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Non-Banking Financial Companies

Implementation of proposed scale-based regulatory approach a positive for investors; NBFC-model likely to remain preferable vis a vis converting to a bank

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Executive Summary

Proposal for 4-layer structure with focus on harmonizing reporting, reducing lending arbitrage and increasing regulatory oversight, governance structure & disclosure requirements for larger entities

Better disclosures and higher regulatory oversight could boost investor/lender confidence

The Reserve Bank of India (RBI) released a discussion paper on January 22, 2021 on its proposal to implement a scale-based regulatory approach towards the non-banking financial company (NBFC) sector. While NBFCs have played a pivotal role in last-mile credit delivery and financial inclusion on the back of a relatively limited regulatory framework (vis-à-vis banks) in the recent past, the RBI notes that the steady increase in their size, complexity and interconnectedness to the overall financial system, especially of larger entities, warrants higher supervision and a regulatory and governance structure similar or close to banks.

In view of the increased systemic position of the NBFC (including housing finance companies (HFCs) and infra NBFCs) sector (about 33% in relation to the total bank assets as of March 2020) post the robust sectoral growth witnessed over the past 5-6 years, the RBI proposes a 4-layered structure for setting up a regulatory and supervisory framework. The proposed framework is basis the systemic positioning of an NBFC, its nature of activity and the perception of risk that it poses to the financial system. NBFCs could accordingly be classified as Base Layer (NBFC-BL), Middle Layer (NBFC-ML), Upper Layer (NBFC-UL) and Top Layer. The framework can be visualised as a pyramid with regulatory intervention being the least at the bottom of the pyramid (NBFC-BL) and increasing as one moves up.

The RBI proposes to up the entry barrier by increasing the minimum capital requirement sharply (Rs. 20 crore from Rs. 2 crore) for the segment to ensure that only serious players continue operations. It has proposed to harmonize non-performing assets (NPA) recognition to 90 days past due (dpd) across NBFCs and has guided on the augmentation of governance structures, implementation of better information technology (IT) & management tools (core banking for NBFC-ML and above entities) and an increase in the disclosure requirements as one moves up the pyramid.

ICRA notes that the RBI proposes no changes in the regulatory capital requirements for NBFC-BL and NBFC-ML and indicated towards the introduction of CET-I and leverage ratios for NBFC-UL, which may not impact most NBFCs given the capital buffers already maintained by them. However, the indication on the introduction of the Internal Capital Adequacy Assessment Process (ICAAP) for NBFC-ML and above and the process being subjected to the RBI's supervisory judgment may result in some entities, depending on their exposure risk profile, enhancing their capital buffers.

The RBI proposes to plug the arbitrage gaps between NBFCs and banks by restricting lending to certain segments/borrowers and implores closer monitoring of the exposures to sensitive sectors (capital markets, commercial real estate (CRE) and NBFCs) by way of a board-approved policy. Since the proposal progressively tightens the regulatory requirements as one moves up the pyramid, NBFC-UL would have capital, provisioning, credit concentration and listing/governance structures similar to banks.

ICRA notes that about 65% of the total NBFC assets, as of March 2020, could fall in the NBFC-UL category due to the concentrated nature of the sector and would be subjected to stringent norms/regulations. Therefore, growth for these would depend on them meeting capital (under ICAAP) and leverage requirements, as and when stipulated. NBFC-UL entities would have to comply with listing requirement, which are proposed to be like private sector banks. ICRA expects consolidation in sector especially in cases where these entities are part of larger group or subsidiaries of banks. While governance, disclosures, capital and credit related tightening is expected for the NBFCs, especially NBFC-UL, they still would have arbitrage over banks as proposal does not indicate requirement of regulatory investment [cash reserve ratio (CRR)/statutory liquidity ratio (SLR)] requirements, targeted lending (priority sector), etc, which are applicable for banks. Thus, NBFC-model would be preferable over converting into a bank; further, liability management would be more onerous post conversion to a bank, especially for larger entities.

Higher regulatory oversight and disclosures would be a credit positive as this would boost investor/lender confidence, which currently is the key as the NBFC sector is likely to face funding-related headwinds.

