CHAPTER 1

Scale-based framework - the revised regulatory framework for NBFCs

This article aims to:

Highlight the importance of NBFCs in the economy and the new and enhanced regulations introduced for greater regulation.

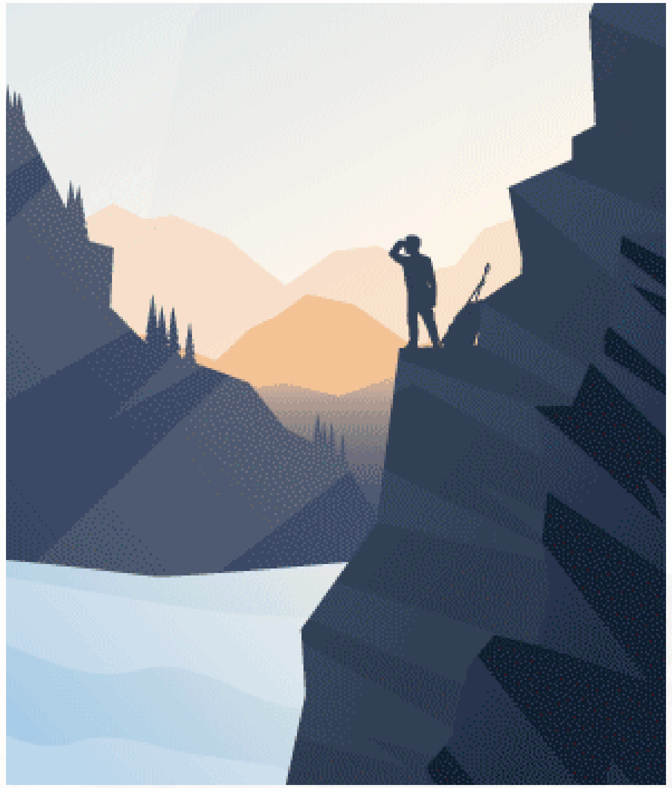
Background

Non-Banking Financial Companies (NBFCs) have increasingly been playing a significant role in financial intermediation by complementing and competing with banks, and by bringing in efficiency and diversity into the financial ecosystem. NBFCs enjoy greater operational flexibility to take up wider scale of activities, enter into new geographies and sectors and thus grow their operations. This is mainly due to less stringent regulatory provisions applicable to NBFCs as compared to banks (often referred to as the regulatory arbitrage in favour of NBFCs).

Over the years, the NBFC sector has evidenced tremendous growth. However, due to the recent stress observed in the NBFC sector, and the contagion risk it posed to other entities due to the interconnectedness of NBFCs in the financial system, there was a need to protect the deposits that investors placed with the NBFCs. Accordingly, the regulatory approach adopted for NBFCs was re-examined in order to reorient it to keep pace with the changing realities in the financial sector.

With a view to develop a strong and resilient financial system, in October 2021, the Reserve Bank of India (RBI) had prescribed a 'scale-based regulation' for the NBFC sector. The Scale-Based Regulatory (SBR) approach renders the regulation and supervision of the NBFCs to be a function of their size, activity and perceived riskiness. Subsequently, RBI has issued clarifications on various provisions of the SBR. These regulations would be applicable to NBFCs effective 1 October 2022. However, an amendment with regard to ceiling on an IPO funding is applicable from 1 April 2022.

