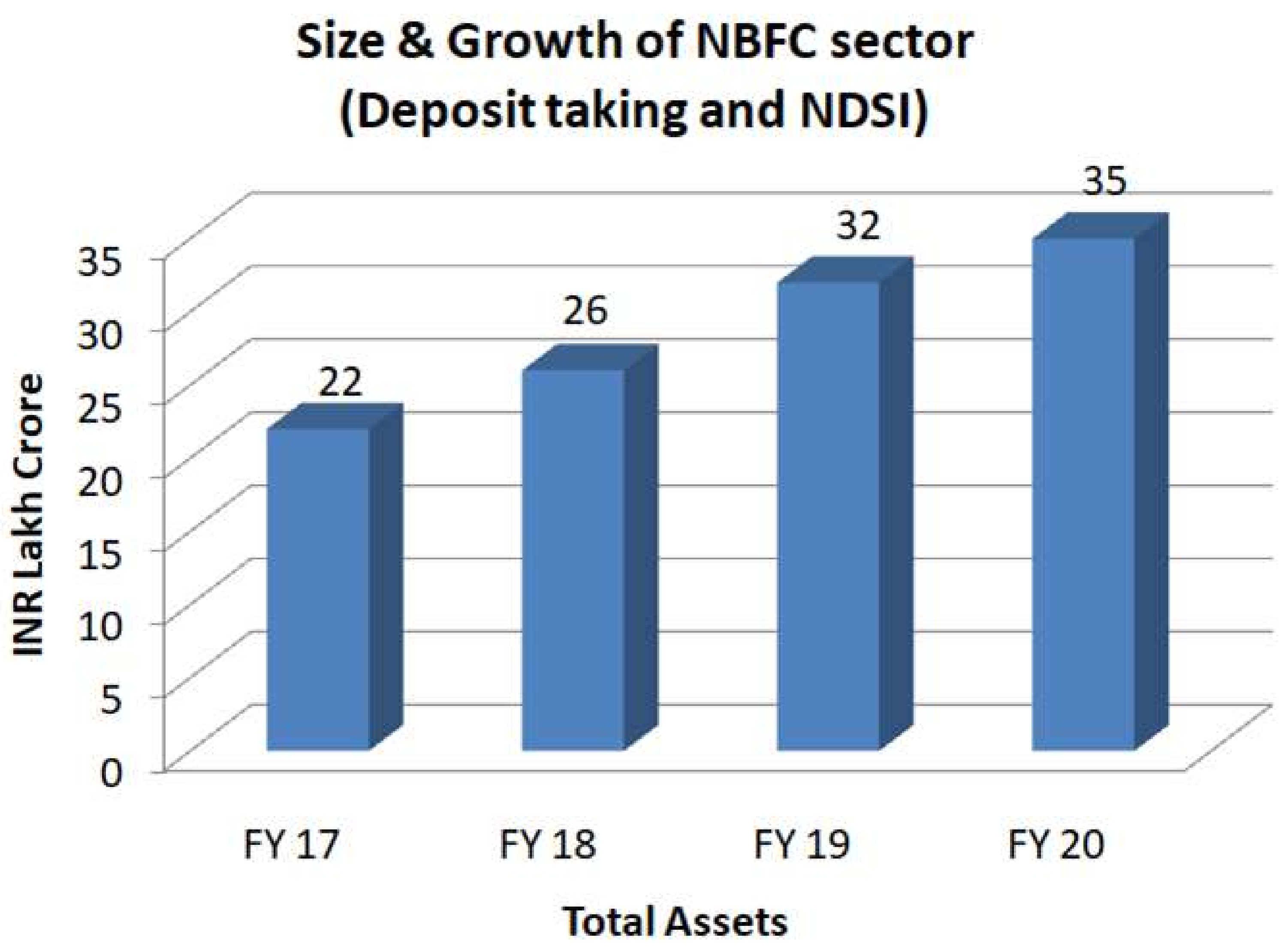
Annual Growth of Wealth per Adult at Current Exchange Rates

