ICRA

Non-banking Financial Companies

RBI's NBFC-UL list largely in line with expectations

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RBI's list of NBFCs in the NBFC-UL under SBR for NBFCs largely in line with expectations

Significant impact on operations not expected as issuers are largely in compliance with enhanced requirements and/or have sufficient time to comply with the requirements

Cost of compliance to increase

On September 30, 2022, the Reserve Bank of India (RBI) released the list of non-banking financial companies (NBFCs) in the Upper Layer (NBFC-UL) under the Scale Based Regulations (SBR) for NBFCs. The RBI had issued an integrated regulatory framework, earlier in October 2021, for NBFCs under SBR, providing a holistic view of the SBR structure and introducing a fresh set of regulations and respective timelines. These SBR guidelines are effective from October 1, 2022 and the NBFC-UL list has been issued accordingly.

- ***The NBFC-UL entities would be subjected to tighter norms/regulations and their growth would depend on them meeting the capital (under internal capital adequacy assessment process – ICAAP) and leverage requirements, as and when stipulated. NBFC-UL entities would have to comply with the listing requirements, which are expected to be like private sector banks. ICRA expects consolidation in the sector, especially in cases where these entities are a part of a larger group or are subsidiaries of banks. While governance, disclosures, capital, and credit-related tightening have been stipulated, especially for NBFC-UL entities, they would still have arbitrage over banks as the proposal does not indicate the requirement of regulatory investments [cash reserve ratio (CRR)/statutory liquidity ratio (SLR)] requirements, targeted lending (priority sector), etc, which are applicable for banks. Thus, the 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***
- Under SBR, 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 their activities and the degree of business risk. The regulations applicable for one category of NBFCs will also be applicable for the categories above that segment
- The 'Systemically Important' classification for NBFCs has been removed and all non-deposit taking NBFCs (excluding a few specific categories designated to be a part of the higher layers) with an asset size of less than Rs. 1,000 crore have been classified as NBFC-BL. Further, entities which are not directly in the lending business or do not have access to public funds or do not have customer interface are proposed to be kept in this category. This category will have relatively relaxed regulatory and governance requirements compared to other higher categories of NBFCs. Irrespective of size, all deposit-taking entities are to be classified as NBFC-ML or above, depending on their size and the other parameters applicable for NBFC-UL
- Higher net owned fund (NOF) requirement is stipulated for investment and credit companies (NBFC-ICC), microfinance institutions (NBFC-MFI) and NBFC-Factors
- All NBFCs which do not follow the 90+ days past due for the recognition of non-performing advances (NPAs) are required to make the transition by March 2026
- Tighter exposure limits for NBFC-ML and NBFC-UL; large exposure framework (LEF) to be made applicable for NBFC-UL
- Increased corporate governance and disclosure requirements for entities across the layers

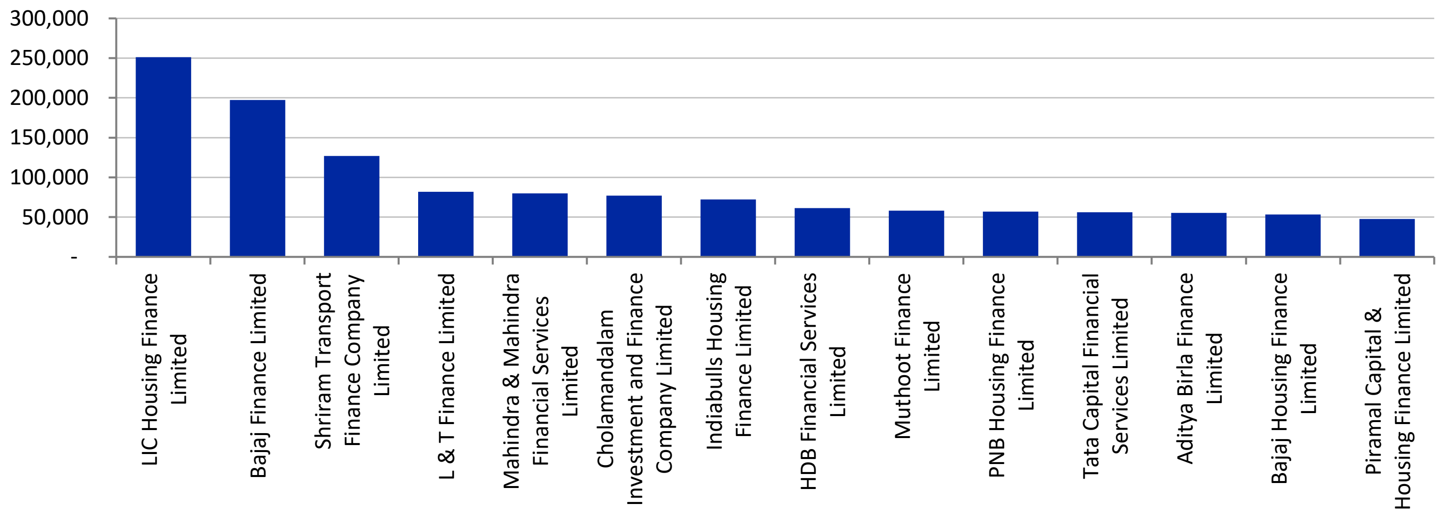
- NBFC-ML and NBFC-UL are required to make an internal capital assessment and maintain capital commensurate with their overall risk. Expect some increase in the capital maintained by the NBFCs in these categories. While the CET-I of 9% indicated for NBFCs is likely to be met without much hassle, the detailed guidelines around leverage and differential standard asset provisioning for NBFC-UL remain to be seen
- Government-owned NBFCs are not included in the UL 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
- SBR specifies that the UL shall comprise those NBFCs which are specifically identified by the RBI on a set of parameters and scoring methodology as provided in the framework. The framework also envisages that the top 10 NBFCs, in terms of the asset size, shall always reside in the UL. The following NBFCs have been identified for categorisation as NBFC-UL under the framework:

Name of entity	Classification
LIC Housing Finance Limited	Deposit-taking HFC
Bajaj Finance Limited	Deposit-taking NBFC-ICC
Shriram Transport Finance Company Limited	Deposit-taking NBFC-ICC
Tata Sons Private Limited	CIC
L&T Finance Limited	Non-deposit taking NBFC-ICC
Indiabulls Housing Finance Limited	Non-deposit taking HFC
Piramal Capital & Housing Finance Limited	Non-deposit taking HFC
Cholamandalam Investment and Finance Company Limited	Non-deposit taking NBFC-ICC
Shanghvi Finance Private Limited	Non-deposit taking NBFC-ICC
Mahindra & Mahindra Financial Services Limited	Deposit-taking NBFC-ICC
PNB Housing Finance Limited	Deposit-taking HFC
Tata Capital Financial Services Limited	Non-deposit taking NBFC-ICC
Aditya Birla Finance Limited	Non-deposit taking NBFC-ICC
HDB Financial Services Limited	Non-deposit taking NBFC-ICC
Muthoot Finance Limited	Non-deposit taking NBFC-ICC
Bajaj Housing Finance Limited	Non-deposit taking HFC

- In its earlier note released in October 2021, ICRA had highlighted that it expected 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. ICRA had also mentioned that the larger entities would be subjected to tighter norms/regulations. As per ICRA's estimates, 15 of the NBFCs in the above-mentioned list (except Tata Sons Private Limited) constituted over 30% of the overall NBFC industry's assets under management (AUM; 49% of NBFC + housing finance companies (HFCs; excluding NBFC-Infra) assets) as on March 31, 2022.

- The NBFCs mentioned in the list are required to place a board-approved policy for the adoption of the enhanced regulatory framework applicable to NBFC-UL and chart out an implementation plan for adhering to the new set of regulations latest by the end of December 2022. Further, the boards of these NBFCs are required to ensure that the stipulations prescribed for the NBFC-UL are adhered to within a maximum period of 24 months, i.e. latest by September 2024
- Most of the entities classified as NBFC-UL have an AUM of over Rs. 50,000 crore. In some cases, while the asset size is lower, the market value of the investments has been significantly high, possibly leading to the inclusion of such entities in the list. Despite appearing in the list of the top 10 NBFCs in terms of the asset size, HDFC Limited has not been included in the list of NBFC-UL due to the ongoing merger process

Exhibit: AUM of NBFC-UL as on March 31, 2022 (Rs. crore)



Source: ICRA Research and annual reports of these issuers

The following section covers the various requirements for the NBFC-UL entities and their positioning on some of these parameters.