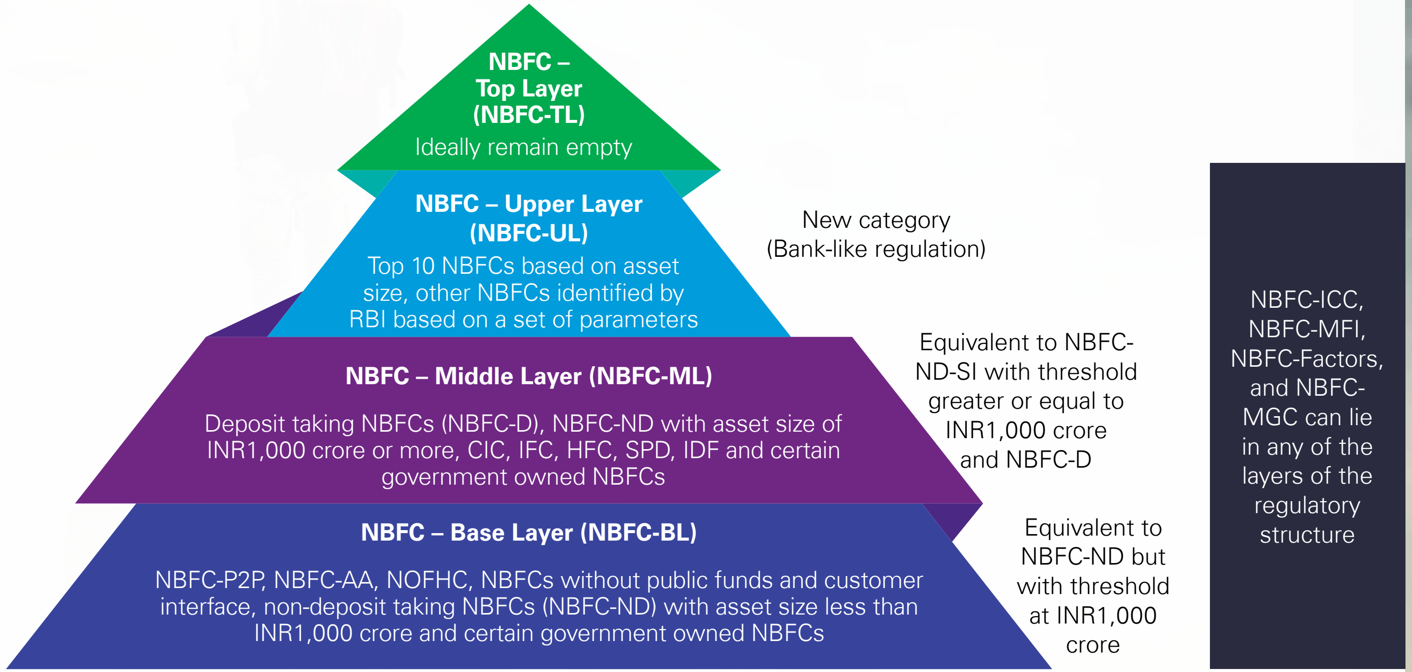
In this article, we aim to provide an overview of the different layers in the scale-based regulation introduced by RBI, the NBFCs that would be classified in each of these layers and the revisions in the structural and regulatory framework applicable to NBFCs in each of the layers.



The scale-based regulatory approach

The SBR framework can be visualised as a pyramid with regulatory intervention being the least at the bottom of the pyramid and increasing as one moves up. This is depicted in figure 1 below:

Figure 1: SBR framework



NBFC-P2P: NBFC-Peer to Peer lending platform
NBFC-AA: NBFC Account Aggregator
NOFHC: Non-Operative Financial Holding Company
CIC: Core Investment Companies
IFC: Infrastructure Finance Companies
HFC: Housing Finance Companies

SPDs: Standalone Primary Dealers
IDF: Infrastructure Debt-Fund- NBFCs
NBFC-ND-SI: Systemically Important NBFC-ND
NBFC-ICC: Investment and Credit Companies
NBFC-MFI: Micro Finance Institutions
NBFC:MGC: Mortgage Guarantee Companies

(Source: KPMG in India's analysis, 2022, read with Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCs issued by RBI on 22 October 2021)

The regulatory structure

Base layer (NBFC-BL)

The **base layer** will be equivalent to the existing non-deposit taking non-systemically important NBFCs (NBFC-NDs) Systemically important, non-deposit taking NBFCs having asset size of INR500 crore and above but below INR1,000 crore (except those necessarily featuring in the middle layer) will be part of NBFC-BL. It will specifically include

- NBFC-P2P (NBFC-Peer to Peer lending platform)
- NBFC-AA (NBFC-Account Aggregator)
- NOFHC (Non-Operative Financial Holding Company) and
- NBFCs without public funds and customer interface[1].

While higher level of prudential regulations will not be applicable to such entities, there will be an increase in the transparency requirements through additional disclosures and improved governance standards.