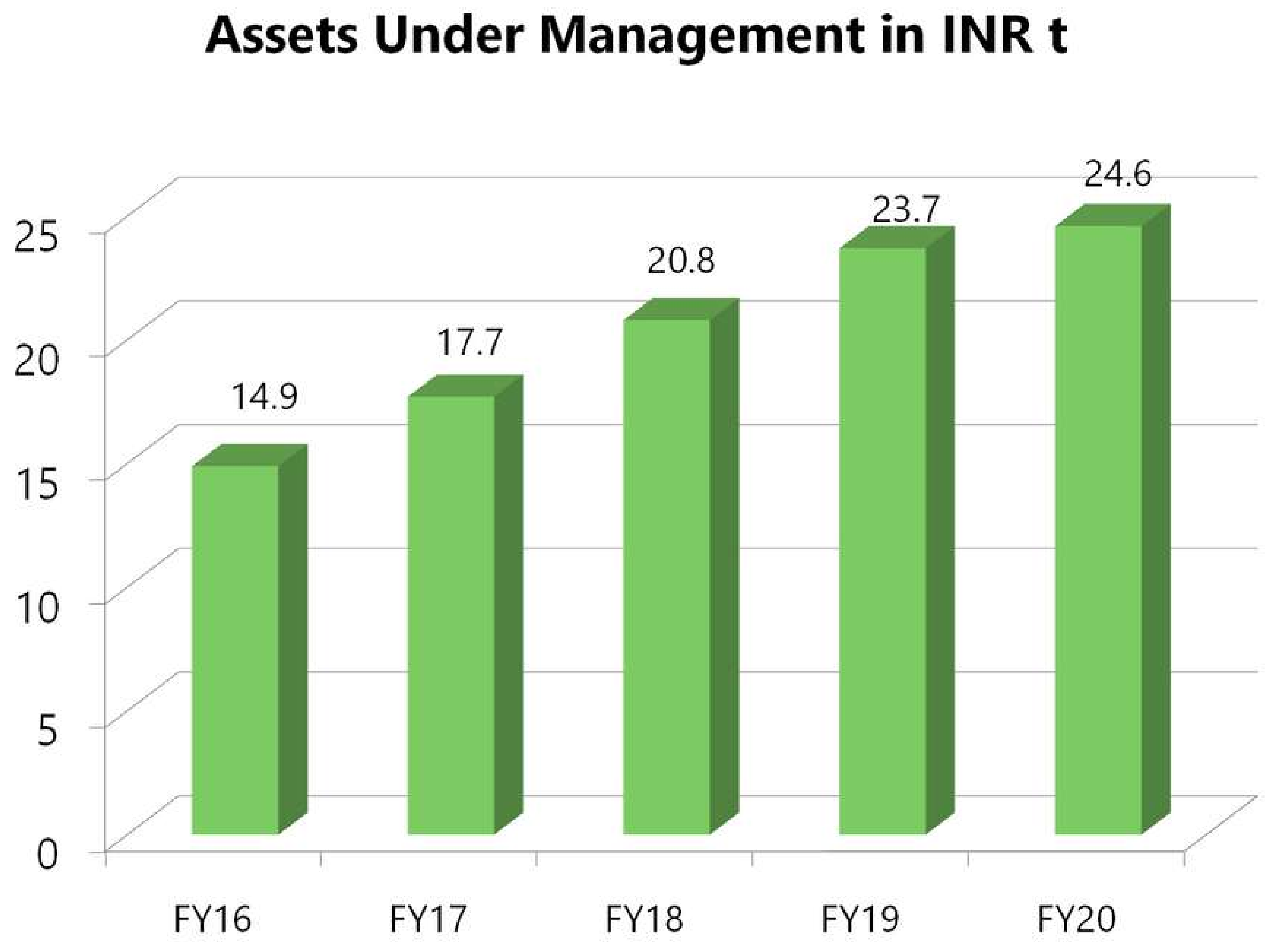
18.89%

CAGR over the past 5 years

7

NBFCs with asset size of more than INR 1 lakh crore


Size & Growth of NBFC sector
(Deposit taking and NDSI)
INR Lakh Crore
0
5
10
15
20
25
30
35
22
26
32
35
FY 17
FY 18
FY 19
FY 20
Total Assets


Assets Under Management in INR t
0
5
10
15
20
25
14.9
17.7
20.8
23.7
24.6
FY16
FY17
FY18
FY19
FY20

GROWTH FACTORS

The growth grapth in the NBFC sector has been constant over the years, and there are many factors that contribute to this constant success of NBFC entities:

