ERGO

RBI notifies scale based regulatory framework for NBFCs

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Introduction

In the past few decades, non-banking financial companies (NBFCs) have played a very critical role in the growth of the Indian financial services landscape. The NBFC eco-system has efficiently supported the formal banking system by providing access to credit and other financial services to various sections of the Indian industry. Over the years, the Reserve Bank of India (RBI) has also closely regulated the operations of NBFCs, and has been rationalizing the applicability of stricter regulations based on their asset size.

In January 2021, the RBI had mooted a new regulatory approach for NBFCs through its discussion paper titled '*Revised Regulatory Framework for NBFCs - A Scale-based Approach*' (Discussion Paper). On 22 October 2021, the RBI issued a notification on '*Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCs*' (SBR Framework). The SBR Framework will come into effect from 1 October 2022 (except for certain compliance requirements relating to funding of initial public offerings (IPOs) which would be effective from 1 April 2022).

Revised Categorisation of NBFCs

- Current Categorisation

  - Presently, NBFCs are categorised on the basis of: (a) type of liabilities and asset size of the NBFCs; and (b) nature of activities undertaken by the NBFCs.

  - With respect to type of liabilities, NBFCs are classified as deposit-accepting NBFCs (NBFC-D) and non-deposit accepting NBFCs. Further, based on their asset size, non-deposit accepting NBFCs are further classified into systemically important NBFCs having an asset size of more than INR 500 crores (NBFC-ND-SI) and non-systemically important NBFCs having an asset size of less than INR 500 crores (NBFC-ND).

  - NBFCs are also classified and regulated under separate buckets based on the nature of activities conducted by them. The various types of NBFCs and the activities undertaken by them are outlined in the following table.

TYPE OF NBFC	PURPOSE / NATURE OF ACTIVITIES
Investment and credit companies (NBFC-ICC)	Lending, asset financing and investments
Micro finance institution (NBFC-MFI)	Microfinance business
Factors (NBFC Factors)	Factoring business
Housing finance companies (HFC)	Housing finance business
Infrastructure finance company (NBFC-IFC)	Infrastructure finance business
Infrastructure debt fund (IDF-NBFC)	Investment in public-private partnerships
Core investment company (CIC)	Investment in shares and securities
Mortgage guarantee company (NBFC-MGC)	Furnishing mortgage guarantees to housing finance lenders

TYPE OF NBFC	PURPOSE / NATURE OF ACTIVITIES
Non-Operative financial holding company (NOFHC)	Holding shares of a banking company
Peer to peer lending platform (NBFC-P2P)	Operating a P2P lending platform
Account aggregator (NBFC-AA)	Account aggregation business
Standalone Primary Dealers (SPD)	Investing in government securities market

- Revised Categorisation under the SBR Framework

Under the SBR Framework, the RBI has introduced four scale-based layers for regulating NBFCs (base layer, middle layer, upper layer, and top layer). Going forward, all NBFCs will be bucketed and regulated under one of these layers. The table below sets out the composition of NBFCs under each of these layers, and the related conditions imposed by the RBI.

SCALE BASED LAYERS	COMPOSITION AND RELATED CONDITIONS
Base Layer (NBFC-BL)	▪ Non-deposit accepting NBFCs (including NBFC-ICC, NBFC-MFI, NBFC-Factor and NBFC-MGC) with asset size of less than INR 1,000 crores ▪ NBFC-P2P ▪ NBFC-AA ▪ NOFHC ▪ NBFCs not availing public funds and not having any customer interface *Of these NBFCs, only non-deposit accepting NBFCs can be shifted to the other layers*
Middle Layer (NBFC-ML)	▪ NBFC-D ▪ Non-deposit accepting NBFCs (including NBFC-ICC, NBFC-MFI, NBFC-Factor and NBFC-MGC) with asset size of more than INR 1,000 crores ▪ HFC ▪ CIC ▪ NBFC-IFC ▪ IDF-NBFC ▪ SPD *All of these NBFCs can be shifted to the upper layer (except IDF-NBFCs and SPDs, which will always remain in the middle layer)*
Upper Layer (NBFC-UL)	▪ These include NBFCs which are specifically identified by the RBI for being subject to enhanced regulatory requirements ▪ Top 10 NBFCs based on their asset size will always fall in the upper layer