Middle layer (NBFC-ML)

The **middle layer** will be equivalent to the existing deposit taking NBFCs (NBFC-D) and systemically important non-deposit taking NBFCs (NBFC-ND-SI). It will specifically include the SPD (i.e. Standalone Primary Dealers) and IDF (Infrastructure Debt Funds) (which will always remain in the middle layer). It will also include NBFC-D, irrespective of their asset size, NBFC-ND-SI with asset size greater than INR1,000 crore, CIC, IFC and HFCs[2]. Government owned NBFCs will not be placed in the upper layer, till further notice, and accordingly, will be placed in NBFC-BL or NBFC-ML.

There will be a higher level of regulatory supervision in this layer, which aims to plug the areas of regulatory arbitrage between banks and NBFCs.

Upper layer (NBFC-UL)

The **upper layer** has been conceived as a new category of NBFCs, in which a chosen few, systemically significant NBFCs would be specifically identified by RBI through parametric analysis of certain quantitative and qualitative criteria[3], which will be reviewed periodically. Accordingly, entities that meet the specified criteria will move from the middle layer to the upper layer of the scale-based framework. The top 10 eligible NBFCs in terms of their asset size will always reside in the upper layer, irrespective of any other factor. Higher prudential regulations and intensive supervision will be applicable for such entities proportionate to their systemic significance.

1. RBI is expected to come out with separate regulations for such NBFCs in due course.
2. NBFC-D, CIC, IFC and HFCs can either be a part of NBFC-ML or NBFC-UL, as the case may be (and not NBFC-BL).
3. The quantitative criteria majorly consists of size and leverage, interconnectedness and complexity, and the qualitative criteria majorly consists of nature and type of liabilities, group structure and segment penetration.

Transition path to the upper layer

NBFCs would be advised about their classification to the upper layer

Once an NBFC is identified for inclusion as NBFC-UL, it would be advised about its classification by the Department of Regulation, RBI, and will be placed under the regulation applicable to the upper layer. For this purpose, the following timelines should be adhered to:

- **Board approved policy and implementation plan to be prepared within three months:** Within three months of being advised by the RBI regarding its inclusion in the NBFC-UL, the NBFC should put in place a board approved policy for adoption of the enhanced regulatory framework and chart out an implementation plan for adhering to the new set of regulations. This board approved implementation plan will be submitted to RBI and be subject to a supervisory review
- **Adherence with stipulations for NBFC-UL within 24 months:** The Board of Directors (BoD) of the NBFC should ensure that the stipulations prescribed for NBFC-UL are adhered to, and the board approved implementation plan should be subsumed within a maximum time-period of 24 months from the date of advise of the NBFC's classification in the upper layer.

Transition of NBFCs in the upper layer

Once an NBFC is identified as NBFC-UL, it will be subject to enhanced regulatory provisions **at least for a period of five years** from its classification in this layer, even if it does not meet the parametric criteria in the subsequent year(s). However, an NBFC classified in the upper layer would be allowed to move out of the enhanced regulatory framework only if the movement is reflected as a voluntary strategic move as clearly laid out by its BoD. However, NBFCs classified in the upper layer that have scaled down operations due to adverse situations specific to the NBFC will not be permitted to move down to a lower regulatory regime.

Intimation to NBFCs close to meeting the NBFC-UL parameters

NBFCs which are close to meeting the parameters and benchmarks that would render them eligible for classification as NBFC-UL, will be intimated about the same in advance to enable them to initiate measures and re-adjust operations in case they intend to continue in the NBFC-ML on a long-term basis and do not want to feature in the upper layer.

Top layer

The **top layer** would ideally remain empty and NBFCs will be slotted into this layer from the upper layer of the scale-based framework at the discretion of RBI if it is of the opinion that the entity is contributing significantly to the systemic risk. Such entities would be required to comply with significantly higher regulatory and supervisory requirements.