1. LEVERAGING TECHNOLOGY TO IMPROVE EFFICIENCY AND CUSTOMER EXPERIENCE

2. CUSTOMISED PRODUCT OFFERINGS TO A LARGER AUDIENCE OF INDIVIDUALS, MSMES AND HOUSEHOLDS

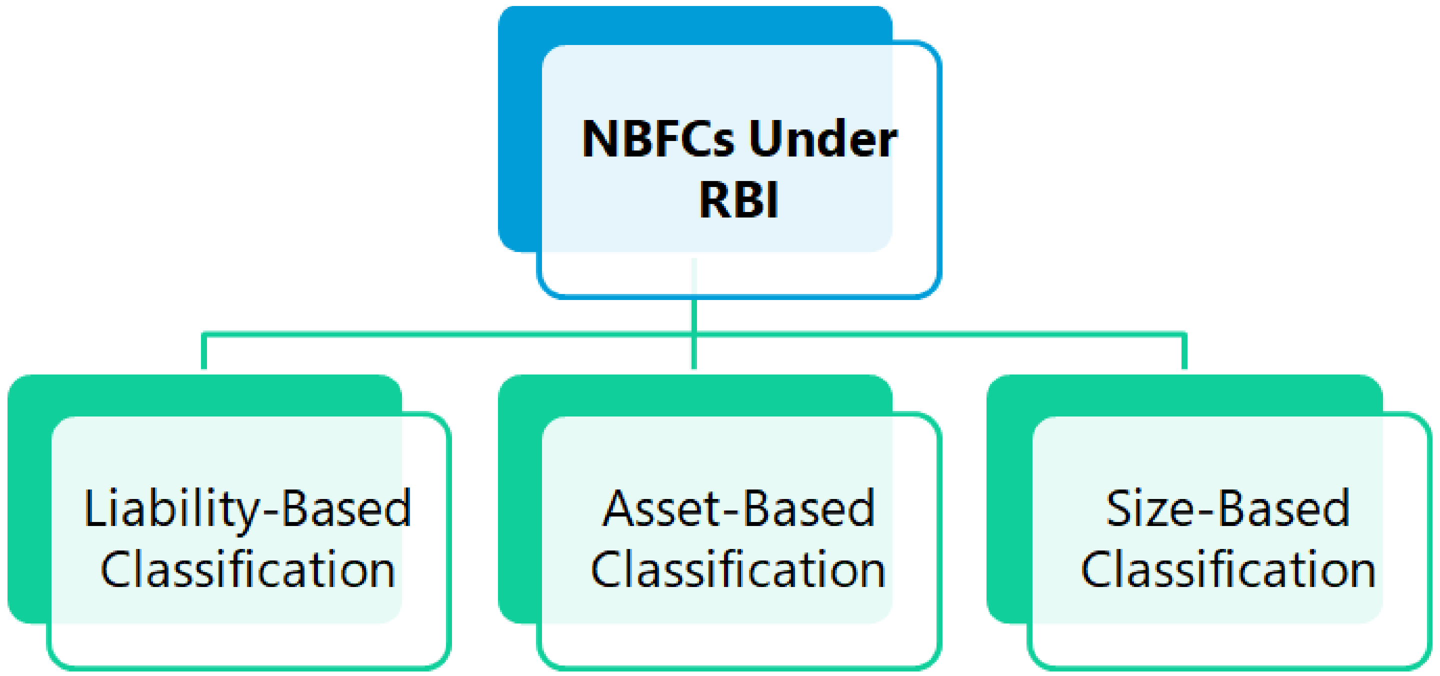
3. ROBUST RISK MANAGEMENT AND PLANNING ABILITIES OF NBFCS

EVOLUTION OF NBFC REGULATORY FRAMEWORK

- Regulatory Framework, 1998
- Malegam Committee, 2011 - Issues and concerns in NBFC-MFIs
- Usha Thorat Committe report, 2011 - Classification of Systematically Important NBFCs
- Revised Regulatory Framework, 2014

EXISTING REGULATORY FRAMEWORK FOR NBFCs

EXISTING CLASSIFICATION OF NBFCs UNDER RBI



Liability-Based Classification

- Deposit-Taking NBFCs (NBFC-D)
- Non Deposit-Taking NBFCs (NBFC-ND)

Asset-Based Classification

- Asset Finance Company
- Investment Company
- Loan Company
- Core Investment Companies
- Infrastructure Finance Companies
- Factor
- Micro Finance Institutions
- Infrastructure Debt Funds

Size-Based Classification

- Systemically Important Non-Deposit taking NBFCs (NBFCs-ND-SI)
- Non Systemically Important Non-Deposit taking NBFCs

Extant Regulatory Approach for NBFC-NDs

-Leverage ratio should not be more than 7

-No CRAR/ exposure norms

-180 days asset classification norm

NBFC-NDs with assets of less than ₹ 500 crore and not accessing public funds –

-No Prudential Regulation

-Conduct of business regulations, such as, KYC and FPC not applicable to NBFCs with no customer interface

EXTANT REGULATORY APPROACH FOR NBFC-ND-SI AND NBFC-D

Capital Requirements

- Minimum Capital of 15% of risk-weighted assets
- Tier I capital at a minimum of 10% and Tier II must not exceed Tier I capital
- NBFCs engaged in lending against gold jewellery (such loans comprising 50% or more of their financial assets) to a minimum Tier I capital of 12%
- The risk weights assigned to the exposures held by NBFCs determined as per Basel I standards, i.e., divided into 0%, 20%, 50% and 100%

Reserve Fund

- Section 45-IC of RBI Act 1934 requires every NBFC to create a reserve fund and transfer a sum not less than 20% of its net profit every year as disclosed in the profit and loss account before declaring any dividend.

PRUDENTIAL REGULATIONS (APPLICABLE TO NBFC-ND-SI AND NBFC-D BUT NOT TO NBFC-MFIS)

Credit Concentration

Type of exposure	Single	Group
Credit	15%	15%
Investment	25%	25%
Composite (Credit + Investment)	25%	40%
Infrastructure related activities (Credit + Investment)	Additional 5%	Additional 10%

Credit Concentration Norms for NBFC-IFC

Type of exposure	Single	Group
Credit	15% and additional 10%	25% and additional 15%
Composite (Credit + Investment)	25% and additional 5%	40% and additional 10%

Asset Classification

Standard Assets	0.40% for NBFC –ND- SI and
	0.25% for NBFC-ND
Sub-standard Assets	10% of outstanding balance
Doubtful Assets	100% on un-secured portion and
	20%, 30% and 50% on the secured portion depending on the age of doubtful assets
Loss Assets	100% of outstanding balance

Corporate Governance and Disclosures:

Every NBFC-ND-SI and NBFC-D needs to

- Frame internal guidelines on corporate governance;
- Constitute a Audit Committee, Nomination Committee and Risk Management Committee;
- Ensure 'fit and proper' status of proposed/ existing directors;
- Ensure rotation of partners of audit firms once in 3 years;
- Make additional disclosures in balance sheets on CRAR, investments, derivatives, ALM, direct and indirect exposure to real estate sector, penalties, concentration, customer complaints, etc.;
- Disclose the internal guidelines on corporate governance on the company's website.

