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Non-Bank Finance Companies

Scale-based regulations positive from long-term perspective; cost of compliance to increase

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SUMMARY

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The Reserve Bank of India (RBI), via its circular of October 22, 2021, issued an integrated regulatory framework for non-banking finance companies (NBFCs) under scale-based regulations (SBR), providing a holistic view of the SBR structure and introducing a fresh set of regulations and respective timelines. These guidelines shall be effective from October 1, 2022 {except those pertaining to initial public offer (IPO) financing, which shall come into effect from April 1, 2022}. The key highlights of the circular are as follows:

- NBFCs are to be classified into four layers- Base Layer (NBFC-BL), Middle Layer (NBFC-ML), Upper Layer (NBFC-UL) and Top Layer (NBFC-TL). The RBI has classified the entities based on their size, the nature of activities they are involved in and their degree of business risk. The applicable regulations for one category of NBFCs will also be applicable for the categories above that segment
- The RBI has removed the 'Systemically Important' classification for NBFCs and has classified all non-deposit taking NBFCs (excluding few specific categories designated to be part of the higher layers) with asset size of less that Rs. 1,000 crore as NBFC-BL. Further, entities which are not directly into the lending business or do not have access to public funds or do not have customer interface are also proposed to be kept under this category. This category would have relatively relaxed regulatory and governance requirements compared to other higher category of NBFCs. Irrespective of the size, all deposit-taking entities are to be classified as NBFC-ML or above, depending on their size and other parameters applicable for NBFC-UL
- Higher net-owned fund (NOF) requirements is stipulated for Investment and Credit Companies (NBFC-ICC), Micro Finance Institutions (NBFC-MFI) and NBFC-Factors
- All NBFCs which do not follow the 90+ days past due for NPA recognition are required to make the transition by March 2026
- Tighter exposure limits for NBFC-ML and NBFC-UL; large exposure framework to be made applicable for NBFC-UL. A ceiling of Rs.1 crore per borrower for financing subscription to IPO.
- Increased corporate governance and disclosure requirements for entities across the layers
- NBFC-ML and NBFC-UL are required to make an internal capital assessment and maintain capital commensurate to their overall risk. Expect some increase in the capital maintained by the NBFCs in these categories. While the CET-I of 9% indicated for NBFCs are likely to be met without much hassle, the detailed guidelines around leverage and differential standard asset provisioning for NBFC-UL remain to be seen.
- NBFC-UL is expected to include the top 10 NBFCs and the entities will be assessed on the basis of scoring across various parameters and as per the RBI' supervisory judgment. Also, NBFCs classified in the upper layer would generally be eligible to move out of the enhanced regulatory framework only if they do not meet the criteria for classification for five consecutive years. The broadening of the UL layer vis-a-vis the draft circular and the stickiness of the entities in this segment indicate the RBI's views on the NBFC segment from a systemic risk perspective.