Scale-based Regulatory Framework Proposed For NBFCs

The RBI released a discussion paper on January 22, 2021 in which it proposes a 4-layered structure for setting up a regulatory and supervisory framework for NBFCs. While NBFCs have played a pivotal role in last-mile credit flow and financial inclusion on the back of relatively limited regulatory framework (vis-à-vis banks) in the recent past, the RBI notes that the steady increase in their size, complexity and interconnectedness to the overall financial system, especially of larger entities, warrants higher supervision.

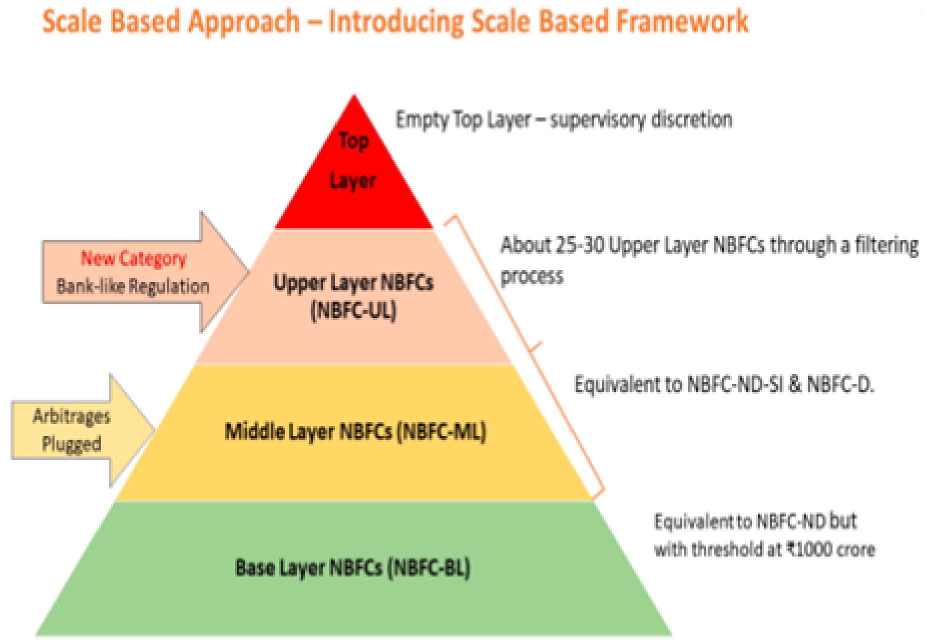
While NBFC regulations have been tightened regularly in the past, the regulatory arbitrage vis-à-vis banks remains in their favour. This has enabled operational flexibility for NBFCs and helped in the development of their sectoral/regional expertise, leading to a steep growth. Currently, NBFC (including HFCs and infra NBFCs) assets are about 33% in relation to the total banking sector's assets (~22-23% in March 2015).

The proposed framework is basis the systemic positioning of an NBFC, its nature of activity and the perception of risk that it poses to the financial system. NBFCs could accordingly be classified as Base Layer (NBFC-BL), Middle Layer (NBFC-ML), Upper Layer (NBFC-UL) and Top Layer, as depicted in Exhibit 1 with regulations progressively being tightened for the higher layers.

The regulatory framework for non-systemically important NBFCs (NBFC-ND) is proposed to be applicable to NBFC-BL with the proposal to tighten the entry criteria (higher minimum capital), harmonize some of the regulations (NPA recognition, etc) in line with larger NBFCs, and improve their governance and disclosures.

For NBFC-ML, the RBI proposes the regulatory framework applicable for systemically-important non-deposit taking NBFCs (NBFC-ND-SI)/deposit-taking NBFCs (NBFC-D). Additionally, entities in this category would have to undertake internal capital assessment, improve corporate governance/disclosures and internally monitor their exposure to sensitive sectors. Further, the RBI proposes a revision in the credit concentration norms and lending restrictions to certain segments, in line with the regulations applicable for banks, thereby plugging lending arbitrage. Entities in this segment (having more than 10 branches) would also be required to implement Core Banking Solution (CBS).

Exhibit 1: Proposed Framework Pyramid



Source: *RBI*

NBFC-UL and Top Layer are new categories. In addition to the regulations applicable for NBFC-ML, NBFC-UL entities would have some bank-like regulations which would include the introduction of CET-I and leverage ratios and differential provisioning. Further, they would have exposure norms and listing norms like banks and additional governance/disclosure requirements.