Fair Practices Code:

Applicable to NBFCs covers responsibility of the Board in ensuring fair practices, transparency in pricing, effective communication with borrowers, appropriate recovery mechanismand guidelines for lending against gold jewellery.

Grievance Redressal Mechanism:

Board of Directors to lay down grievance redressal mechanism. NBFCs to display the details of the grievance redressal officer at every branch and the escalation process to the Reserve Bank/ Ombudsman.

KYC Norms:

All NBFCs with customer interface to follow the Know Your Customer Directions, 2016

EXTANT REGULATORY APPROACH FOR DEPOSIT TAKING NBFCS (NBFC-D)

Norms on Maintenance of Liquid Assets:
Deposit accepting NBFCs to invest 15% of their public deposits in statutory liquid assets; out of which 10% must be in unencumbered approved securities and the remaining 5% in term-deposits with Scheduled Commercial Banks.

Restriction on Acceptance of Public Deposit

- Public deposit can be accepted for a minimum period of 12 months and maximum period of 60 months (5 years).
- Only Deposit taking NBFCs with minimum investment grade or other specified credit rating can accept deposits.
- Public deposits can be raised to the tune of 1.5 times of NOF.
- Maximum interest rate payable on public deposits by NBFCs is 12.5% per annum.
- Cannot accept deposits repayable on demand.

EXISTING MINIMUM CAPITAL REQUIREMENT FOR NBFC REGISTRATION

NBFCs other than mentioned below
- ₹ 2 crore

NBFC-MFI
- ₹ 5 crore

NBFC- MFI in NE Region
- ₹ 2 crore

NBFC- Factor
- ₹ 5 crore

NBFC-HFC
- ₹ 20 crore

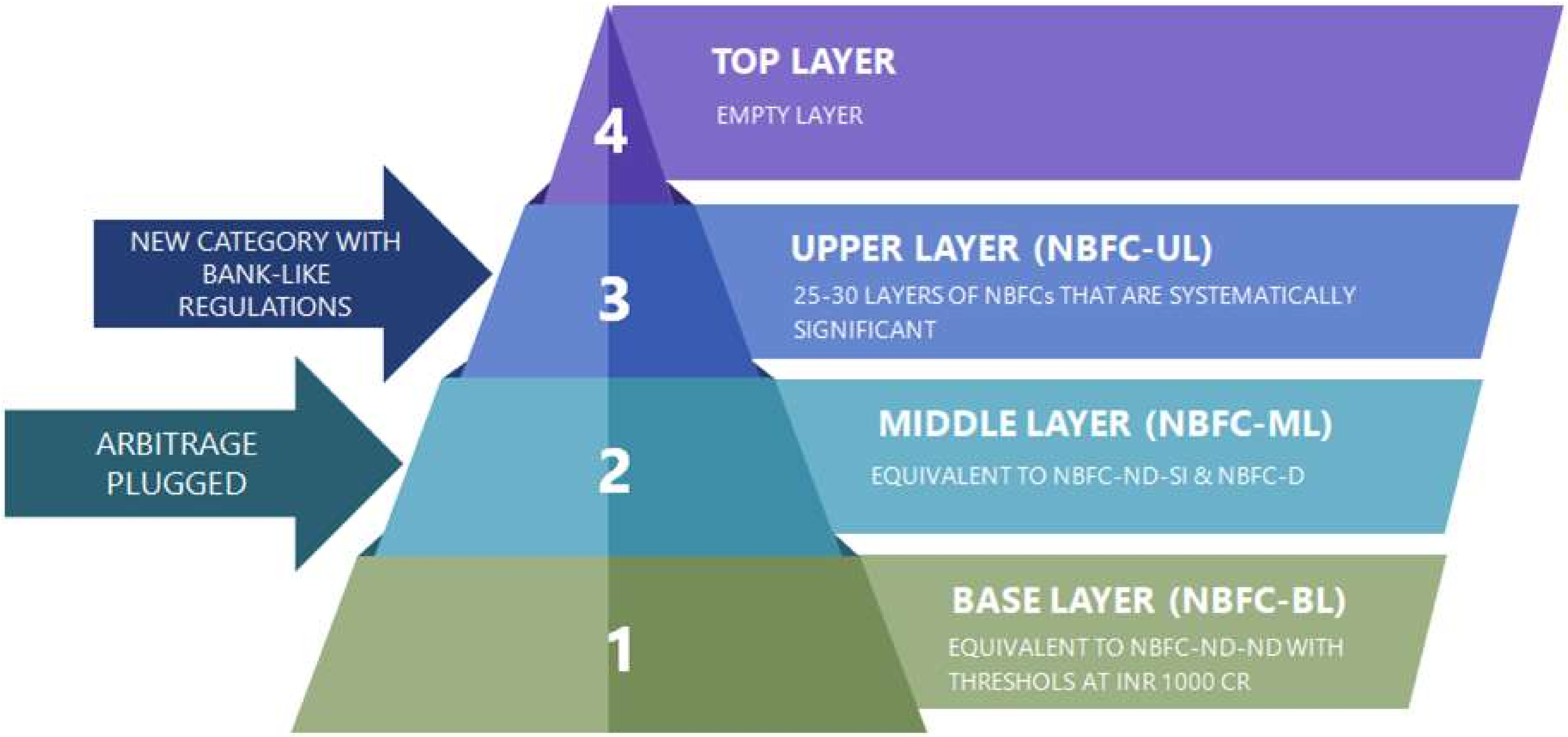
NBFC-MGC
- ₹ 100 crore

IDF – NBFC
- ₹ 300 crore

NBFC- IFC
- ₹ 300 crore

PROPOSED REGULATORY FRAMEWORK BY THE RBI

NEW CLASSIFICATION OF NBFCs



PRINCIPLE OF PROPORTIONALITY IN REGULATION

TRIGGERS:

Comprehensive Risk Perception: Once an NBFC crosses the thresholds for identified parameters such as size, leverage, interconnectedness, complexity, and supervisory inputs, it should be subject to proportionately higher regulation.

Size of Operations: If the balance sheet size of an NBFC breaches a certain threshold, it can be regulated at a higher pedestal.

Activity of NBFCs: NBFCs can be subjected to differential regulations based on the activity carried out by them and risks involved in those activities.

FILTERING PROCESS UNDER THE SCALAR-BASED APPROACH

SIZE

SCALE OF SIGNIFICANCE

ACTIVITY

UPPER LAYER (NBFC-UL)

Top 50 NBFCs based on their asset size will be evaluated through the following yardsticks:

- ✓Size: 35%
- ✓Inter-connectedness: 25%
- ✓Complexity: 10%
- ✓Supervisory Inputs: 30%

Top 10 NBFCs will be included without evaluation

MIDDLE LAYER (NBFC-ML)

- ✓Housing Finance Company
- ✓Standalone Primary Dealers
- ✓Infrastructure Finance Company

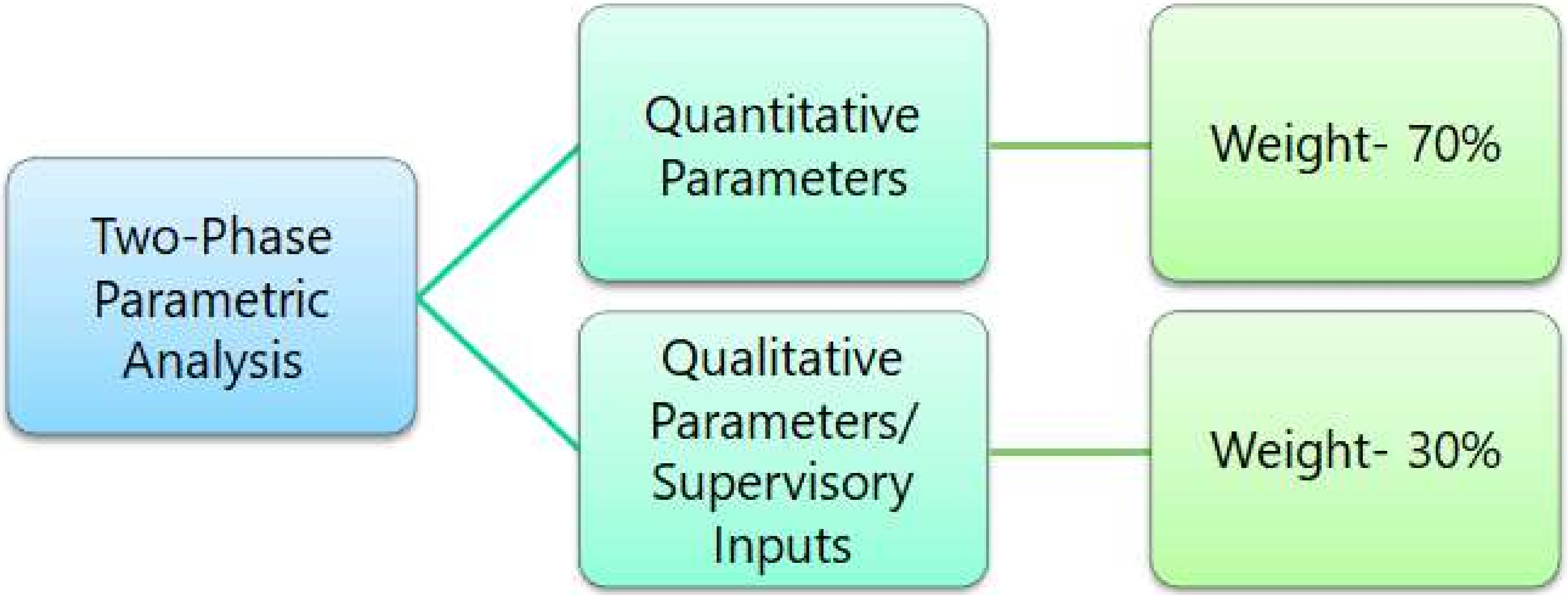
Always NBFC-ML

- ✓Infrastructure Debt Fund
- ✓Core Investment Company

BASE LAYER (NBFC-BL)

- ✓Type I NBFC
- ✓Peer-to-Peer (P2P)
- ✓Account Aggregator (AA)
- ✓NOFHC
- ✓Up to INR 1000 cr Asset Size

IDENTIFICATION OF NBFCS IN UPPER LAYER



Scoring Methodology

- A composite score will be calculated to identify NBFC-UL. For each NBFC, the score for a particular indicator will be calculated by dividing the individual NBFC's amount by the aggregate amount for the indicator summed across all NBFCs in the sample. The score for each category will be converted into basis points and the overall systemic significance of an NBFC will be calculated as weighted average scores of all indicators. NBFCs that score more than a threshold (to be decided by the Reserve Bank) will be classified as NBFC-UL.
- Top ten NBFCs as per asset size will automatically be identified as NBFC-UL and lie in the upper layer, irrespective of the fact whether they fit in to the other parameters or not.

