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RBI introduces Scale-based Regulations for NBFCs

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In January 2021, RBI had issued a discussion paper to introduce a revised scale-based regulatory framework for NBFCs and has sought comments on the same and has now issued final regulations around the same. These guidelines would be effective from October 01, 2022, however, instructions relating to ceiling on IPO funding would come into effect from April 01, 2022.The following short note summarises key points of the same.

Introduction

The NBFC space evolved over the last few years with a complex web of inter-linkages of the sector with banks, capital market and other financial sector entities. The sector has grown from being around 12% of the balance sheet size of banks (2010), to around 25% of the size of banks. NBFCs by design have had a lighter and differential regulation as compared to banks for operational flexibility and extending the access of financial services. The arbitrage between banks and NBFCs can be broadly categorised as structural arbitrage and prudential arbitrage. However, in view of the recent stress in the sector, RBI has developed a scale-based approach to regulation from a 'systemic significance' vantage point.

Scale-Based Approach to Regulation

Apart from the existing nomenclature, NBFCs would be categorized across four different layers (Base, Middle, Upper, and Top) based on various parameters including size, interconnectedness with the system, etc. The scale-based approach can be visualised as a pyramid with the base layer being subjected to the least regulation and the topmost layer facing the most stringent regulations.

Figure 1: Four layers for classification of NBFCs

Base Layer	Middle Layer	Upper Layer	Top Layer
• NBFC-ND below asset size of Rs 1,000 crore • NBFC-P2P • NBFC-Account Aggregator • Non-Operative Financial Holding Company (NOFHC) • NBFCs who do not avail public funds and do not have any customer interface	• NBFC-D irrespective of asset size • NBFC-ND with asset size of Rs. 1,000 crore and above • Standalone Primary Dealers • IDF-NBFCs • CICs • HFCs • NBFC-IFCs	• Shall comprise of those NBFCs which are specifically identified by RBI as warranting enhanced regulatory requirement based on a set of parameters and scoring methodology and guidelines.	• The Top Layer will ideally remain empty. • This layer can get populated if RBI is of the opinion that there is a substantial increase in the potential systemic risk from specific NBFCs in the Upper Layer.

Source: RBI, CARE Ratings

The structural placement shall be as follows

Always Base Layer	Always Middle Layer	Middle/Upper Layer	Any Layer
• NBFC-P2P, NBFC-AA, NOFHC • NBFCs who do not avail public funds and do not have any customer interface	• SPD and IDF-NBFC • Government owned NBFCs (#)	• NBFC-D, CIC, IFC and HFC	• NBFC-ICC, NBFC-MFI, NBFC-Factors, and NBFC-MGC

(#) Shall be placed in the Base Layer or Middle Layer. They will not be placed in the Upper Layer till further notice.

Scoring methodology for identification of an NBFC as NBFC-UL shall be based on the set of NBFCs fulfilling the following criteria:

- Top 50 NBFCs (excluding top ten NBFCs based on asset size, which automatically fall in the Upper Layer) based on their total exposure including credit equivalent of off-balance sheet exposure.
- NBFCs designated as NBFC-UL in the previous year.
- NBFCs added to the set by supervisors using supervisory judgment.

The computation of scores of all NBFCs in the above set shall be performed annually based on their position as on March 31st each year.

Figure 2: Scoring Methodology for Identification of NBFC as NBFC-UL

Quantitative Parameters (70%)	Qualitative Parameters (30%)
• **Size & Leverage**: 35% • **Interconnectedness**: 25% • **Complexity**: 10%	• **Nature/type of liabilities:** 10% • **Group Structure:** 10% • **Segment Penetration:** 10%

