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RBI seeks to introduce Scale-based Regulations for NBFCs

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RBI has issued a discussion paper to introduce a revised scale-based regulatory framework for NBFCs and has sought comments on the same. 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. The major arbitrage opportunities include:

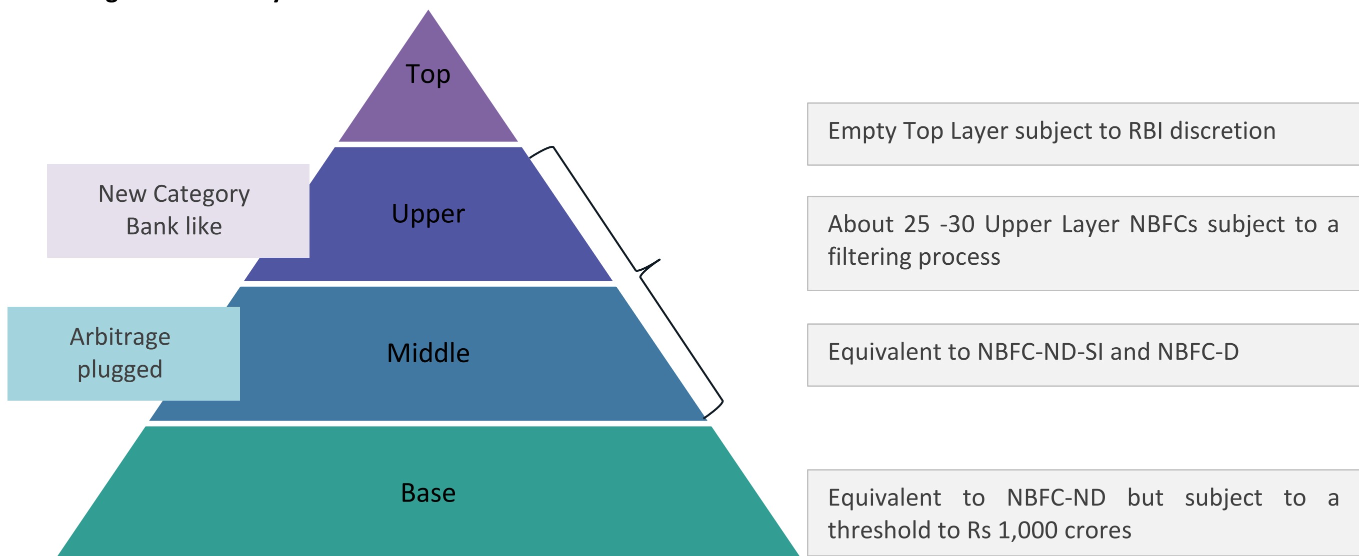
- **Structural arbitrage:** Some of them include maintenance of CRR/ SLR by banks against demand and time liabilities, ceiling on voting rights of shareholders, prohibition in holding non-banking assets, and deposit insurance.
- **Prudential arbitrage:** As compared to banks, NBFCs have flexibility in terms of capital adequacy, exposure framework, asset classification and provisioning norms.

However, in view of the recent stress in the sector, RBI aims to re-examine the suitability of this regulatory approach, and examine the need to develop a scale-based approach to regulation from a 'systemic significance' vantage point and recommend appropriate regulatory measures.

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

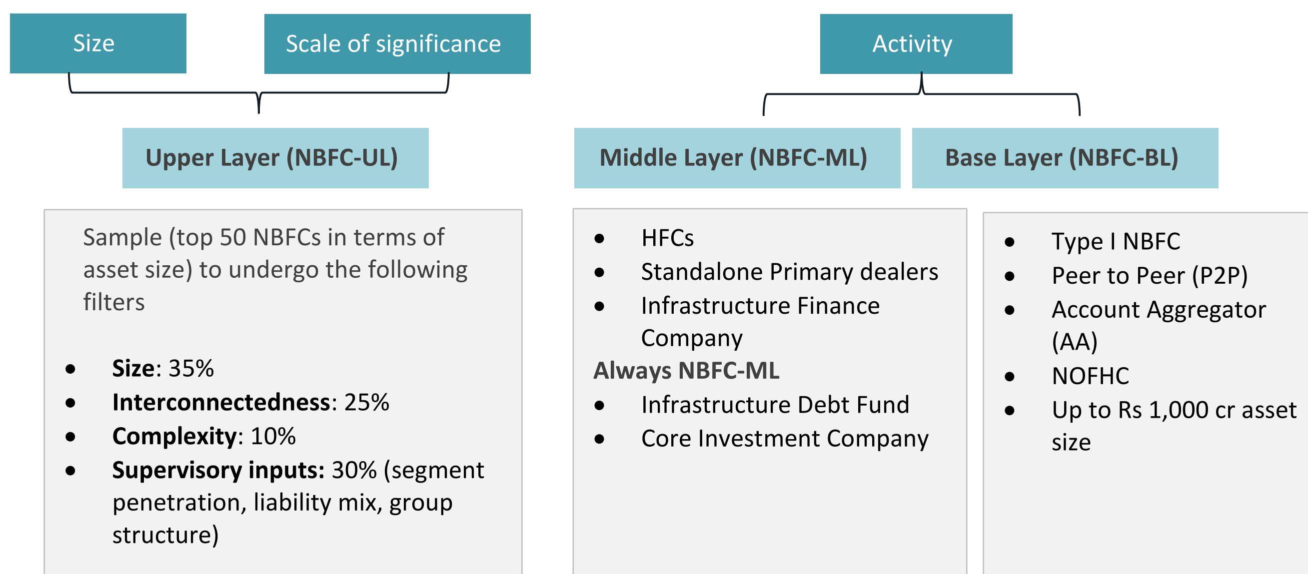


(Source: RBI)