Implementation Plan

The process of identification of NBFC-UL based on parametric analysis will be performed as a yearly exercise based on the following processes -

- Once identified as NBFC-UL, the NBFC will be advised individually about its classification as a NBFC-UL and notified that it will be subjected to regulation parallel to banks.
- A time-period of 8 weeks will be provided to the NBFC to enable it to draw a plan for implementation. The NBFC would need to form a Board approved policy for the adoption of its enhanced regulatory framework.
- The Board approved policy would need to be complied with within a maximum time-period of 18 months from the date of its declaration as a NBFC-UL. During the transition period, calibrated increment to business may be allowed through supervisory engagement.
- The roadmap will be submitted to the Reserve Bank and be subject to supervisory review at the time of annual inspection.

Quantitative Measures

Parameter	Sub-Parameters	Sub-Para Weights	Parameter Weights
1. Size & Leverage	Total exposure (on- and off-balance sheet) & Leverage - total debt to total equity	20 + 15	35
2. Inter-connectedness	(i) Intra-financial system assets • Lending to financial institutions (including undrawn committed lines); • Holdings of securities issued by other financial institutions; • Net mark-to-market reverse repurchase agreements with other financial institutions; • Net mark-to-market OTC derivatives with financial institutions.	10	25
	(ii) Intra-financial system liabilities • Borrowings from financial institutions (including undrawn committed lines) • All marketable securities issued by the finance company to financial institutions; • Net mark-to-market repurchase agreements with other financial institutions; • Net mark-to-market OTC derivatives with financial institutions	10	
	(iii) Securities outstanding with non-financial institutions (issued by the NBFC)	5	
3. Complexity	(i) Notional Amount of Over-the-Counter (OTC) Derivatives • OTC derivatives cleared through a central counterparty • OTC derivatives settled bilaterally	5	10

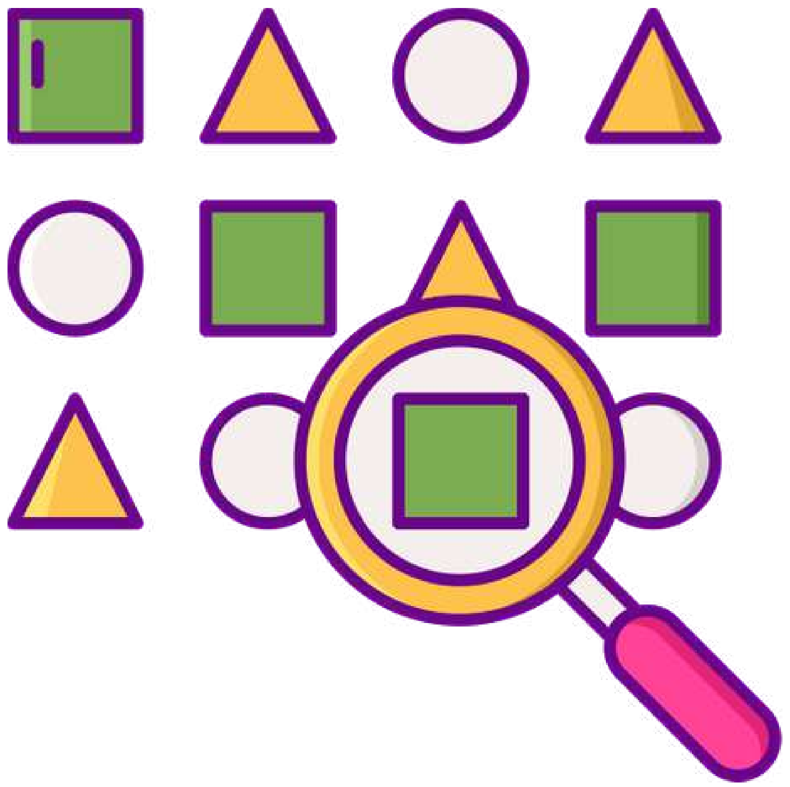
Qualitative Measures

Parameter	Sub-Parameters	Sub-Para Weights	Parameter Weights
4. Nature and type of liabilities	• The amount and type of liabilities, including the degree of reliance on short-term funding	10	30
	• Liquid asset ratios, which are intended to indicate a nonbank financial company's ability to repay its short-term debt.		
	• The ratio of unencumbered and highly liquid assets to the net cash outflows that a nonbank financial company could encounter in a short-term stress scenario.		
	• Callable debt as a fraction of total debt, which provides one measure of a nonbank financial company's ability to manage its funding position in response to changes in interest rates.		
	• Asset-backed funding versus other funding, to determine a nonbank financial company's susceptibility to distress in particular credit markets.		
	• Asset-liability duration and gap analysis, which is intended to indicate how well a nonbank financial company is matching the re-pricing and maturity of the nonbank financial company's assets and liabilities.		
	• A study on the borrowings split by type i.e. Secured debt securities; subordinated debt securities; preferred shares/CCPS; CPs; unsecured debt; securitisation and any other		
5. Group Structure	• Total Number of entities	10	
	• Total number of layers		
	• Total Intra group exposure		
6. Segment penetration	The importance of the NBFC as a source of credit to a specific segment or area	10	