SCALE BASED LAYERS	COMPOSITION AND RELATED CONDITIONS
	▪ RBI to scrutinise top 50 NBFCs based on their total exposure or identify any other NBFCs (as per its supervisory judgment) for inclusion in the upper layer ▪ Detailed scoring methodology prescribed for identification of NBFCs based on quantitative parameters (such as size, leverage, interconnectedness, and complexity) and qualitative parameters (such as quality of liabilities on its balance sheet, group structure, and segment penetration) ▪ Selected NBFCs will be intimated by the RBI and must adopt a policy approved by the board of directors (Board) for enhanced regulatory framework within three months, and must implement such framework within 24 months ▪ Once categorised in the upper layer, NBFCs must mandatorily remain in the upper layer for a period of five years, irrespective of whether they meet the scoring criteria or not
Top Layer (NBFC-TL)	▪ RBI to identify and shift NBFCs from upper layer to top layer if it is of the opinion that such NBFCs carry substantial potential systemic risk ▪ RBI to specifically communicate higher capital requirements for such NBFCs at the time of their categorisation into the top layer ▪ Such NBFCs will be subject to enhanced and intensive supervisory engagement by the RBI ▪ RBI may not categorise any entity in the top layer if it does not perceive any systemic risk with respect to NBFCs in the upper layer

Comment: With the introduction of these scale-based layers of NBFC categorisation, the RBI is doing away with the earlier classification of NBFCs based solely on their asset size (into systemically important and non-systemically important NBFCs). The new framework takes into account both asset-size based categorisation (with the RBI prescribing a threshold of INR 1,000 crores for NBFCs in the middle layer as against the earlier threshold of INR 500 crores for systemically important NBFCs), as well as categorisation of high-risk NBFCs through specified quantitative and qualitative parameters. Such categorisation will enable the RBI to closely monitor NBFCs which are unable to manage their funding positions and repay their liabilities in a timely manner, and put in place specific corporate governance and prudential norms for such potential high-risk NBFCs (which if remain unchecked and unregulated, could adversely affect the larger financial eco-system).

That being said, the RBI could have considered including a specific category in the base layer for NBFCs which have no customer interface and have not accepted any public funds. Such NBFCs do not undertake any business except for holding shares / investments. While the RBI has mentioned its intention to separately deal with such NBFCs, given these provisions itself come in force from October 2022, such NBFCs may not expect a prompt action on this issue.

Key regulatory changes under the SBR Framework

➢ Applicability of existing regulations / directions issued by the RBI

- The RBI has clarified that the existing regulations and directions notified for NBFCs will continue to apply other than the changes introduced under the SBR Framework.

- On and from 1 October 2022, all references to NBFC-ND under existing regulations would be construed as NBFC-BL, and all references to NBFC-ND-SI and NBFC-D would mean NBFC-ML or NBFC-UL, as the case may be. The RBI has clarified that NBFC-ND-SIs whose asset size is more than the previous threshold of INR 500 crores, but less than the new threshold of INR 1,000 crores would fall under the NBFC-BL category.

- Any regulatory stipulation applicable to a lower layer under the new NBFC categorisation will automatically apply to a higher layer, unless otherwise notified by the RBI.

➢ Changes to minimum capitalisation requirements for specified NBFCs

- The RBI has increased the minimum net owned fund (NOF) requirement for NBFC-ICC from INR 2 crores to INR 10 crores. For NBFC-MFI and NBFC-Factor, the NOF requirement has been increased from INR 5 crores to INR 10 crores.

- The RBI has provided a transition period for existing market players to comply with this increased capitalisation requirement. Such NBFCs must maintain minimum NOF of at least (a) INR 5 crores (for NBFC-ICC) and INR 7 crores (for NBFC-MFI and NBFC-Factor) by 31 March 2025; and (b) INR 10 crores by 31 March 2027 (and at all times thereafter).

- The RBI has also clarified that NBFCs which do not have any customer interface and public funds (*i.e.*, funds raised from external sources) are exempt from the aforesaid regulatory changes, and the minimum NOF requirement for such NBFCs would continue to be INR 2 crores.