Detailed below are the revisions proposed in the regulatory framework of NBFCs depending on the layer applicable to them. Therefore, the current extant guidelines would continue to be applicable. The revisions proposed for the lower layers shall automatically be applicable to NBFCs in the higher layers.

1) Base Layer

The Base Layer is proposed to consist of NBFCs currently classified as NBFC-ND, Type-I NBFCs, NOFHC, NBFC-P2P and NBFC-AA[1]. NBFCs in this category shall largely continue to be subjected to the regulations that are applicable for NBFC-ND. The proposed revisions are detailed below:

Proposals	Impact Assessment
• **Revision in total assets threshold for systemically important (SI) classification of an NBFC to Rs. 1,000 crore from Rs. 500 crore**	- Entities with an asset base between Rs. 500 crore and Rs. 1,000 crore are already complying with the NBFC-ND-SI regulations and should thus be able to comply with NBFC-ND regulations
• **Increase in net owned fund (NOF) to Rs. 20.00 crore from Rs. 2.00 crore**	- Proposal is to up the entry barrier and facilitate adequate investment in governance & control structures and thereby improve entity-level resilience - NBFCs which operate with a smaller base, have localised operations and target borrower segment would have to enhance their capital base. While the RBI proposes to implement this over a defined time-frame, some non-serious players could exit and there could be some consolidation
• **Harmonization of NPA classification norms to 90+dpd from 180+dpd**	- Expect reported NPAs to go up for smaller entities (with asset size less than Rs. 500 crore), which followed the 180+ dpd norms in the past. This was observed when NBFC-D and NBFC-ND-SI moved to the 90+ dpd recognition norm in a phased manner. While there is no mention in the current circular for a phased implementation of for NBFC-BL, it is expected to be provided by the regulator
• **Role/responsibility of Risk Management Committee to be decided by the board** • **Improvement and diversification in board profile, with at least one director with experience in retail lending bank/NBFC** • **Higher disclosure regarding types of exposure, related-party transactions, customer complaints, etc**	- Largely governance and control guidelines, which could be met without significant constraint

[1] *NOFHC – Non-operating financial holding company, NBFC-P2P – NBFC peer to peer, NBFC-AA – NBFC account aggregators*

2) Middle Layer

The Middle Layer would consist of all NBFC-ND-SI and NBFC-D. NBFC-HFCs, infrastructure finance companies (IFCs), infrastructure debt funds (IDFs), standalone primary dealers (SPDs) and core investment companies (CICs), irrespective of their asset size, would be part of this layer (unless classified as Upper Layer). NBFC-ML entities are proposed to be subjected to the regulatory structure applicable for NBFC-ND-SI and NBFC-D at present. However, the RBI notes that adverse regulatory arbitrage, posing systemic risk, is required to be addressed and has proposed the following changes. Moreover, regulations applicable to NBFC-BL will be applicable to NBFC-ML.

Proposals	Impact Assessment
• **Capital requirement; currently total capital adequacy of minimum 15% with minimum Tier-I capital of 10% (12% for gold loan companies) – No change proposed** • **Proposal to introduce ICAAP based on various operational, market and financial risks**	- While there are no changes in the regulatory capital requirement, ICAAP assessment may require some entities to enhance their capital profile. As NBFCs currently compute capital as per Basel-I requirements, capital requirements for risks other than credit risk (i.e. operational risk, market risk and other risks), as decided by the board, would need to be bolstered - The RBI shall also apply its supervisory judgement on a case-to-case basis for the assessment and validation of the outcome of the ICAAP
• **Credit concentration norm to be considered on a combined credit + investment basis vis-à-vis separate caps of credit and investment and also combined caps as per the current guidelines** • **25% (for single borrower) and 40% (for group exposure) are similar to current guidelines; however, it is proposed to be as a proportion of Tier-I vis-à-vis owned funds currently (additional exposure of 5% [single borrower]/10% [group exposure] if used for infrastructure)**	- Exposure norms are proposed to be tightened somewhat by making it a proportion of tier I vis a vis owned funds in the past. It however is still lenient vis-à-vis banks, where the single borrower and group exposures are 20% and 25%, respectively
• **Statutory Auditor rotation after 3 years; would not be eligible for reappointment for 6 years after completion of the tenor**	- Significant tightening vis-à-vis the currently applicable requirement to rotate audit partners after 3 years for NBFC-D and NBFC-ND-SI; the proposed regulations are similar to the ones applicable for banks
• **Appointment of Chief Compliance Officer (CCO) with direct reporting to the Managing Director (MD) & Chief Executive Officer (CEO) and/or board/Audit Committee of board. In**	- Like banks, the RBI proposes an independent corporate compliance function for NBFCs. Skill requirements of the CCO for a bank include good understanding of