NBFCs would be classified into four categories for scale-based supervision – Base Layer (BL), Middle Layer (ML), Upper Layer (UL), and Top Layer (TL).

- The Base Layer would constitute >97% of NBFCs and would include NBFCs with an asset size of less than Rs 1000 cr., P2P lenders, account aggregators, NOFHCs, and Type 1 NBFCs.
- The Middle Layer would include NBFCs with asset size greater than Rs 1,000 cr., NBFC-D, HFC, IFCs, IDF, SPDs, and CICs.
- The Upper layer would comprise the Top 10 NBFCs as per asset size as well as other NBFCs shortlisted on criteria including size, leverage, assets/liabilities within the financial system, and group structure.
- The Top Layer as per RBI is supposed to be empty. The layer would be populated if RBI views the systemic risk spill-overs from specific NBFCs in the Upper Layer has witnessed an unsustainable increase. Such NBFCs would be moved to the Top Layer from the Upper Layer. Such NBFCs would be subject to higher capital charge, including Capital Conservation Buffers.

Figure 2: Filtering process for the scale based regulations of NBFCs



(Source: RBI)

As the Government owned NBFCs are still in the transition period wherein they have to attain the minimum CRAR by March 31, 2022 as per RBI's circular on 'Withdrawal of Exemptions Granted to Government Owned NBFCs' dated May 31, 2018, these NBFCs would not be subject to Upper Layer regulatory framework.

Summary of the Proposed Regulatory changes for NBFCs – Scale Based Approach

Figure 3: Table of proposed changes

Parameters	NBFC – Base Layer (NBFC-BL)	NBFC – Middle Layer (NBFC-ML)	NBFC – Upper Layer (NBFC-UL)
Capital Regulation			
CET 1	Not stipulated	Not stipulated	9%
Leverage	7	Not stipulated	To be stipulated
Standard Asset provisioning	0.25%	0.40%	Differential Provisioning – Similar as banks
NPA Classification	Harmonisation from 180 days to 90 days overdue	90 days	90 days
ICAAP	Not stipulated	Board approved policy taking into account all risks	Board approved policy taking into account all risks
Concentration norms			
Computed as a percentage of	Owned funds	Tier 1 Capital	Tier 1 Capital
Credit Concentration Norms and Applicability of Large Exposure Framework	Extant guidelines as applicable for NBFC-NDs	Merger of lending and investment limits into a single exposure limit	(i) LEF as applicable to banks with suitable modification

(LEF)			(ii) Transition time for implementation
Governance and Disclosure norms			
Compensation Guidelines – Constitution of Nomination and Remuneration Committee	Not stipulated	(i) Constitution of a Remuneration Committee (ii) Principles for fixed/ variable pay structures (ii) Malus/ claw back requirements	On similar lines as applicable for Private Sector Banks, including guidelines on general compensation policy & remuneration committee.
Rotation of Statutory Auditors/ Firms	Not stipulated	(i) A uniform tenure of three consecutive years (ii) After completion of three years, mandatory cooling period of six years (two tenures) before reappointment.	(i) A uniform tenure of three consecutive years (ii) After completion of three years, mandatory cooling period of six years (two tenures) before reappointment.
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 or subsidiaries (ii) An Independent Director cannot be director in more than two NBFCs (NBFC-ML and NBFC-UL) at the same time	(i) No KMP of an NBFC shall hold office in any other NBFC-ML or NBFC-UL or subsidiaries (ii) An Independent Director cannot be director in more than two NBFCs (NBFC-ML and NBFC-UL) at the same time
Appointment of Chief Compliance Officer	Not stipulated	Mandatory	Mandatory
Listing	Not Mandatory	Not Mandatory	Adequate phase-in-time for mandatory listing. However, disclosure requirements will start earlier than actual listing within the implementation plan for NBFC-UL
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	(i) Adequate experience & educational qualification (ii) At least one of the directors should have experience in retail lending in a bank/NBFC	(i) Adequate experience & educational qualification (ii) At least one of the directors should have experience in retail lending in a bank/NBFC Specific expertise may be prescribed in addition
Removal of Independent Directors with Supervisory approval	Not stipulated	Not stipulated	Requires Supervisory approval
Risk Management Committee	(i) Roles and responsibilities to be laid out (ii) Could be Board or Executive level as decided by the Board	Board-level RMC applicable	Board-level RMC applicable
Business Conduct and Disclosure Regulations	(i)Extant guidelines as applicable to NBFC-NDs (ii)Additional disclosures on type of exposures, related party transactions, customer complaints	Additional disclosures	To be at par with banks (SEBI-LODR)
Other Regulatory Arbitrage			
Sensitive Sector Exposure (SSE)	Not stipulated	(i) Board approved internal limits separately for capital	(i) Board approved internal limits separately