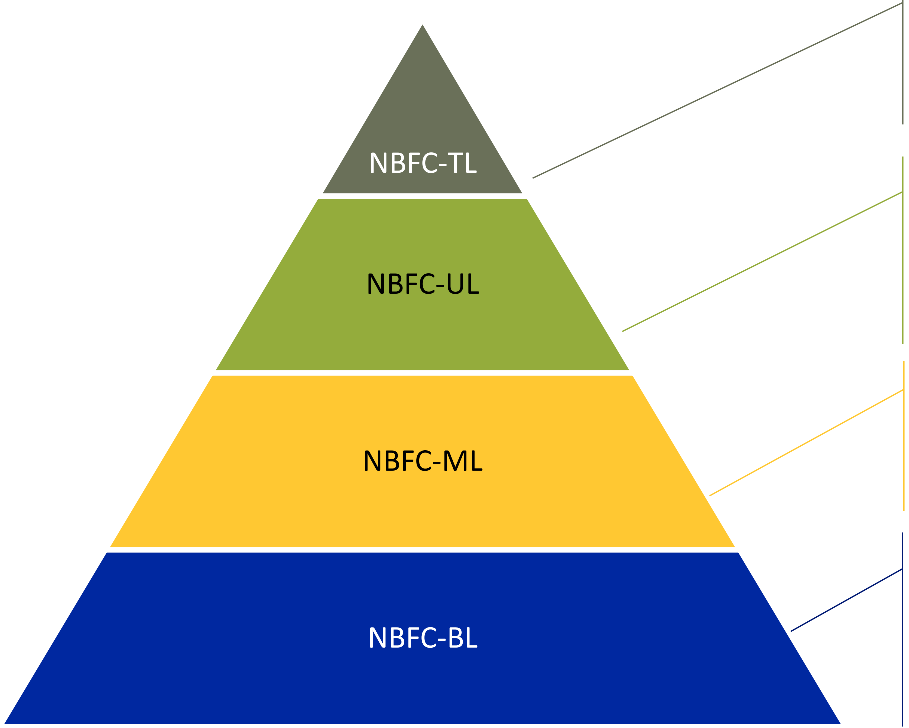
- Govt-owned NBFCs are not to be included in the upper layer at this juncture. Regulations for NBFCs not availing public funds and not having customer interface will not be affected by these guidelines; separate guidelines for these entities are expected in the future.

To sum up, ICRA expects that entities comprising a sizeable share of the total NBFC assets, may fall in the NBFC-UL category due to the concentrated nature of the sector and the larger entities would be subjected to tighter norms/regulations. 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 expected 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.

FOUR-LAYERED REGULATORY FRAMEWORK FOR ENHANCED SUPERVISION

The RBI released a discussion paper on December 22,2020 in which it proposed a layered structure for framing a regulatory and supervisory framework for NBFCs. Over the past few years, NBFCs have played a pivotal role in last-mile credit flow and financial inclusion on the back of a relatively limited regulatory framework vis-a-vis banks. The RBI, however, notes that the steady increase in the size, complexity and interconnectedness of NBFCs to the overall financial system, especially of the larger entities, warrants higher supervision. NBFC regulations have been regularly tightened in the past even as the regulatory arbitrage vis-a-vis banks remained in their favor. This has enabled operational flexibility for NBFCs and aided in the development of their sectoral/regional expertise, leading to a steep growth. Currently, NBFC (including HFC and infra NBFCs) assets are about 1/3rd in relation to the total banking sectors assets (~22-23% in March 2015).

The RBI, via its circular of October 22, 2021, is implementing a scale-based regulatory (SBR) structure under which NBFCs would be classified into four layers as detailed below.



Designed to be empty - reserved for NBFCs to be specifically designated so by RBI

Category to be populated by large entities, which would be assessed on parameters, including their importance to the financial system and complexity of their operations

Category to be populated by mid-sized NBFCs (Including deposit taking entities)

Category to be populated by non-depositing taking and small-sized NBFCs and the NBFCs, which do not have focus on lending or do not avail public finds or have customer interface

The RBI has classified the entities based on their size, the nature of activity they are involved in and their degree of business risk. The RBI has removed the 'Systemically Important' classification of NBFCs and has classified all non-deposit taking NBFCs with asset size of less that Rs. 1,000 crore (barring NBFC-CIC, NBFC-IFC and NBFC-HFC) as NBFC-BL. Further, entities which are not directly into the lending business or have access to public funds or have customer interface are also proposed to be under this category. This category would have relatively relaxed regulatory or governance requirements compared to the higher category of NBFCs.

Irrespective of the size, all deposit-taking entities are to be classified as NBFC-ML or above, depending on their size and other parameters applicable for NBFC-UL. From October 1,2022, the nomenclatures pertaining to NBFC-D, NBFC-ND and NBFC-ND-SI are to be replaced with the scale-based nomenclature. The applicable regulations for one category of NBFCs would also be applicable for categories above that particular segment.