Regulatory changes under the scale-based regulatory framework

The scale-based regulatory framework envisages a progressive increase in the intensity of regulations. Therefore, regulatory revisions[4] applicable to lower layers of NBFCs will automatically be applicable to NBFCs residing in higher layers, unless stated otherwise. The regulatory revisions applicable to the various layers of NBFC are given in the table below:

Regulatory revision	Regulatory revisions applicable to			Additional clarifications received from RBI[5]
	Base Layer (NBFC-BL[6])	Middle Layer (NBFC-ML[7])	Upper Layer (NBFC-UL[8])	
A. Regulatory revisions applicable to all layers of NBFCs				
Revisions in regulatory guidelines				
Raising minimum Net Owned Fund (NOF) for certain NBFCs	Raised minimum NOF requirement for NBFC-ICC, NBFC-MFI and NBFC-factors to INR10 crore. A glide path to achieve this requirement has been provided.			Not Applicable (NA)
Harmonising Non-Performing Assets (NPA) classification norms	NBFC-ND are now required to classify assets with an overdue period of more than 90 days as NPA. A glide period for complying with this norm has been provided	No impact, since NBFCs classified under these layers are already required to follow the 90-day NPA norm		This has been discussed in Chapter 3
Experience of the board	At least one of the directors in the BoD should have relevant experience of having worked in a bank/NBFC. This is a new requirement for all NBFCs.			NA
Ceiling on Initial Public Offer (IPO) funding	A limit of INR1 crore per borrower has been set for financing subscription to IPOs (currently, NBFCs have no ceiling on an IPO funding). Ceiling on an IPO funding has been made applicable from 1 April 2022.			NA

4. The regulatory provisions discussed in this article are the revisions that will be made in the existing regulatory framework.
5. The circular issued in October 2021, provided a holistic view of the SBR structure. Detailed guidelines on certain amendments were to be issued subsequently.
6. NBFC-BL would largely continue to be subjected to regulation that is currently applicable for NBFC-ND. Since NBFC-ND with asset size upto INR1,000 crore will now be classified as NBFC-BL (as per current regulations, non-deposit taking NBFCs with an asset size of less than INR500 crore are considered as non-systemically important NBFCs. Under the scale-based regulations, non-deposit taking NBFCs with an asset size of upto INR1,000 crore will be classified in the base layer of the regulatory framework.), the existing regulatory framework should be supplemented by enhanced governance and disclosure standards. The specific changes in regulations for NBFC-BL is given in the table.
7. NBFCs in the middle layer will be governed by the extant regulations applicable to NBFC-ND-SIs, NBFC-Ds, CICs, SPDs and HFCs as discussed in the table.
8. NBFCs in the upper layer will be subject to regulations applicable to NBFC-ML and to the regulatory revisions stipulated in the table.

Regulatory revision	Regulatory revisions applicable to			Additional clarifications received from RBI
	Base Layer (NBFC-BL)	Middle Layer (NBFC-ML)	Upper Layer (NBFC-UL)	
Revisions in governance guidelines				
Risk Management Committee (RMC)	Could be at board or executive level, as per discretion of BoD	Board-level RMC	Board-level RMC	NA
Disclosures	Disclosure requirements for NBFCs have been expanded, to include related party transactions, loans to directors/senior officers and customer complaints			Yes, these have been discussed in subsequent chapters
Loans to directors, senior officers and relatives of directors	NBFCs to have a board approved policy on these matters	Not applicable	Not applicable	Yes, this has been discussed in Chapter 4
B. Regulatory revisions appliable to NBFC-ML and NBFC-UL				
Revisions in capital guidelines				
Introduction of Internal Capital Adequacy Assessment Process (ICAAP)	Not applicable	NBFCs in the middle and upper layer are required to make a thorough internal assessment of the need for capital, commensurate with the risks in their business, on similar lines as ICAAP for commercial banks		NA
Revisions in prudential guidelines				
Concentration of credit/investment	Current norms are applicable- no change in limits	The separate lending and investment exposure limits have now been merged into a single exposure limit. Limit will now be computed as a percentage of Tier 1 capital (instead of being computed as a percentage of owned fund)	NBFCs in the upper layer of the SBR are required to follow the Large Exposure Framework (LEF)	Yes, detailed regulation on the LEF has been issued by RBI. This is briefly discussed in Chapter 7
Sensitive Sector Exposure (SSE)	Not applicable	BoD approved internal limits to be fixed for SSE, separately for capital market and commercial real estate exposures. No change in norms for HFCs, which will continue to follow current regulations		NA
Regulatory restrictions on loans	Not applicable	Regulatory restrictions applicable on loans to directors, senior officers and on appraising loan proposals involving real estate		Yes, this has been discussed in Chapter 4