Source: RBI, CARE Ratings

Summary of Select Regulatory changes for NBFCs – Scale Based Approach

Figure 3: Table of Select Changes

<table>
<tr><th>Parameters</th><th>NBFC – Base Layer (NBFC-BL)</th><th>NBFC – Middle Layer (NBFC-ML)</th><th>NBFC – Upper Layer (NBFC-UL)</th></tr>
<tr><td>CET 1</td><td></td><td></td><td>9% of RWA</td></tr>
<tr><td>Leverage</td><td></td><td></td><td>To be stipulated</td></tr>
<tr><td>Standard Asset provisioning</td><td></td><td></td><td>Differential Provisioning towards different classes of standard assets</td></tr>
<tr><td>NPA Classification</td><td>Harmonisation from 180 days to 90 days overdue</td><td colspan="2">No impact since NBFCs with asset size of more than Rs 500 crores are already required to follow the 90-day NPA norm</td></tr>
<tr><td>ICAAP</td><td></td><td colspan="2">Board approved policy considering all risks. This internal assessment shall be on similar lines as ICAAP prescribed for commercial banks under Pillar 2</td></tr>
<tr><td>Credit Concentration Norms</td><td>Extant instructions on concentration norms</td><td colspan="2">Merger of lending and investment limits into a single exposure limit. As a percentage of Tier 1 capital: Single borrower/ party (25%) and Single group of borrowers/ parties (40%)</td></tr>
<tr><td>Large Exposure Framework (LEF)</td><td></td><td></td><td>NBFC-UL to follow above Credit Concentration Norms till Large Exposure Framework is operationalised</td></tr>
<tr><td>Compensation Guidelines – Constitute Nomination and Remuneration Committee</td><td>Not stipulated</td><td colspan="2">(i) Constitution of a Remuneration Committee
(ii) Principles for fixed/ variable pay structures
(ii) Malus/ claw back requirements</td></tr>
<tr><td>Governance Norms</td><td></td><td colspan="2">• The Board shall delineate the role of various committees (Audit Committee, Nomination and Remuneration Committee, or any other Committee) and lay down a calendar of reviews.
• NBFCs shall formulate a whistle blower mechanism for directors and employees to report genuine concerns.
• The Board shall ensure good corporate governance practices in the subsidiaries of the NBFC.</td></tr>
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Key Managerial Personnel (KMP) - whole time employee in the nature of CEO, CFO, CS and WTD	As per Companies Act, 2013	(i) No KMP of an NBFC shall hold office in any other NBFC-ML or NBFC-UL except for directorships in subsidiaries (ii) An Independent Director cannot be director in more than three NBFCs (NBFC-ML and NBFC-UL) at the same time Timeline of two years is provided with effect from October 01, 2022, to ensure compliance	
Appointment of Chief Compliance Officer	Not stipulated	Mandatory	Mandatory
Listing	Not Mandatory	Not Mandatory	Shall be mandatorily listed within 3 years of identification as NBFC-UL. Disclosure requirements shall be put in place on the same lines as applicable to a listed company even before the actual listing, as per Board approved policy of the NBFC.
Expertise for Board members	(i) Adequate experience & educational qualification (ii) At least one of the directors should have experience in retail lending in a bank/NBFC (iii) The composition of the Board should ensure mix of educational qualification and experience within the Board. Specific expertise of Board members will be a prerequisite depending on the type of business pursued by the NBFC.		
Removal of Independent Directors with Supervisory approval	Not stipulated	Not stipulated	Required to report to the supervisors in case any Independent Director is removed/ resigns before completion of normal tenure.
Risk Management Committee	Could be Board or Executive level as decided by the Board	Board-level RMC applicable	Board-level RMC applicable
Disclosures	Expanded to include types of exposure, related party transactions, loans to Directors/ Senior Officers and customer complaints.	Beginning March 2023, additional disclosures include: • Corporate Governance report containing composition and category of directors, shareholding of non-executive directors, etc. • Disclosure on modified opinion, if any, expressed by auditors, its impact on various financial items and views of management on audit qualifications. • Items of income and expenditure of exceptional nature. • Breaches in terms of covenants in respect of loans availed by the NBFC or debt securities issued by the NBFC including incidence/s of default. • Divergence in asset classification and provisioning above a certain threshold to be decided by the Reserve Bank.	
Loans to directors, senior officers and relatives of directors	Have a Board approved policy		
Sensitive Sector Exposure (SSE)	Not stipulated	(i) Board approved internal limits separately for capital market exposure and commercial real estate sector, supplemented by adequate disclosures ii) Internal sub-limit within the CRE ceiling for financing land acquisition (iii) Dynamic vulnerability assessment by NBFCs (iv) Supervisory review	(i) Board approved internal limits separately for capital market exposure and commercial real estate sector, supplemented by adequate disclosures ii) Internal sub-limit within the CRE ceiling for financing land acquisition (iii) Dynamic vulnerability assessment by NBFCs (iv) Supervisory review

			(v) Board approved internal exposure limits on other important sectors of the economy (vi) Internal Board approved limit on exposure to NBFC sector
Regulatory Restrictions on lending	Not stipulated	Restrictions on grant of loans and advances for/to the following: (a) Directors and relatives of directors (b) Officers and relatives of Senior Officers (c) Real Estate – disbursals only after the borrower has obtained requisite clearances from the government authorities.	
IPO Financing with effect from April 01, 2022	Ceiling of Rs.1 crore per individual. NBFCs can prescribe more conservative criteria		
Core Banking Solution for NBFCs	Not mandatory	Mandatory for NBFCs with more than 10 branches with a glide path of 3 years with effect from October 01, 2022	Mandatory for NBFCs with more than 10 branches with a glide path of 3 years with effect from October 01, 2022

RBI would release detailed circulars due course wherever required in the above parameters
Source: RBI, CARE Ratings

Changes in Regulatory minimum Net Owned Fund (NOF)