Selection of Sample for Identification of NBFCs in Upper Layer

The NBFCs fulfilling the following criteria can be included in the sample:

- Top ten NBFCs (as per asset size) will automatically fall in the Upper Layer of regulation.
- Next 50 NBFCs based on the total exposure, including off-balance sheet exposure;
- NBFCs designated as NBFC-UL in the previous year (unless supervisors agree that there is a compelling reason to exclude any one of them); and
- NBFCs added to the sample by supervisors using their supervisory judgment.



STRUCTURE AND REGULATORY FRAMEWORK FOR NBFCS IN BASE LAYER

- Threshold for systematic importance: ₹1000 crore
- Minimum Net Owned Funds revised from ₹2 crore to ₹20 crore
- The extant NPA classification norm of 180 days will be harmonized to 90 days

Risk Management Committee:

1. At least one of the directors shall have experience in retail lending in a bank/ NBFC.
2. Adequate mix of experience and educational qualification among members.

For a non-disruptive transition, a timeline of 5 years will be prescribed for existing NBFCs. For new registrations, the higher NOF norms will be applicable immediately on issue of instructions.

STRUCTURE AND REGULATORY FRAMEWORK FOR NBFCS IN MIDDLE LAYER

NBFC-ML shall comprise:

- All non-deposit taking NBFCs classified currently as NBFC-ND-SI and all deposit taking NBFCs.
- NBFC-HFCs, IFCs, IDFs, SPDs and CICs, irrespective of their asset size

Proposed Framework for Minimum Capital Requirement:

- At present, NBFCs are on a Basel I type framework is applicable
- Minimum capital to risk weighted assets ratio (CRAR) of 15% with minimum Tier I of 10%
- No changes are proposed for now

Credit Concentration Norms

NBFC				Banks	
(as a percentage of Owned Funds)				(as a percentage of Tier I Capital)	
	Lending	Investment	Total		Exposure
Single borrower/ counterparty	15	15	25	Single Counterparty	20
Group of borrowers/ parties	25	25	40	Groups of connected counterparties	25

Introduction of Internal Capital Adequacy Assessment Process (ICAAP) similar to banks

- Internal capital can be assessed based on it by factoring credit, market, operational, and all other residual risks.
- Objective of ICAAP: To ensure availability of adequate capital to support all = business risks as also to encourage NBFC to develop and use better techniques for risk monitoring and management.

Governance Arbitrage

- **Rotation of Auditors**- A tenure of three consecutive years; cannot be reappointed for the next six years
- **Chief Compliance Officer**- An independent Chief Compliance Officer to be appointed to ensure an effective compliance culture and a strong compliance risk management programme
- **Compensation Guidelines**- Along the lines of banks to address issues arising out of excessive risk taking caused by misaligned compensation packages; constitution of a Remuneration Committee; principles of fixed/variable pay structures; malus/clawback provisions
-
- **Key Managerial Personnel**- KMP such as CEO, CFO, CS and WTD will not hold any office (including directorships) in any other NBFC-ML or NBFC-UL.
- **Corporate Governance and Disclosure Requirements**-

1. Current disclosure requirements prescribed for NBFC-ND-SI will be applicable
2. Corporate Governance report like composition, category and relationship between directors, shareholding of non-executive directors
3. Disclosure on modified opinion expressed by auditors
4. Items of income and expenditure of exceptional nature.
5. Breach in terms of covenants, incidence of default
6. Divergence in asset classification and provisioning based on inspection findings

Regulatory Restrictions on Lending

An NBFC-ML cannot grant loans and advances to the following:

- To companies for buy-back of shares/securities.
- To directors, their relatives and to entities where directors or their relatives have major shareholding (10% or more of the paid-up share capital).
- To officers and relatives of senior officers.
- For setting up of new units consuming/producing the Ozone Depleting Substances.
- To real estate entitiy when no prior permission from government / local governments / other statutory authorities is obtained.

Other Areas of Arbitrage

- Requirements for Secretarial Audit.
- IPO financing shall be capped at ₹1 crore per individual.
- NBFCs with 10 and more branches shall mandatorily have to adopt Core Banking Solution (CBS).
- An independent director cannot be director in more than two NBFCs (NBFC-ML and NBFC-UL) at the same time.

STRUCTURE AND REGULATORY FRAMEWORK FOR NBFCS IN UPPER LAYER

Capital Regulations:

- Minimum requirements for Common Equity Tier 1 at 9% within the Tier I capital.
- Subject to a leverage requirement to ensure growth supported by adequate capital.
- Differential standard asset provisioning on lines of banksagainst the current flat rate of 0.40% as standard asset provision.

Credit Concentration Norms:

- Minimum requirements for Common Equity Tier 1 at 9% within the Tier I capital.
- Subject to a leverage requirement to ensure growth supported by adequate capital.
- Differential standard asset provisioning on lines of banksagainst the current flat rate of 0.40% as standard asset provision.