		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	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) buy back of shares/ securities (b) activities leading to Ozone Depleting Substances (c) Directors and relatives of directors (d) Officers and relatives of Senior Officers (e) Real Estate – only where project approvals other permissions are in place.	Restrictions on grant of loans and advances for/to the following: (a) buy back of shares/ securities (b) activities leading to Ozone Depleting Substances (c) Directors and relatives of directors (d) Officers and relatives of Senior Officers (e) Real Estate – only where project approvals other permissions are in place.
IPO Financing	Not stipulated	Ceiling of Rs.1 crore per individual	Ceiling of Rs.1 crore per individual
Sale of stressed assets	To be at par with banks once guidelines are finalised	To be at par with banks once guidelines are finalised	To be at par with banks once guidelines are finalised
Core Banking Solution for NBFCs	Not mandatory	Mandatory for NBFCs with more than 10 branches	Mandatory for NBFCs with more than 10 branches

(Source: RBI)

Conclusion

The discussion paper by the RBI strongly indicates its intentions to tighten the NBFC regulation and reduce regulatory arbitrage with banks. However, RBI at the same time has acknowledged that NBFCs have contributed significantly to the under-banked segment. This scale based approach is far superior 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.

As can be seen in figure 3, 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 cr, 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 proposed regulations related to capitalization and governance. This discussion report also indicates that RBI could have some say in the NBFC board composition.

Contrary to expectations, the report has made no specific recommendation to impose CRR / SLR requirements, however these may be imposed in the final sections on entities pushed to the top layer or even the top 10 entities in the upper layer. Even though the top entities have sufficient cash/ investments which could be diverted for fulfilling such requirements. This would negatively impact the lending portfolio of these NBFCs. 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

from no limits currently. Such regulatory restrictions on lending could hamper some businesses of NBFCs. The proposed sensitive Sector Exposure (SSE) norms could shift these business to smaller NBFCs which may reduce the availability of funds for such businesses. Additionally implementation of a core banking solutions could impose further costs on NBFCs and the proposed changes in corporate governance including risk management systems may limit the flexibility of entities as a NBFC platform. Even as a majority of the NBFCs have an adequate levels of Tier I capital, some entities which include significant portion of debt as a part of CRAR, may have to raise capital for boosting their CET I levels

Additionally considering the reduced regulatory arbitrage, some of the upper level NBFCs could opt for conversion into a bank subject of course to regulatory approval. The RBI's draft report of the IWG to Review Ownership Guidelines and Corporate Structure for Indian Private Sector Banks has already included an additional pathway for NBFCs, with an asset size of Rs 50,000 crore and above, which have operated for more than 10 years, including those which are owned by a corporate house, could be converted into banks. Additionally banks benefit on the Capital adequacy front with lower risk weights on quite a few loans such as retail loans, appropriately rated corporates compared to NBFCs which for similar assets have a higher risk weight enabling banks to have a larger book with similar capitals. On the other hand, if such NBFCs regard these regulations as onerous, they may decide to shrink their book, which impact credit delivery/ financial inclusion, and focus on fee income.

In absolute terms, the asset size of NBFC sector (including HFCs), as on March 31, 2020, was Rs.51.47 lakh crore. 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	29%
Select five HFCs	19%
Select 20 NBFCs (excl. HFCs and govt. controlled NBFCs)	20%

As at end-March 2020, NBFCs have been the largest net borrowers of funds from the financial system, of which, more than half of the funds were from SCBs. NBFCs which convert into banks would have to let go of these borrowing and diverse into market borrowings, depositors and other borrowing plans. This could free up lending to other parts of the industry as well as allowing the smaller NBFCs to access the capital which is being currently deployed towards the larger NBFCs. Secondly these large NBFCs have significant underwriting capabilities and have increased credit penetration with a large network. Even regulations for large-sized NBFCs are coming on par with banks now. Banking licenses may resolve the issues on the liability side. Further if NBFCs were issued with banking licenses, this would reduce overall cost of funds for them. Compliance with CRR of 3% and SLR of 18% could be a challenge. However, several of the eligible NBFCs have an adequate liquidity level which could enable them to meet these criteria. Additionally, compliance with overall PSL may not be a big issue, but NBFCs could require additional time lines on compliance with sub limits. It should be noted that, several of the large private sector NBFCs which satisfy the size and the length of operations criteria are bank owned/sponsored and consequently would not be converting into banks consequently limiting the set of entities. It should also be noted that currently banks have tighter NPA recognition requirements vs. NBFCs. Banks have to maintain an account as NPA for a cooling period even after the account has become current whereas, NBFCs currently can change the NPA tag when the number of overdue days goes below 90 days.

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.

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