Comment: An onerous minimum NOF requirement of INR 20 crores was proposed in the Discussion Paper. Based on the feedback received from market participants, the RBI has significantly reduced the capitalisation requirement and has also provided a gliding path or a transitional period of around five years for businesses to achieve and maintain such minimum NOF. This is yet another example of the RBI being receptive to the concerns raised by the financial services industry. From an M&A perspective, entities which acquire existing NBFCs will benefit from such transition period. Companies which propose to apply for a fresh NBFC license should also be able to avail such benefit if their application is successfully processed by the RBI prior to the effective date of the SBR Framework (i.e., 1 October 2022).

➢ Changes to NPA classification norms

- The RBI has prescribed a uniform overdue period of more than 90 days for classification of a non-performing asset (NPA) by all categories of NBFCs.

- Presently, all NBFCs other than NBFC-MFIs enjoy a longer overdue period of six months (or twelve months for lease rental and hire purchase instalments) for classifying an asset as an NPA.

- The RBI has provided a transition period for NBFCs to comply with the new NPA classification norms. NBFCs must ensure that the overdue period for classification of an asset as an NPA is not more than: (a) 150 days by 31 March 2024; (b) 120 days by 31 March 2025; and (c) 90 days by 31 March 2026.

Comment: Going forward, the NPA classification requirements for banks and NBFCs would be aligned. The gliding path or transition period of around four years provided by the RBI should provide sufficient time for businesses to prepare and comply with the relevant NPA provisioning norms.

➢ Key changes to capital and prudential norms

- Internal Capital Adequacy Assessment Process (ICAAP). NBFCs in the middle and upper layers are required to undertake a thorough internal capital assessment taking into account various risks associated with their business. The ICAAP will be on similar lines prescribed for banks. NBFCs may internally determine the methodology to be followed for such internal assessment as per a Board approved policy.

- Additional requirements for upper layer. In order to improve the quality of regulatory capital, the RBI has prescribed that NBFCs falling in the upper layer must maintain common equity tier 1 capital (which would typically consist of the paid-up capital, free reserves and balances in the profit & loss account) of at least 9% of its risk weighted assets. Such NBFCs will also be required to comply with leverage ceilings and differential standard asset provisioning requirements to be prescribed by the RBI in due course.

- Credit concentration norms. The RBI has prescribed a single credit concentration limit (as against separate limits for lending and investments) for NBFCs in the middle and upper layers. Such limit must now be determined with reference to the tier 1 capital of the NBFC (as against owned funds). Such NBFCs must ensure that their exposure to a single party and a single borrower group does not exceed 25% and 40% of their tier 1 capital respectively.

- Large exposure framework. The RBI also proposes to notify a separate large exposure framework for NBFCs in the upper layer. This will take into account large exposures of such NBFCs to all counterparties (as well as business groups of connected counterparties). The RBI will detail out the definition of large exposure, the relevant exposure limits, and the related reporting requirements in due course.

- Limits for sensitive sector exposures. The RBI has prescribed that exposure of NBFCs in the middle and upper layers to capital market and commercial real estate would be considered as sensitive sector exposures, requiring such NBFCs (other than HFCs) to set internal limits as per Board approved policy for such exposures. Such NBFCs are also required to separately fix sub-limits (within the overall limits for real estate exposure) for financing land acquisition. The RBI has also prescribed a limit of INR 1 crore per borrower for financing subscription to IPOs.

- Real estate financing. The RBI has prescribed that NBFCs in the middle and upper layers must ensure that borrowers have obtained prior permission from all government and statutory authorities, as required for the relevant real estate project. While NBFCs may sanction loans pending compliance of this requirement, they can undertake disbursement of such loans only after the borrower has obtained requisite approvals from the relevant authorities.

Comment: These changes would enable the RBI to closely monitor and regulate various critical aspects pertaining to NBFCs in the middle and upper layers. Such NBFCs must focus on internal risk management on a continuous basis to ensure that sufficient capital is available to support the business in the long-term. The ICAAP process would allow the RBI to engage in meaningful conversations with NBFCs on risk assessment and mitigation factors. The changes prescribed to the credit concentration norms will require NBFCs to closely monitor their large exposures and ensure compliance with the new limits and calculation method. NBFCs must also ensure that they carefully structure real estate financing deals going forward to ensure compliance with the specific pre-disbursement conditions prescribed by the RBI. NBFCs will also have to adopt board approved policies for various matters in line with these regulatory changes.