Proposals	Impact Assessment
case the CCO reports to the MD & CEO, the Audit Committee shall meet the CCO quarterly on a one-to-one basis	the industry and risk management, knowledge of regulations, legal framework and sensitivity to supervisors' expectations
• **Key managerial personnel – whole-time employees like CEO, Chief Financial Officer (CFO), Company Secretary (CS) and Whole Time Directors (WTD) will not hold any office (including directorships) in any other NBFC-ML or NBFC-UL** • **Independent director shall not be on the board of more than two NBFCs (NBFC-ML and NBFC-UL)**	- Controls to avoid conflict of interest
• **Additional disclosure norms** ▪ Corporate governance report like composition and category of directors, relationship between directors, shareholding of non-executive directors, etc ▪ Disclosure on modified (i.e. non-clean) opinion expressed by auditors, its impact on various financial items and views of management on audit qualifications ▪ Items of income and expenditure of exceptional nature ▪ Breach in terms of covenants, incidence/s of default ▪ Divergence in asset classification and provisioning based on inspection findings	- While some NBFCs report the mentioned disclosures voluntarily, mandatory requirement would streamline the format and timeliness - Divergence in asset classification/provisioning based on inspection finding, however, would provide insight into the regulator's view on the company as the RBI's inspection findings (divergence and others) are generally not disclosed as a part of NBFC reporting - Disclosure of other key RBI inspection findings (apart from asset classification/provisions) would provide greater insight to investors/lenders
• **Sensitive sector exposure (SSE)** ▪ RBI proposes board-approved internal limits separately for capital market exposure and commercial real estate (CRE) sector, supplemented by adequate disclosures ▪ Internal sub-limit within CRE ceiling for financing land acquisition ▪ Dynamic vulnerability assessment by NBFCs and periodic supervisory review ▪ Initial public offer (IPO) financing by individual NBFCs to fix a ceiling of Rs. 1.0 crore per individual for any NBFC	- As entities have tightened their SSE norms over the past 2 years, more so in view of the Covid-19 pandemic, compliance to the satisfaction of the regulatory review should not be difficult if applied in a phased manner - Fixing a low limit for IPO financing could impact fund flow to high net worth individuals (HNIs) during an IPO and thereby affect the overall subscription levels of the issue. IPO financing by NBFCs were largely funded via short-term commercial paper (CP; tenor of about 7-10 days). Thus, the IPO financing product of NBFCs is likely to be impacted significantly

Proposals	Impact Assessment
• **Regulatory restrictions on lending** ▪ To provide loans to companies to buy back shares/securities ▪ Granting loans and advances to directors, their relatives and to entities where the directors or their relatives have major shareholding (10% or more of the paid-up share capital) ▪ Granting loans and advances to officers and relatives of senior officers ▪ To extend finance for setting up new units consuming/producing ozone depleting substances ▪ NBFCs to ensure that borrowers have obtained prior permission from Government/local governments/other statutory authorities for the project, wherever required, while appraising loan proposals involving real estate	- These are largely restrictions for banks which are made applicable for NBFCs. While the entities have tightened most of these in the recent past, a restriction to these segments is the removal of the arbitrage that NBFCs currently have.
• **Guidelines for sale of stressed assets**	- Similar to banks is being proposed
• **CBS for NBFCs with more than 10 branches**	- One-time cost of transition and other recurring cost post implementation

3) Upper Layer

The Upper Layer shall include NBFCs which are identified as systemically significant. This would include the top 10 NBFCs and another 10-15 entities, based on a parameterised approach involving size, leverage, interconnectedness, substitutability, complexity, and nature of activity. Government-owned entities, which are currently in transition to comply with various requirements including CRAR, would not be classified as Upper Layer. Further, certain categories like CIC, NOFHC, IDF, NBFC-AA, NBFC-P2P and NBFC-mortgage guarantee company (NBFC-MGC) are not proposed to be subjected to the Upper Layer regulatory framework owing to their unique business models. Changes suggested are detailed below; regulations applicable to NBFC-ML will also be applicable to NBFC-UL. As per ICRA estimates, entities with an asset size of over Rs. 25,000 crore may fall in the Upper Layer, which could include about 6-8 HFCs and 19-22 NBFCs, accounting for about 65% of the total NBFC assets as on March 31, 2020.