REGULATORY CHANGES UNDER SBR APPLICABLE FOR NBFC-UL

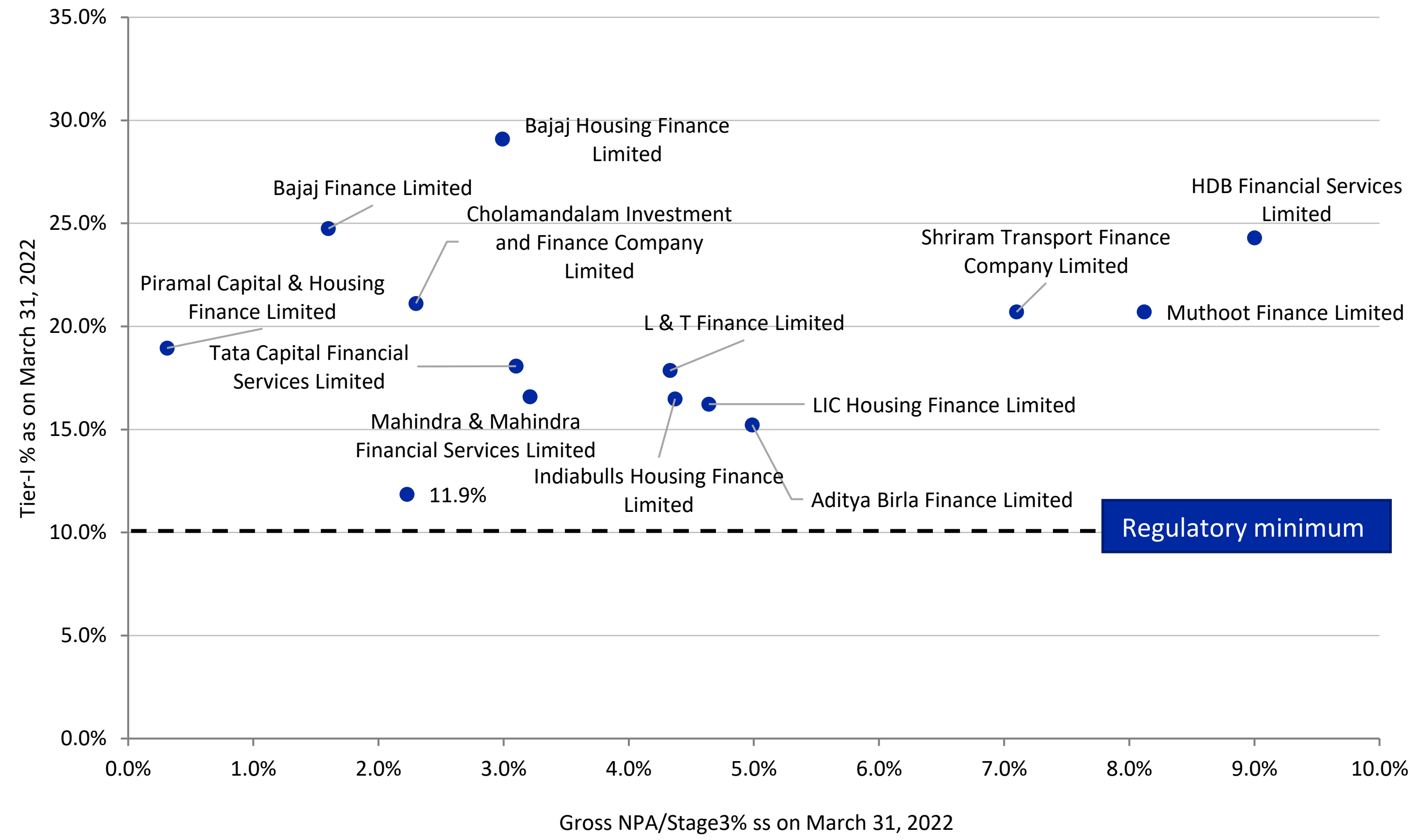
Capital guidelines

Exhibit: Capital guidelines for NBFC-UL

	ICAAP	Min CET-I of 9%	Leverage	Provisioning
NBFC-UL	Internal risk assessment to be done and commensurate capital to be maintained While assessment is guided to be similar to the pillar 2 approach, the same is not insisted upon at present	Min CET-I 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 the current levels for some entities*	CET-I requirement is new, though it is expected to be met comfortably as very few entities have hybrid Tier-I instruments. Further, most entities have a fairly comfortable buffer at present over the current Tier-I requirement (current Tier-I requirement is 10%)*	*Leverage was not a requirement for NBFC-ND-SI and NBFC-D in the past. The RBI is, however, expected to place leverage caps for NBFC-UL. The circular on this is awaited*	*Entities are following the expected credit loss (ECL) model under IndAS and carry higher provisions; however, implementation of differential standard asset provisions would up the floor requirements for entities operating in risky segments*

**12% for gold loan companies*
Note: NBFC-ND-SI – Systemically important non-deposit accepting NBFCs; NBFC-D – Deposit accepting NBFC

Exhibit: Positioning of NBFC-UL entities basis Tier-I capital % as on March 31, 2022



Source: ICRA Research and annual reports of these issuers

Prudential guidelines

Exhibit: Prudential guidelines for NBFC-UL

	Concentration of credit/investment	Sensitive sector exposure (SSE)	Lending restrictions	LEF	Internal exposure limit
NBFC-UL	Concentration limits for NBFCs merged on total exposure basis vis-à-vis separate limits for lending and investments in the past. Exposure limit fixed at 20% for single borrower/party (additional 5% allowed subject to board approval) and 25% for single group of borrowers/parties (additional 10% allowed subject to board approval). Additional 5%/10% exposure for single/group counterparty permitted in case of NBFC-UL-IFC. The concentration limits shall be determined with reference to the NBFC's Tier-I capital instead of its owned fund	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 project finance	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 NBFC sector
Impact	*Exposure norms are proposed to be tightened somewhat by making the same a proportion of the Tier-I capital vis-à-vis owned funds in the past. This is in line with the requirement for banks.*	*Most of these entities have tightened their SSE norms over the past 2-3 years, in view of the stress in the wholesale book and also on account of the Covid-19 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*		*Single party and group exposure norms could get tighter for NBFC-UL when LEF is applied*	*Not expected to have a significant impact. The same could, however, supplement the existing prudent risk management policies*