Listing and Corporate Governance

- On similar lines as applicable for Private Sector Banks
- Removal of Independent Directors before completion of their normal tenure subject to approval by supervisors
- Detailed disclosure on group companies including consolidated financial position and details of related party transactions.
- Guidelines on compensation for Whole Time Directors / Chief Executive Officers / Other Risk Takers on the lines as applicable to Private Sector Banks; creation of Remuneration Committee for the same.

Other Guidelines

- KMP Guidelines: Same as NBFC-ML
- Appointment of Chief Compliance Officer mandatory
- Adequate phase-in-time for mandatory listing. However, disclosure will kick in earlier than actual listing within the broad implementation plan for NBFC-UL.

SUMMARY COMPARISON BETWEEN REGULATORY FRAMEWORK FOR NBFC LAYERS

Parameters	NBFC-Base Layer (NBFC-BL)	NBFC-Middle Layer (NBFC-ML)	NBFC-Upper Layer (NBFC-UL)
		CAPITAL REGULATION	
CET 1	Not specified	Not specified	9%
Leverage	7	Not specified	To be specified
Standard Asset Provisioning	0.25%	0.40%	Provisions similar to banks
NPA Classification	Harmonisation from 180 days to 90 days overdue	90 days	90 days
ICAAP	Not specified	Board approved policy considering all risks	Same as NBFC-ML
		CONCENTRATION NORMS	
Percentage based on	Owned funds	Tier I Capital	Tier I Capital
CC norms and Large Exposure Framework (LEF) Applicability	Existing guidelines applicable to NBFC-NDs	Lending and investment limits merged into a single exposure limit	LEF applicable to banks with requisite changes; Transition period for adoption
		GOVERNANCE AND DISCLOSURE NORMS	
Compensation Guidelines; Remuneration Committee	Not specified	Consitution of Remuneration Committee; Principles of fixed/variable pay structures; Malus/claw back requirements	Similar to Private Sector Banks; Compensation Policy and Remuneration Committee
Rotation of Statutory Auditor	Not specified	Uniform tenure of 2 consecutive years; Mandatory 6-year cooling period before re-appointment	Same as NBFC-ML

Parameters	NBFC-Base Layer (NBFC-BL)	NBFC-Middle Layer (NBFC-ML)	NBFC-Upper Layer (NBFC-UL)
KMP	As per the Companies Act, 2013	KMP cannot hold office in any other NBFC-ML, UL or subsidiary; Independent director must nor be director in more than two NBFC-ML or UL simultaneously	Same as NBFC-ML
Chief Compliance Officer	Not specified	Mandatory	Mandatory
Listing	Not mandatory	Not Mandatory	Adequate adoption time for mandatory listing; Disclosure requirements applicable earlier than actual listing
Expertise of the Board	Adequate experience and educational qualification, with at least 2 director holding experience in retail lending in a bank/NBFC	Same as NBFC-BL	Same as NBFC-ML; specific expertise may be specified
Removal of Independent Directors	Not specified	Not specified	Supervisory approval needed
Risk Management Committee	Roles and responsibilities to be defined; can be Board of Executive level	Board-level RMC applicable	Board-level RMC applicable
Business Conduct and Disclosure	Current guidelines applicable to NBFC-NDs; additional disclosure on type of exposure, customer complaints, related party transations, etc.	Additional disclosures	Similar to banks (SEBI-LODR)

Parameters	NBFC-Base Layer (NBFC-BL)	NBFC-Middle Layer (NBFC-ML)	NBFC-Upper Layer (NBFC-UL)
		OTHER REGULATORY ARBITRAGE	
Sensitive Sector Exposure (SSE)	Not Specified	(Board approved internal limits separately for capital market exposure and commercial real estate sector, supplemented by adequate disclosures; internal sub-limit within the CRE ceiling for financing land acquisition; Dynamic vulnerability assessment by NBFCs; Supervisory review	In addition to MBFC-ML, Board approved internal exposure limits on other important sectors of the economy; Internat Board approved limit on exposure to NBFC sector
Regulatory Restrictions on lending	Not Specified	Restrictions on grant of loans and advances for/to certain activities/entities	Same as NBFC-ML
IPO Financing	Not Specified	Ceiling of INR 1 crore per individual	Same as NBFC-ML
Sale of stressed assets	At par with banks	To be at par with banks	To be at par with banks
Core banking Solutions	Not mandatory	Mandatory for NBFCs with more than 10 branches	Same as NBFC-ML

ABOUT ENTERSLICE

We are a globally acclaimed Management Consulting Firm - a leading Legal Tech and CPA Firm that prides itself as a one-stop solution for entrepreneurs and corporate houses for their business setup worldwide.
We are a team of seasoned - Chartered Accountants, CPAs, Company Secretaries, Lawyers and other professionals, helping our clients achieve unmatched levels of growth.
From financial expertise to business advisory, from CFO solutions to regulatory assistance, we have solutions for all.

info@enterslice.com

www.enterslice.com

B-78 Sector 60, Noida
201301 Uttar Pradesh

Noida | Mumbai | Bengaluru | Chennai

Prepared by- Shivi Gupta
Legal Researcher | Enterslice