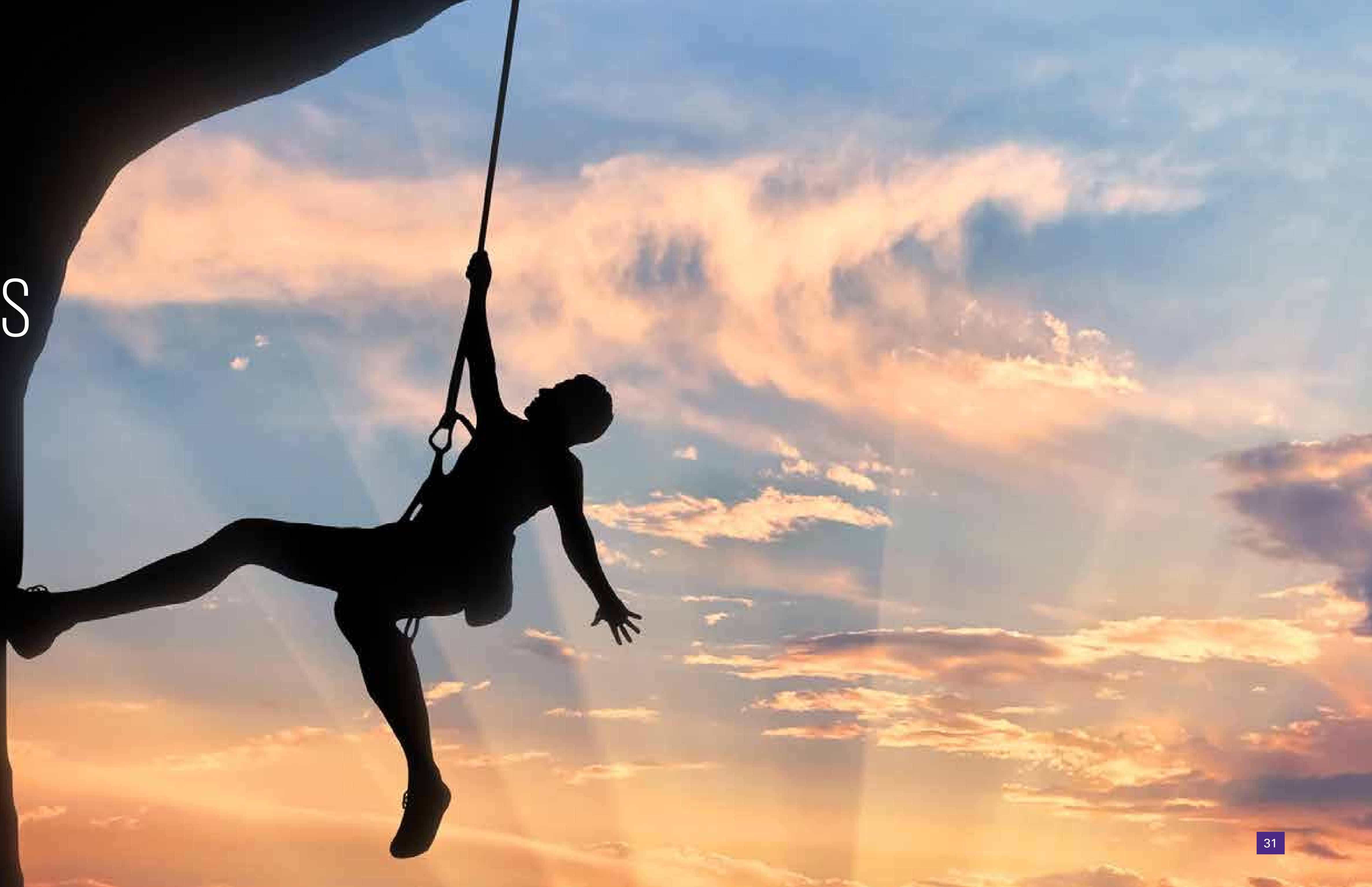
CHAPTER 5

Capital requirements for NBFCs

This article aims to:

Provide an overview of the revised capital requirements for NBFCs under SBR.