NBFC-UL is expected to include the top ten NBFCs in terms of their total assets, further top 50 (excluding the top 10) would be subjected to a scoring exercise based on their size, leverage, interconnectedness, complexity, nature of liabilities, group structure and segmental exposure. Entities classified as NBFC-UL by the RBI would have to comply with the enhanced regulations for UL for a period of five years, even if they do not meet the parameters in the subsequent years.

The RBI has enhanced the regulatory minimum net-owned funds (NOF) for NBFC-ICC, NBFC-MFI and NBFC-Factors to Rs.10.0 crore, while not touching the NOF requirement for other segments. While the same is lower than the levels (Rs. 20.0 crore) prescribed in the draft circular, this is likely to up the entry barrier and ensure that only serious players continue operations. All NBFCs which do not follow the 90+ days past due for NPA recognition are required to make the transition to the same by March 2026 in a phased manner.

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

NBFCs in the middle and upper layers are expected to monitor their exposure to sensitive sectors (capital markets, commercial real estate and NBFCs) by way of a board-approved policy. Since the proposal progressively tightens the regulatory requirements as one moves up the pyramid, "Large Exposure Framework" (LEF) is expected to be introduced for NBFC-UL. NBFC-UL would also have listing and some governance structures like banks. RBI has augmented the 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.

Detailed below is a table on the classification of various NBFCs under the SBR approach.

Exhibit 1: NBFC classification under the SBR approach

<table>
<tr><th colspan="2">Based on size</th><th colspan="4">Based on activity</th></tr>
<tr><td>NBFC-BL</td><td>1) Non-deposit taking NBFCs below the asset size of Rs. 1,000 crore (NBFC-ND)</td><td>(i) NBFC-Peer to Peer Lending Platform (NBFC-P2P),
(ii) NBFC-Account Aggregator (NBFC-AA),
(iii) Non-Operative Financial Holding Company (NOFHC) and
(iv) NBFCs not availing public funds and not having any customer interface</td><td></td><td rowspan="2">Government owned NBFCs shall be placed in the Base or Middle Layer, as the case may be</td><td rowspan="3">NBFC-ICC, NBFC-MFI, NBFC-Factors and mortgage guarantee companies (NBFC-MGC) could lie in any of the layers of the regulatory structure depending on the parameters of the scale based regulatory framework.</td></tr>
<tr><td>NBFC-ML</td><td>1) Non-deposit taking NBFCs with asset size of Rs. 1,000 crore and above (NBFC-ND SI) and not identified as NBFC-UL</td><td>(i) Standalone Primary Dealers (SPDs),
(ii) Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFCs),</td><td rowspan="2">(i) All deposit taking NBFCs (NBFC-Ds), irrespective of asset size
(ii) Core Investment Companies (CICs)
(iii) Housing Finance Companies (HFCs)
(iv) Infrastructure Finance Companies (NBFC-IFCs).</td></tr>
<tr><td>NBFC-UL</td><td>1) Top ten eligible NBFCs in terms of their asset size shall always reside in the upper layer, irrespective of any other factor.
2) Apart from the above, entities specifically identified by the RBI, based on a set of parameter-based scoring would be included in this category.</td><td></td><td></td></tr>
<tr><td>NBFC-TL</td><td colspan="5">RBI may classify entities to this category from the NBFC-UL category, in case any entity in NBFC-UL pose systemic risk</td></tr>
</table>

REGULATORY CHANGES UNDER SBR APPLICABLE FOR ALL LAYERS

1) **Increase in net-owned funds (NOF)-** *The increase in the NOF has been lower than the proposed level of Rs.20.0 crore in the draft guideline of Jan 2021, further the increase was effected only in a few segments of NBFCs which were perceived to be more risky*