Regulatory revision	Regulatory revisions applicable to			Additional clarifications received from RBI
	Base Layer (NBFC-BL)	Middle Layer (NBFC-ML)	Upper Layer (NBFC-UL)	
Revisions in governance guidelines				
Key Managerial Personnel (KMP)	Not applicable	Restrictions on KMPs from holding any office (including directorships) in any other NBFC-ML or NBFC-UL		NA
Independent director (ID)	Not applicable	IDs are restricted from being on the BoD of more than **three NBFCs** at the same time		NA
Disclosures in annual financial statements	Not applicable	With effect from **31 March 2023**, NBFCs are required to make the following additional disclosures in their annual financial statements: • Corporate governance report • Disclosure on modified opinion • Exceptional income or expenses • Breaches in terms of covenants or defaults • Divergence in asset classification and provisioning		Further clarification on corporate governance disclosures, breaches in terms of covenants or defaults and on divergence in asset classification and provisioning has been provided by RBI. These are discussed in subsequent chapters.[9]
Chief compliance officer	Not applicable	NBFCs in the middle and upper layer are required to have an independent compliance function and appoint a Chief Compliance Officer (CCO)		Yes, this is briefly discussed in Chapter 7
Compensation guidelines	Not applicable	NBFCs to put in place a BoD approved compensation policy for KMP and senior management, which includes: • Constitution of a remuneration committee • Principles for fixed/variable pay structures • Malus/claw back provisions		Yes, this is briefly discussed in Chapter 4
Additional governance matters	Not applicable	Additional governance matters to be complied with include: • Delineate the role of various committees • Formulate a whistle blower mechanism • Ensure good corporate governance practices in subsidiaries		Clarification on these matters is awaited.
Introduction of core financial services solution	Not applicable	Mandatory for NBFCs with 10 or more branches		Yes, this is briefly discussed in Chapter 7

9. Clarification on disclosures of modified opinion and exceptional income and expenses is awaited.

Regulatory revision	Regulatory revisions applicable to			Additional clarifications received from RBI
	Base Layer (NBFC-BL)	Middle Layer (NBFC-ML)	Upper Layer (NBFC-UL)	
C. Regulatory revisions applicable only to NBFC-UL				
Revisions in capital guidelines				
Common Equity Tier (CET) 1	Not applicable	Not applicable	CET 1 of at least **nine per cent of risk weighted assets**[10]	Yes, this has been discussed in Chapter 5
Leverage	Not applicable	Not applicable	Leverage requirement will be applicable. A suitable ceiling for leverage will be prescribed by RBI	Clarification on this matter is awaited
Differential standard asset provisioning	Not applicable	Not applicable	Differential standard asset provisioning applicable, similar to provisions applicable to banks	Yes, this is further discussed in Chapter 3
Revisions in prudential guidelines				
Internal exposure limits	Not applicable	Not applicable	BoD approved internal exposure limits to be set for important sectors to which credit is extended[11]. This is in addition to SSE limits which is applicable to NBFCs in both, the middle and upper layer	NA
Revision in governance guidelines				
Qualification of board members	Not applicable	Not applicable	Composition of BoD to include a mix of educational qualification and experience	This has been discussed in Chapter 4
Listing and disclosures	Not applicable	Not applicable	NBFCs in the upper layer to get listed within three years of identification as NBFC-UL. Unlisted NBFC-ULs to draw up board approved road map for compliance with disclosure requirements of listed companies.	Yes, this has been discussed in Chapter 6
Removal of independent directors	Not applicable	Not applicable	NBFCs in the upper layer are required to report to RBI in case any ID is removed/resigns before the completion of his/her normal tenure. Earlier NBFCs were not required to report removal/resignation by an ID.	Not applicable

10. Currently, the provisions with regard to maintenance of CET 1 is not applicable to NBFCs.
11. This is a new provision, NBFCs were not required to set such internal limits earlier.