➢ Key changes to corporate governance norms

- Prior experience of directors. The RBI has prescribed that at least one director appointed by all NBFCs must mandatorily have prior professional experience of working in a bank or NBFC.

- Risk management committee. All NBFCs must constitute a risk management committee for evaluating various risks, including liquidity risk. Such committee must submit its report to the Board of the NBFC.

- Grant of loans to employees and their relatives. All NBFCs must have a Board approved policy for grant of loans to directors, senior officers, and relatives of directors (as well as entities where such directors or their relatives have major shareholding).

- Disclosure requirements. The RBI will notify minimum disclosures to be made by all NBFCs in their financial statements, including on matters such as related party transactions, loans to directors and senior officers, types of exposure, customer complaints, etc. NBFCs in the middle and upper layers will be subject to additional disclosure requirements from 31 March 2023, under which such NBFCs must disclose in their annual financial statements certain prescribed information including a report on corporate governance, details of breaches under financing documents, views of the management on audit qualifications, etc.

- Restrictions on KMPs holding other offices. Key managerial personnel (KMPs) of NBFCs in the middle and upper layers must not hold any office in any other NBFCs in such layers (other than taking up directorship positions in subsidiaries of the NBFCs they are employed with). Such NBFCs have been provided with time until 30 September 2024 to comply with this requirement.

- Independent directors. The RBI has prescribed that an independent director must not simultaneously hold more than three directorship positions in NBFCs falling in the middle and upper layers. Such NBFCs have until 30 September 2024 to ensure compliance. Further, any removal or resignation (prior to original tenure) of an independent director of NBFCs in the upper layer must be promptly reported to the RBI.

- Chief compliance officer. All NBFCs in the middle and upper layers must mandatorily appoint a chief compliance officer who would be in charge of an independent compliance function. Such NBFCs must adopt a Board approved policy on the roles and responsibilities of such chief compliance officer.

- Adoption of core banking solution. The RBI has prescribed that all NBFCs in the middle and upper layers which have at least ten branches must form part of e-Kuber, which is the core banking solution (CBS) platform of the RBI. This will require such NBFCs to comply with various functioning and technical requirements of such CBS platform.

- Whistle-blower mechanism. All NBFCs in the middle and upper layers must adopt a whistle-blower mechanism for whistle blowers to report genuine concerns and mishandling within the organisation.

- Compensation policy. In order to minimise excessive risks taken due to misaligned compensation packages offered by NBFCs to its senior management, the RBI has prescribed that all NBFCs in the middle and upper layers must adopt a comprehensive compensation policy, which must require constitution of a remuneration committee, and must set out the principles for fixed / variable pay structures, and claw-back provisions.

- Mandatory listing requirement. All NBFCs in the upper layer must be mandatorily listed within three years from its identification as an NBFC-UL. Such NBFCs must also be subject to additional disclosure requirements (akin to those applicable to a listed company) prior to the actual listing of its securities on the stock exchange.

Comment: The RBI has introduced a plethora of changes from a corporate governance and compliance risk management perspective thereby ensuring that the regulatory requirements for NBFCs are largely aligned with those applicable to banks. These measures are intended to ensure that NBFCs adopt high standards of governance and internal management, and *proactively implement various checks and balances to identify risk areas and ensure full compliance. Applicable NBFCs must obtain Board clearance for various matters and policies, and constitute the relevant committees as prescribed by the RBI. NBFCs must also relook at the compensation packages offered to senior management to ensure that sufficient protection in terms of claw-back provisions, etc. are incorporated in their employment agreements.*

While these requirements primarily apply to NBFCs in the middle and upper layers, NBFCs in the base layer would also need to be mindful of these requirements so as to ensure better preparedness in anticipation of breaching the prescribed asset-size threshold for upgradation to the middle layer.

Concluding Remarks

The SBR Framework introduces sweeping changes in the current regulatory ecosystem for NBFCs, and such changes seem to be driven by RBI's experience of dealing with mismanaged NBFCs in the past few years. As a financial sector regulator, the RBI has looked to tighten the screws on several regulatory and compliance aspects, so as to ensure that NBFCs are well-funded, efficiently managed, and insulated against various risks. Overall, the SBR Framework seems to be a positive step towards bringing accountability and responsibility in the shadow banking space.

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