Governance guidelines

Exhibit: Governance guidelines for NBFC-UL – I

Particulars	KMP	Independent directors	Additional disclosures	CCO
Details	Key managerial personnel (KMP) to not hold any position in other NBFC-ML or UL (except subsidiaries)	Independent directors should not be on the boards of more than three entities	▪ Breach of financial covenants ▪ Divergence in asset quality and provisions ▪ Exceptional income/expenses ▪ Impact of any modified auditor opinion on financial performance ▪ 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 findings would, however, 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 has proposed an independent corporate compliance function for NBFCs. The skill set of the Chief Compliance Officer (CCO) of a bank includes good understanding of the industry and risk management, knowledge of regulations, legal framework and sensitivity to supervisors' expectations*

Exhibit: Governance guidelines for NBFC-UL -- II

Particulars	Compensation guidelines	Other governance matters	Core banking solution
Details	Constitution of a Remuneration and Compensation Committee and a defined compensation structure	Clearly defined roles of various board committees Good whistleblower mechanism and policy to monitor subsidiaries	NBFCs with 10 and more branches are mandated to adopt a core banking solution. A glide path of three years with effect from October 01, 2022 has been provided
Impact	*Largely governance related and in place for most entities. Also, can be easily complied with if required*		*One-time cost for transition and other recurring costs, post implementation*

Exhibit: Governance guidelines, specifically for NBFC-UL (not applicable to lower categories)

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's operations	NBFC-UL shall be required to report to the supervisors if 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*		*Six entities (L&T Finance Limited, Piramal Capital & Housing Finance Limited, Tata Capital Financial Services Limited, Aditya Birla Finance Limited, HDB Financial Services Limited, Bajaj Housing Finance Limited) are unlisted and would require to be listed within the next three years*

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ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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- Provide intermediaries with a tool to improve efficiency in the funds raising process.

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