- For NBFC-ICC, NBFC-MFI and NBFC-Factors has been increased from Rs 2/5 crores to Rs. 10 crores. These institutions must achieve the same by March 31, 2027.
- For NBFC-P2P, NBFC-AA, and NBFCs with no public funds and no customer interface, the NOF continues to be Rs. 2 crores.
- no change in the existing regulatory minimum NOF for NBFCs - IDF, IFC, MGCs, HFC, and SPD. Minimum NOF for different categories: IDF and IFC – Rs 300 crore, MGC- Rs 100 crore, HFCs- Rs 20 crore, SPDs which undertake only the core activities – Rs 150 crore, SPDs which also undertake non-core activities – Rs 250 crore

NBFCs falling in the Top Layer of the regulatory structure would be subject to a higher capital charge. Such higher requirements would be specifically communicated to the NBFC at the time of its classification in the Top Layer. There will be enhanced and intensive supervisory engagement with these NBFCs by RBI.

Currently most of the NBFCs are likely have an adequate level of Tier I capital as required under these guidelines; some entities may have to raise capital for boosting their CET I levels. Regulations on leverage of NBFC-UL in addition to CRAR, would reduce the regulatory arbitrage (especially of HFCs). This would strengthen their balance sheets thereby minimizing the chances of systemic risk arising from such large HFCs. Introduction of internal capital assessment on similar lines as ICAAP prescribed for commercial banks under Pillar 2 is also expected to significantly enhance standards of overall risk assessment of NBFCs from present level.

As per initial assessment, the top 10 companies that could form part of the Upper layer are already listed. The second list of NBFCs in the Upper Layer would consist of a set of NBFCs that may have to go public**.** Further the disclosure requirements for the Middle Layer NBFCs especially at the lower end of the threshold might see a significant increase (NBFCs at the higher end are already subject to listing requirements as quite a few of them have listed debt securities that already impose more or less similar requirements).

Conclusion

In absolute terms, the asset size of NBFC sector (including HFCs), as on March 31, 2021, was over Rs.54 lakh crore with over 9,600 NBFCs registered across 12 categories and the sector has grown at a CAGR of close to 18% over the last five years. Out of this size of the sector, the following figure quite deftly indicate the top-heavy nature of the sector.

Figure 4: Share of the sector's assets

Set of NBFCs	~% Share of the asset size
Select seven Govt. controlled NBFCs	~30%
Select five HFCs	~20%
Select 20 NBFCs (excl. HFCs and govt. controlled NBFCs)	~20%

The level of regulation / compliance requirement increases with each layer. Over 90% of the NBFCs which have an asset size of less than Rs 1,000 crores, would be in the Base Layer, where no meaningful changes have been suggested. A significant portion of the listed NBFCs would form part of the Middle/Upper layer and would need to comply with the new regulations related to capitalization, disclosure norms, and governance.

These scale-based regulations tighten and consolidates regulations across categories along with reducing regulatory arbitrage with banks especially for the Upper Layer NBFCs. These changes are expected to increase the resiliency of the sector going forward. However, RBI at the same time has acknowledged that NBFCs have contributed significantly to the under-banked segment. This scale-based approach is more pragmatic to following the one size fits all model. Smaller NBFCs which typically cater to the bottom of the pyramid of the population would be negatively impacted if tighter regulations are imposed on the same and which would defeat the raison d'etre of such NBFCs i.e., the goal of financial inclusion.

Given the current market highs and IPO issuances, IPO financing could witness some impact as the individual exposure has been capped at Rs 1 crore per NBFC from no limits beginning from April 01, 2022. However, there is no stated cap on number of lenders, consequently an investor could still use leverage by utilising multiple NBFCs. But such regulatory restrictions on lending could hamper some businesses of NBFCs. Given the implementation deadline, no impact would be witnessed in the current financial year, however, beginning the next fiscal, IPO oversubscription could see some moderation from current peak levels estimated to be over one trillion rupees.

The sensitive Sector Exposure (SSE) norms could shift this business to smaller NBFCs which may reduce the availability of funds for such businesses. Additionally, implementation of a core banking solutions and the changes in corporate governance including risk management systems may limit the flexibility of entities as a NBFC platform.

Further as expected, at least for the time being, government entities have been kept out of these proposed regulations. Hence it would be business as usual for these entities.

Contact:

Sanjay Agarwal	Senior Director	sanjay.agarwal@careratings.com	+91-22-6754 3582/+91-810-800-7676
Saurabh Bhalerao	Associate Director – BFSI Research	saurabh.bhalerao@careratings.com	+91-22-6754 3519/+91-900-495-2514
Mradul Mishra	Media Relations	mradul.mishra@careratings.com	+91-22- 6837 4424

CARE Ratings Limited
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Tel.: +91-22-6754 3456 I CIN: L67190MH1993PLC071691

Connect: