CHAPTER 7

Other key provisions applicable for NBFCs

This article aims to:

Summarise other key regulatory revisions applicable to NBFCs as part of SBR framework.

Background

The SBR framework has revised the regulatory requirements that are pervasive to the operations, functioning and governance of all NBFCs. We have discussed some of the regulatory revisions in the previous chapters. Other key revisions prescribed in the SBR which the NBFCs need to comply with are:

Regulatory revision: Ceiling on IPO funding

Applicable to: All layers

Effective date: 1 April 2022

Regulatory revision: Large Exposure Framework

Applicable to: NBFC-UL

Effective date: 1 October 2022

Regulatory revision: Implementation of 'Core Financial Services Solution' (CFSS) by NBFCs

Applicable to: NBFC-ML and NBFC-UL with 10 or more fixed-point service delivery units

Effective date: 30 September 2025 and 30 September 2024 for 70 per cent fixed point service delivery units of NBFC-UL

Quarterly progress report on implementation of CFSS to be submitted from quarter ending 31 March 2023

Regulatory revision: Compliance framework within NBFC

Applicable to: NBFC-ML and NBFC-UL

Effective date: 1 October 2022

Set BoD approved policy by 1 April 2023

Establish compliance function, including appointment of Chief Compliance Officer (CCO) by 1 October 2023

(Source: KPMG in India's analysis, 2022)

In this article, we aim to provide an overview of these provisions.

Overview of the provisions

An overview of some of the other key provisions of the SBR is given below:

I. Ceiling on IPO Funding

In conjunction with the regulatory changes under the SBR framework, RBI has now set a ceiling limit of INR1 crore per borrower for financing subscription to Initial Public Offers (IPOs), with effect from 1 April 2022. While the ceiling limits have been set by RBI, NBFCs may opt to have more conservative limits. Before this revision, NBFCs had no ceiling limits on IPO funding.

II. Implementation of 'Core Financial Services Solution' by NBFCs

In line with the requirements stated under the SBR framework NBFCs with 10 or more branches need to adopt Core Banking Solution (CBS). Detailed guidelines on implementation of CBS has been provided by RBI (in a circular issued in February 2022)

As per the circular, NBFCs in the Upper Layer (NBFC-ULs) and NBFCs in the Middle Layer (NBFC – MLs) with 10 or more 'fixed point Service Delivery Units' (SDUs)[1] as on 1 October 2022 will be mandatorily required to implement 'Core Financial Services Solution (CFSS)' akin to the CBS adopted by banks. All NBFCs in the Base Layer (NBFC-BL) and NBFC-ML and UL with fewer than 10 SDUs may consider implementation of the CFSS, though such implementation is not mandatory.

The objective of the CFSS would be to provide for seamless customer interface in digital offerings and transactions relating to products and services with anywhere/anytime facility, enable integration of NBFCs' functions, provide centralised database and accounting records, and be able to generate suitable Management Information Systems (MIS), both for internal purposes and regulatory reporting.

The timeframe for the implementation of CFSS by NBFCs would be as follows:

Category of NBFC	Timeframe for implementation
NBFC – Middle and upper layer with 10 or more 'fixed point service delivery units'	On or before 30 September 2025 NBFC-UL to ensure that the CFSS is implemented at least in 70 per cent of 'fixed point service delivery units' on or before 30 September 2024.

1. 'Fixed point service delivery unit' is a place of operation from where the business activity of non-banking financial intermediation is carried out by the NBFC and which is manned either by its own staff or outsourced agents. It carries uniform signage with name of the NBFC and it functions under administrative control of the NBFC. Administrative Offices and Back Offices which do not have any direct interface with customers should not be treated as a 'Fixed point service delivery unit'.

Quarterly progress report

The NBFCs are required to submit a quarterly progress report on implementation of the CFSS, along with various milestones as approved by the Board/Committee of the Board to the Senior Supervisory Manager (SSM) Office of RBI starting from quarter ending 31 March 2023.

III. Compliance Framework within an NBFC

The RBI as part of the overall guidelines under the SBR framework issued in October 2021 had observed that an independent compliance function and a strong compliance risk management framework are necessary to ensure an effective compliance culture in the organisation. Therefore, the governance guidelines introduced the mandatory requirement for appointment of Chief Compliance Officer (CCO) and having a Board approved policy laying down the roles and responsibilities of the CCO for NBFCs in the upper and middle layer.

NBFCs in the base layer shall continue to be governed under the existing guidelines prescribed under the Master Direction – Non-Banking Finance Company – Systemically Important Non-Deposit taking and Deposit taking Company (Reserve Bank) Directions, 2016 (SI-NBFC Master Directions) and the Master Direction - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 (NSI-NBFC Master Directions), as applicable.

Pursuant to the SBR framework guidelines, the RBI provided a more detailed circular in April 2022 focusing on the scope and responsibilities of the compliance function and role of CCO within NBFCs. A summary of some of the key requirements have been provided herewith.

- **Timelines:** NBFCs in the upper and middle layer shall be required to put in place a Board approved policy latest by 1 April 2023 and a Compliance Function which includes appointment of a CCO latest by 1 October 2023.
- **Role of BoD:** The primary responsibility of oversight over the Compliance function would rest with the BoD and Senior Management. The BoD are required to ensure that an appropriate compliance policy is put in place and implemented along with review and reporting timelines.
- **Role of senior management:** The senior management would be required to review the compliance risk which is the risk of legal and financial sanctions, material financial loss or loss of reputation an NBFC may suffer on account of failure to comply with laws, regulations, rules and codes of conduct applicable to its activities, and submit its detailed findings to the BoD at least once a year.
- **Compliance function:** The compliance function to be set up by the NBFCs should be commensurate to its scale of operations, corporate governance framework, risk profile and organisational structure. The scope of the compliance function will be to ensure strict observance to all statutory and regulatory requirements for the NBFC which would include standards of market conduct, managing conflict of interest, treating customers fairly and suitability of customer service. RBI also has laid down certain minimum responsibilities of the compliance function of an NBFC.
- **Compliance framework:** While setting up the Compliance framework in NBFCs, the RBI has also outlined some key pointers to be considered which include amongst others:
  - ***Formulating a Board approved compliance policy*** which includes aspects on the company's compliance culture and philosophy, structure and role of compliance function, role of the CCO, processes for identifying, assessing, monitoring, managing and reporting on compliance risk. This policy is required to be reviewed at least once a year.
  - The CCO and the compliance function should be given the ***authority for access*** of any information and communication with any staff member in order to carry out its responsibilities.
  - The CCO shall ***not be allowed to do any dual roles*** which bring conflict of interest to his/her primary role of compliance head. Staff in the compliance department are also required to primarily focus on compliance functions.
  - The compliance department shall be ***subjected to internal audit*** and compliance risk would be included in the risk assessment framework of the Internal audit function,
- **CCO:** The RBI has also prescribed certain guidelines around the appointment, removal and tenure of the CCO. The guidelines also state that the CCO is required to have the relevant experience and considered 'Fit and Proper' as per the MD & CEO certification and that he shall be a senior executive of the NBFC with direct reporting lines to the MD and CEO and/or BoD.

IV. Large exposure framework

The RBI had prescribed a Large Exposure Framework (LEF) for NBFCs in the upper layer as per the SBR framework circular dated 22 October 2021. LEF aims at addressing credit risk concentration in NBFCs by setting out how to identify large exposures, refine the criteria for grouping of connected counterparties and put in place reporting norms for large exposures.