Background

As per the current RBI guidelines, all NBFCs and HFCs are required to maintain a minimum capital ratio consisting of Tier I and Tier II capital, which shall not be less than 15 per cent of its aggregate risk weighted assets on-balance sheet and risk adjusted value of off-balance sheet items. The Tier I capital in respect of the NBFCs (except NBFC-Micro Finance Institution (NBFC-MFI) and Infrastructure Debt Fund-NBFC (IDF-NBFC)) at any point in time should not be less than 10 per cent of its aggregate risk weighted assets on-balance sheet and risk adjusted value of off-balance sheet items. NBFCs primarily engaged in lending against gold jewellery (such loans comprising 50 per cent or more of their financial assets) are required to maintain a minimum Tier I capital of 12 per cent of its aggregate risk weighted assets on-balance sheet and risk adjusted value of off-balance sheet items.

Regulatory revision

The RBI, vide the SBR framework requires all NBFCs in the upper layer (except Core Investments Companies (CICs)[1]) to maintain, on an on-going basis, a Common Equity Tier 1 (CET 1) ratio of at least **nine per cent** of risk weighted assets. The new requirement is applicable from 1 October 2022. Detailed guidelines have been provided by RBI in this regard[2].

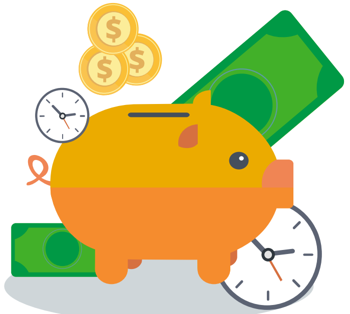
$$\textbf{CET 1 ratio} = \frac{\text{Common Equity Tier 1 Capital (CET 1 Capital) (Note 1)}}{\text{Total Risk Weighted Assets (Total RWAs) (Note 2)}}$$

Note 1: CET 1 Capital will be computed as given in figure 1 below:

Figure 1: Components of CET 1 Capital

Capital and share premium

- Paid-up equity share capital issued by NBFC
- Share premium resulting from issue of equity shares



Add

Reserves

- Capital reserve representing surplus arising out of sale proceeds of assets
- Statutory reserve
- Revaluation reserve (post adjustments)
- Other disclosed free reserves
- Retained earnings at the end of the previous financial year, less accumulated losses
- Profits in current financial year*

Less

Regulatory adjustments/deductions

- Goodwill and other intangible assets
- Deferred tax assets
- Investments in shares of other NBFCs and certain securities of companies in the same group
- Impairment reserve
- Unrealised gains and/or losses
- Securitisation transactions
- Defined benefit pension fund assets and liabilities
- Investment in own shares

** Profits in the current financial year may be included in this calculation on a quarterly basis if it has been audited or subject to limited review by the statutory auditors of the NBFC. The profits will be reduced by average dividend paid in the last three years. Losses in the current year will be fully deducted.*

(Source: KPMG in India's analysis, 2022 read with SEBI circular Scale Based Regulation (SBR) for NBFCs: Capital requirements for Non-Banking Finance Companies – Upper Layer (NBFC-UL) dated 19 April 2022)

Note 2: The Total Risk Weighted Assets (RWAs) to be used in the computation of Tier I capital shall be the same as the total RWAs computed under the relevant Directions of the concerned NBFC category.

1. CICs identified as NBFC-UL shall continue to maintain, on an on-going basis, Adjusted Net Worth as per the Master Direction DoR (NBFC).PD.003/03.10.119/2016-17 - Core Investment Companies (Reserve Bank) Directions, 2016 dated August 25, 2016.
2. Detailed guidelines have been provided vide the RBI circular number DOR.CAP.REC.No.21/21.06.201/2022-23, Scale Based Regulation (SBR) for NBFCs: Capital requirements for Non-Banking Finance Companies – Upper Layer (NBFC-UL) dated 19 April 2022