Proposals	Impact Assessment
• **Capital and provisioning regulations** ▪ CET-I of 9% within Tier-I capital ▪ Leverage cap for NBFCs (to be stipulated) ▪ Differential standard asset provisioning, in line with banks (farm credit and SME@ 0.25%, CRE @ 1.00%, CRE-RH @ 0.75%, and all other loans @0.40% vis-à-a vis a flat rate of 0.4%)	- Most entities would comply with the CET-I requirement as the current minimum Tier-I requirement is 10% and they carry adequate buffer over the same. Further, very few entities have issued perpetual debt which qualifies for Tier-I - Do not expect any significant impact as most have an adequate capital structure and leverage (debt to equity). However, with the introduction of ICAAP and the ensuing supervisory actions, some entities may be required to bring down the leverage - Entities are following expected credit loss (ECL) model under IndAS and carry higher provision; however, implementation of differential standard asset provisions would up the floor requirements for entities operating in risky segments
• **Credit concentration norms and applicability of Large Exposure Framework with suitable adaptable**	- Norms tighter than NBFC-ML and similar to banks; however, implementation is proposed to be in phases
• **Listing and corporate governance structure like private banks; disclosure requirements to precede listing**	- While the RBI expects NBFC-UL to have a diffused ownership structure to minimise the possibility of abuse of dominance, entities which are a part of a larger corporate group or subsidiaries of other NBFCs and banks would be affected by the listing requirement. Some entities have been incorporated to get

Proposals	Impact Assessment
	regulatory arbitrage and limited disclosures; with the same being trimmed, there could be consolidation of these holdings/structures
• **Governance Structures** ▪ Qualified board member, independent director changes, group structure and remuneration policy	- Largely governance and control guidelines, which could be met without significant constraint
• **SSE** ▪ NBFCs may fix SSE ceilings based on internal board-approved policy; HFCs to be guided by applicable regulations for CRE ▪ Board-approved policy for sectoral exposures and limits on exposure to NBFC sector	- Tighter and defined exposure norms would alleviate credit concerns to some extent

4) Top Layer

Entities in the NBFC-UL category, if envisaged to pose systemic risks, would be moved to the top layer by the RBI. NBFCs in this layer will be subject to higher capital and more intensive supervisory oversight. The RBI notes that the legislative framework for NBFCs is different from banks and envisages to have a comprehensive legislative solution to address the issue of the resolution of failing NBFCs. The RBI expects this layer to be empty to start with.

Summary: ICRA notes that about 65% of the total NBFC assets, as of March 2020, could fall in the NBFC-UL category due to the concentrated nature of the sector and would be subjected to stringent norms/regulations. Therefore, growth for these NBFCs would depend on them meeting capital (under ICAAP) and leverage requirements, as and when stipulated. NBFC-UL entities would have to comply with listing requirement, which are proposed to be like private sector banks. ICRA expects consolidation in sector especially in cases where these entities are part of larger group or subsidiaries of banks. While governance, disclosures, capital and credit related tightening is expected for the NBFCs, especially NBFC-UL, they still would have arbitrage over banks as proposal does not indicate requirement of regulatory investment [cash reserve ratio (CRR)/statutory liquidity ratio (SLR)] requirements, targeted lending (priority sector), etc, which are applicable for banks. Thus, NBFC-model would be preferable over converting into a bank. Further, liability management would be more onerous post conversion to a bank, especially for larger entities.

Overall, higher regulatory oversight and disclosures would be a credit positive as this would boost investor/lender confidence, which is currently the key as the NBFC sector is likely to face funding-related headwinds.

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- Enhance the ability of borrowers/issuers to access the money market and the capital market for tapping a larger volume of resources from a wider range of the investing public;
- Assist the regulators in promoting transparency in the financial markets;
- Provide intermediaries with a tool to improve efficiency in the funds raising process.

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