Exhibit 2: NOF for various NBFC categories based on the nature of activity

(Amount in Rs. crore)	Current minimum NOF requirement	Revised NOF requirement by March 31, 2025	Revised NOF requirement by March 31, 2027	Impact
NBFC-ICC	2.0	5.0	10.0	Increased Minimum Capital Requirement
NBFC-MFI	5.0 (2.0 for NE)	7.0 (5.0 for NE)	10.0	
NBFC -Factors	5.0	7.0	10.0	
NBFC-P2P/NBFC-AA/NBFC-Type I	2.0	2.0	2.0	No Change
NBFC-IDF/NBFC IFC	300.0	300.0	300.0	
NBFC-MGC	100.0	100.0	100.0	
HFC	20.0	20.0	20.0	
NBFC-SPD	150.0 250.0	150.0 250.0	150.0 250.0	

2) **NPA classification-** Harmonisation of NPA classification is in line with the draft circular. Entities not following the 90+ day norm for reporting NPAs would have to follow the 150+ day basis classification by March 2024, 120+ basis classification by March 2025 and 90+ day basis by March 2026. *The proposed timelines for implementation is relatively liberal compared to what was applicable for NBFC-ND-SI and NBFC-D in FY2015, when they were required to move to 90 days reporting in by March 2018.*

3) **Experience of the board -** At least one of the directors on the board is expected to have the relevant experience of having worked in a bank/NBFC. *This requirement is expected to be tighter for NBFCs in the higher layers and most entities are expected to comply with this requirement without much issues. Some small and promoter-driven NBFCs in the NBFC-BL segment may find this requirement challenging.*

4) **Ceiling on IPO funding** – There is a ceiling of Rs.1 crore per borrower for financing subscription to IPO. NBFCs are guided to fix more conservative limits. *More than 50% of the CP issuances by NBFCs (including HFCs) between Oct. -20 and Sept. 21 was for a tenor of seven days or lower (about 57% had a tenor of 10 days or lower); a sizeable portion of this is estimated to be for IPO financing. Typically, the CP rates for IPO financing is also higher than the levels at which an entity raises CP for its other lending operations. The current move is to control the high-ticket and wholesale exposures in this category. However, 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.*

REGULATORY CHANGES UNDER SBR APPLICABLE FOR NBFC-ML AND NBFC-UL

Capital guidelines

Exhibit 3: Capital guidelines for NBFC-ML and NBFC-UL

	I CAAP	Common Equity Tier-I (CET-I)	Leverage	Provisioning
	NBFC-ML/NBFC-UL	NBFC-UL	NBFC-UL	NBFC-UL
NBFC-ML	Internal risk assessment to be done and commensurate capital to be maintained. While assessment is guided to be done similar to the pillar 2 approach; the same is not insisted upon presently	NA	NA	NA
NBFC-UL		Min CET-1 of 9%	RBI to prescribe leverage	Differential provisioning depending on the asset class
Impact	*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 assessed. On a base case, the capital requirement may go up by up to 10%, from current levels, for some of the entities.*	*CET-I requirement is new, however the same is expected to be met comfortably as there are very few entities which have hybrid tier-I instruments. Further, most entities presently have a fairly comfortable buffer over the current tier-I requirements (current Tier-I requirement is 10%)**	*Leverage was not a requirement for NBFC-ND-SI and NBFC-D in the past. RBI however is expected to place leverage caps for NBFC-UL.*	*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*

**12% for the gold loan companies*

A detailed circular on CET-I, leverage and provision is expected from the RBI going forward.