Other provisions pertaining to capital

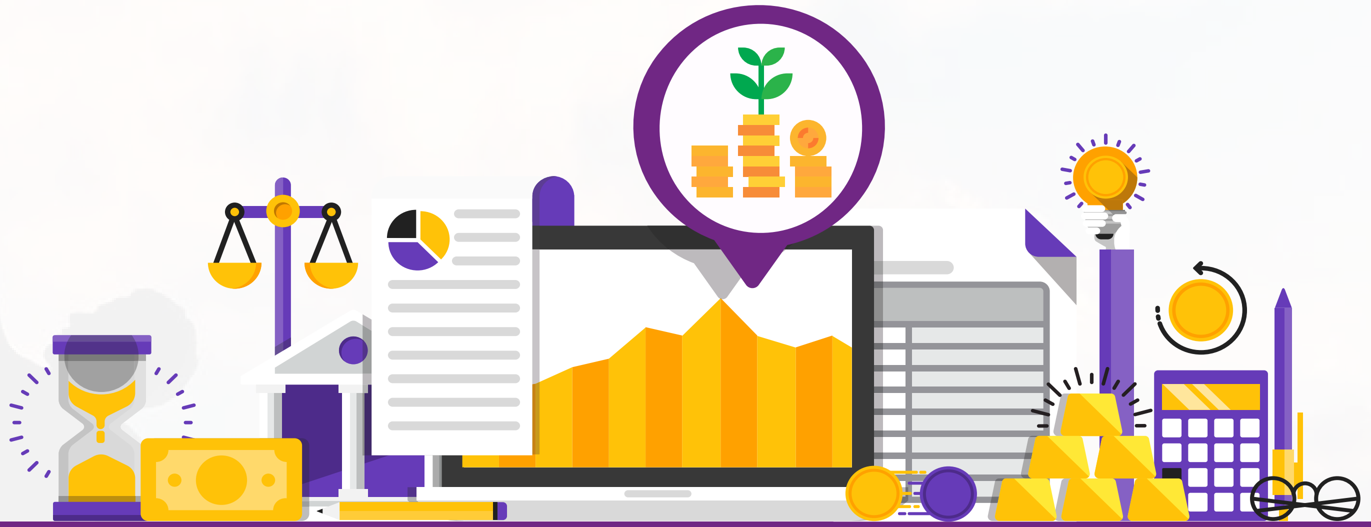
Leverage: In addition to Capital Risk Adequacy Ratio (CRAR), NBFC-UL will also be subjected to leverage requirement to ensure that their growth is supported by adequate capital, among other factors. A suitable ceiling for leverage would be prescribed subsequently for these entities- further clarification on this provision is awaited from RBI.

Internal Capital Adequacy Assessment Process (ICAAP): The SBR framework introduced the ICAAP to NBFCs in the middle and upper layers, requiring them to undertake a thorough internal assessment of the needs for capital, commensurate with the risks in their business. This is on similar lines as the ICAAP prescribed for commercial banks under Pillar 2[3].

The NBFCs would need to consider the following under ICAAP:

- **Board approved policy:** NBFCs need to develop a BoD approved policy (policy) for internal assessment of capital based on ICAAP. This internal assessment would be proportionate to the scale and operations of the NBFC and factor in credit risk, market risk, operational risk and all other residual risks as mentioned in the policy
- **Objective of ICAAP:** The objective of ICAAP is to ensure availability of capital to support all risks in business as also to encourage NBFCs to develop and use better internal risk management techniques for monitoring and managing their risks. This will facilitate an active dialogue between RBI and NBFCs on the assessment, monitoring and mitigation of risks.

This requirement is applicable from 1 October 2022



Next steps

- With ICAAP being applicable to NBFCs in the middle and upper layer from 1 October 2022, it is essential that these NBFCs develop a board-approved policy on internal assessment of capital considering the risks in their business. Reference may be made to the Master circular issued by RBI on Basel III Capital Regulations. As RBI would monitor the internal capital assessment process, NBFCs may consider having a dialogue with RBI while developing the policy.
- NBFCs which will be placed in the upper layer need to develop a transition plan in order to maintain CET 1 ratio at nine per cent of risk weighted assets, from the existing Tier I capital required to be maintained at 10 per cent of the NBFCs' aggregate risk weighted assets on-balance sheet and risk adjusted value of off-balance sheet items.
- NBFCs in the upper layer should watch out for further clarifications on leverage requirement from RBI.

3. Master Circular- Basel III Capital Regulations dated 1 July 2015