The LEF has put in place single counterparty and group of connected counterparty limits for lending by NBFCs. The LEF limits have been summarised as below:

(as percentage of eligible capital base)

	NBFC-UL (Other than infrastructure finance company)	NBFC – UL (Infrastructure finance company)
Single Counterparty	• 20 per cent • Additional 5 per cent with board approval • Additional 5 per cent if exposure towards infrastructure loan/investment (Single counterparty limit shall not exceed 25 per cent in any case)	• 25 per cent • Additional 5 per cent with board approval
Group of connected counterparties	• 25 per cent • Additional 10 per cent if exposure towards infrastructure loan/investment	• 35 per cent

An exposure to a counterparty shall constitute both on and off-balance sheet exposures. Additionally, the current exposure ceiling limits were capped at 15 per cent for single borrower and 40 per cent in case of group borrower and therefore, the new guidelines especially with respect to group borrower limits would require NBFC-ULs to put in place an effective mechanism to bring down existing exposures to below 25 per cent in case of non-IFC companies.

Eligible capital base

Eligible capital base is the Tier 1 capital as defined in the SI-NBFC Master Directions. In addition, profits accrued during the year would be considered in Tier I capital for the purpose of LEF after making necessary adjustments as per the other guidelines applicable to NBFC-UL.

Determining group of connected counterparties

Group of connected parties has been defined within the LEF circular for NBFCs in the upper layer released in April 2022. There are two primary relationships which have been defined for identification of the connection:

a. Control relationship

b. Economic interdependence.

While there is detailed guidance on identification of the parties which would be covered under the group of connected parties, there are also specific exemptions for sovereign exposures and NBFC-UL's exposure to group entities (that is deducted from owned funds for calculation of Net Owned Funds (NOF)). While determining group of connected parties, RBI has also exempted an NBFC-UL's investment in the equity capital of an insurance company to the extent specifically permitted in writing by the regulator.

Under the LEF, the NBFC-ULs would need to frame a board approved policy to determine the existence of a group of connected counterparties. This policy, as well as the periodic assessment for completeness checks would be subject to supervisory checks.

Adjustments to be made to the exposures before the LEF limits are calculated

The RBI has permitted exposures to be offset with credit risk transfer instruments as permitted within the LEF guidelines. These include:

- Cash margin/caution money/security deposit against which right to set off is available, held as collateral against the advances;
- Central government guaranteed claims which attract 0 per cent risk weight for capital computation;
- State government guaranteed claims which attract 20 per cent risk weight for capital computation;
- Certain corporate bonds held in the current category and hedged by Credit Default Swap (CDS)

Breach of the LEF limits

Any breach of large exposure limits should have occurred only under exceptional conditions beyond the control of NBFC-UL, and it shall be reported to RBI (Department of Supervision, Central Office) immediately and rapidly rectified. In addition, NBFC-UL cannot undertake any further exposure (at the entity or group level, as the case may be) until the exposure is brought down within the limit.

Additional applicable reporting to RBI

RBI requires the NBFC–UL to report its large exposures (i.e. exposure values to a single counterparty or group of connected counterparties equal to or above 10 per cent of the NBFC-UL's eligible capital base) to the RBI. The LEF reporting shall cover the following exposures:

- All exposures, meeting the definition of large exposures
- All other exposures, without offsetting the credit risk transfer instruments, are equal to or above 10 percent of the NBFC-UL's eligible capital base.
- All exempted exposures with values equal to or more than 10 percent of the NBFC-UL's eligible capital base
- 10 largest exposures irrespective of the values of these exposures.

Effective date

These guidelines are applicable from 1 October 2022, with effect from which the currently applicable credit concentration norms in respect of single/group of borrowers contained in SI-NBFC Master Directions shall no longer be applicable to NBFC-UL.

Next steps

NBFCs within each of the layers of the SBR framework, should take note of the provisions applicable to them and draw up broad guidelines for implementation. This includes putting in place a board approved compliance policy, setting up a compliance function, identifying existing officers that can take up the role of a CCO or recruiting such officers, developing a plan for implementation of the CFSS, etc.