Prudential guidelines

Exhibit 4: Prudential guidelines for NBFC-ML and NBFC-UL

	Concentration of credit/investment	Sensitive Sector Exposure (SSE)	Lending restrictions	LEF	Internal exposure limit
NBFC-ML	Concentration limits for NBFCs merged on total exposure basis vis a vis separate limits for lending and investments in the past. Exposure limit fixed at 25% for single borrower/ party and 40% for single group of borrowers/ parties.	Board-approved internal limits for SSE separately for capital market and commercial real estate exposures	Loan to senior officer, directors and entities where they have major shareholding Regulatory and statutory approval for projects finance		
NBFC-UL	The concentration limits shall be determined with reference to the NBFC's Tier 1 capital instead of their Owned Fund. NBFC-UL shall follow these norms till Large Exposure Framework is put in place for them. Other concentration norms for different categories of NBFC, to continue to remain applicable.			Large Exposure Framework (LEF)	NBFC-UL to determine internal exposure limits on sectors other than SSE. NBFC-UL to have an internal Board approved limit for exposure to the NBFC sector.
Impact	*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*	*Entities have tightened their SSE norms over the past 2-3 years, in view of the stress in the wholesale book and further on account of the pandemic. Further, checks are being put in place for intra group or related transactions. Thus, compliance to the satisfaction of the regulatory requirement should not be difficult if applied in a phased manner.*		*The single party and group exposure norms could get tighter for NBFC-UL when LEF is applied*	*Not expected to have any significant impact. The same could however supplement existing prudent risk management.*

Governance guidelines

For NBFC-BL (would be applicable for categories above this segment too)

Exhibit 5: Governance guidelines for NBFC-BL

Particulars	Risk Management Committee	Disclosure	Loans to directors, relatives and other senior officials
Details	A Board level or an Executive level committee to be constituted to evaluate overall risks	Improved disclosures of exposure, related party transactions, and customer complaints	Board approved policy required
Impact	*Positive for smaller NBFCs from a governance perspective, which would provide comfort to various external stakeholders but cost of compliance would go up*		

For NBFC-ML and NBFC-UL

Exhibit 6: Governance guidelines for NBFC-ML and NBFC-UL --I

Particulars	Key Managerial Personnel	Independent Directors	Additional disclosures	Chief Compliance Officer
Details	KMP to not hold any position in other NBFC ML or UL (except subsidiaries).	Independent Directors should not be on the Board of more than three entities	1) Breach of financial covenants 2) Divergence in Asset quality and provisions 3) Exceptions income/ expenses 4) Impact of any modified Auditor opinion on financial performance 5) Corporate governance report on Director composition and shareholding in the company	Independent and senior position for ensuring strong compliance risk management framework
Impact	• *KMP and Independent director are to avoid conflict of interest* • *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*			*Like banks, the RBI proposes an independent corporate compliance function for NBFCs. Skill requirements of the CCO for a bank include good understanding of the industry and risk management, knowledge of regulations, legal framework and sensitivity to supervisors' expectations*

Exhibit 7: Governance guidelines for NBFC-ML and NBFC-UL --II

Particulars	Compensation Guidelines	Other Governance matters	Core Banking Solution
Details	Constitution of a remuneration and compensation committee and defined compensation structure	Clearly defined roles of various Board committees Good whistle blower mechanism and policy to monitor subsidiaries	NBFCs with 10 and more branches are mandated to adopt Core Banking Solution. A glide path of 3 years with effect from October 01, 2022 is being provided.
Impact	*Largely governance related and is expected to be easily complied with.*		*One-time cost of transition and other recurring cost post implementation*

For NBFC UL

Exhibit 8: Governance guidelines specifically for NBFC-UL

Particulars	Board members	Removal of independent directors	Listing requirement
Details	Board to consist of members with commensurate, expertise, experience and qualification basis the complexity of the NBFC operations	NBFC-UL shall be required to report to the supervisors in case any Independent Director is removed/ resigns before completion of his normal tenure.	To be listed within three years of being identified as an NBFC-UL
Impact	*Most entities are expected meet these requirements*		*Could impact NBFCs which are part of large groups. We expected the NBFC-UL classification to be basis the entity level and some group which have listed their holding companies may have to list their large subsidiaries e.g Tata, HDFC, L&T, IIFL etc*

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