Chapter 2

RBI introduces scale-based regulation for NBFCs

This article aims to:

Provide an overview of the scale-based framework prescribed by RBI and regulatory provisions applicable for NBFCs in each layer within the framework.

Introduction

The Non-Banking Finance Companies (NBFC) sector plays a significant complementary role in financial intermediation, along with banks, and caters to the unmet and exclusive credit needs of various segments, such as infrastructure, factoring, leasing, etc. Considering the lower scale of operations of NBFCs vis-à-vis banks, and with an aim of providing them with greater operational flexibility to grow, NBFCs have been enjoying the freedom to undertake a wider spectrum of activities and have less stringent regulatory provisions applicable as compared to banks (often referred to as the regulatory arbitrage in favour of NBFCs).

Over the years, the NBFC sector has shown tremendous growth. However, stress has been observed in the NBFC sector which has generated vulnerabilities by giving rise to systemic risk through the NBFC sectors' interlinkages within the financial system.

With a view to develop a strong and resilient financial system, in January 2021, the Reserve Bank of India (RBI) had issued a discussion paper on revised regulatory framework for NBFCs. Basis the inputs received from stakeholders, RBI, vide a notification dated 22 October 2021 has prescribed a 'scale-based' regulation for the NBFC sector. The scale-based regulatory approach renders the regulation and supervision of the NBFCs to be a function of their size, activity and perceived riskiness. Thereby, a higher degree of regulation would be applicable for NBFCs that have greater size and complexity and pose a higher risk for the financial system, and a lower degree of regulation would be applicable to NBFCs that pose a lower risk for the financial system, allowing them operational flexibility. These regulations will be applicable to NBFCs effective 1 October 2022. However, the provision with regard to ceiling on IPO funding will be 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 will be classified in each of these layers, and the revisions in the structural and regulatory framework applicable to the NBFCs in each of the layers.

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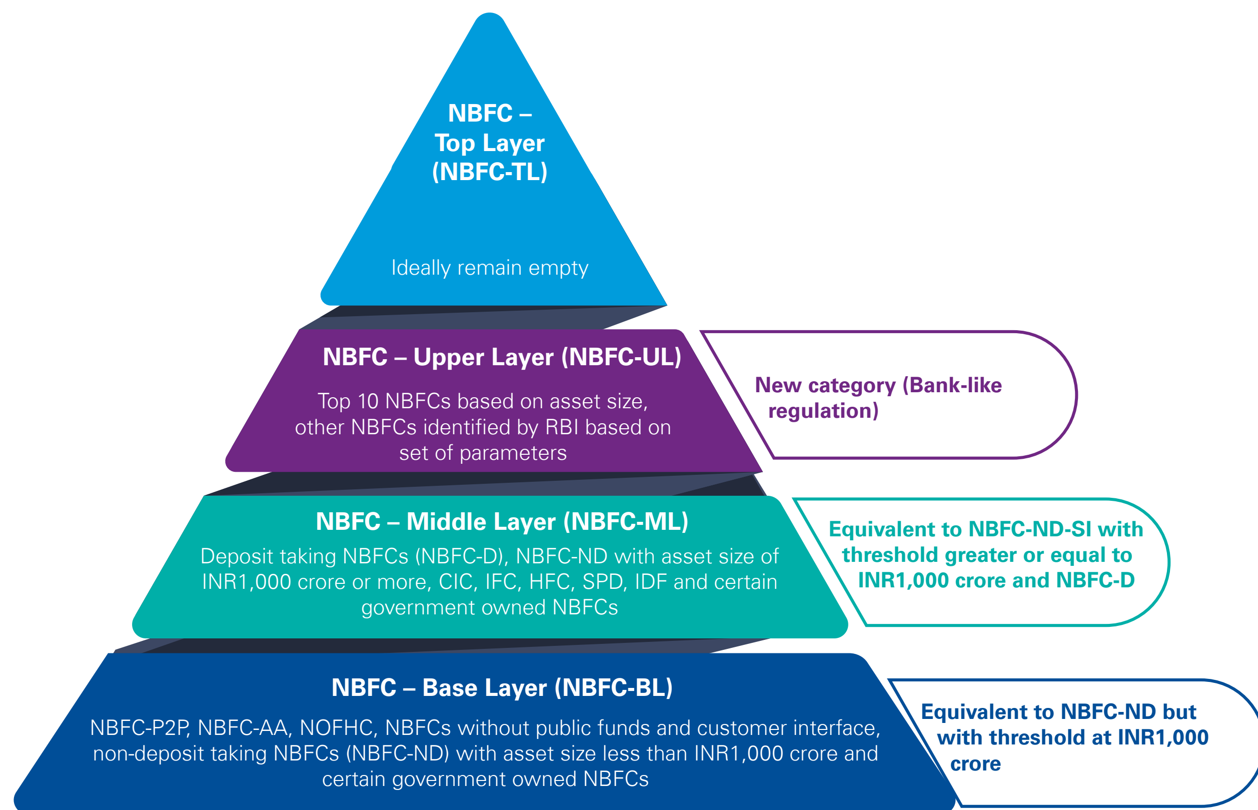
The scale-based regulatory approach

The scale-based regulatory 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: Scale-based regulatory 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, 2021, 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 existing non-deposit taking non-systemically important NBFCs (NBFC-NDs), but with an asset size less than INR1,000 crore. It will specifically include:

- NBFC-P2P,
- NBFC-AA,
- NOFHC 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 by way of greater 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 and IDF (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 higher 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. These NBFCs can either be a part of NBFC-ML or NBFC-UL, as the case may be.
3. The quantitative criteria majorly consist of size and leverage, interconnectedness and complexity, and the qualitative criteria majorly consists of nature and type of liabilities, group structure and segment penetration.

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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:

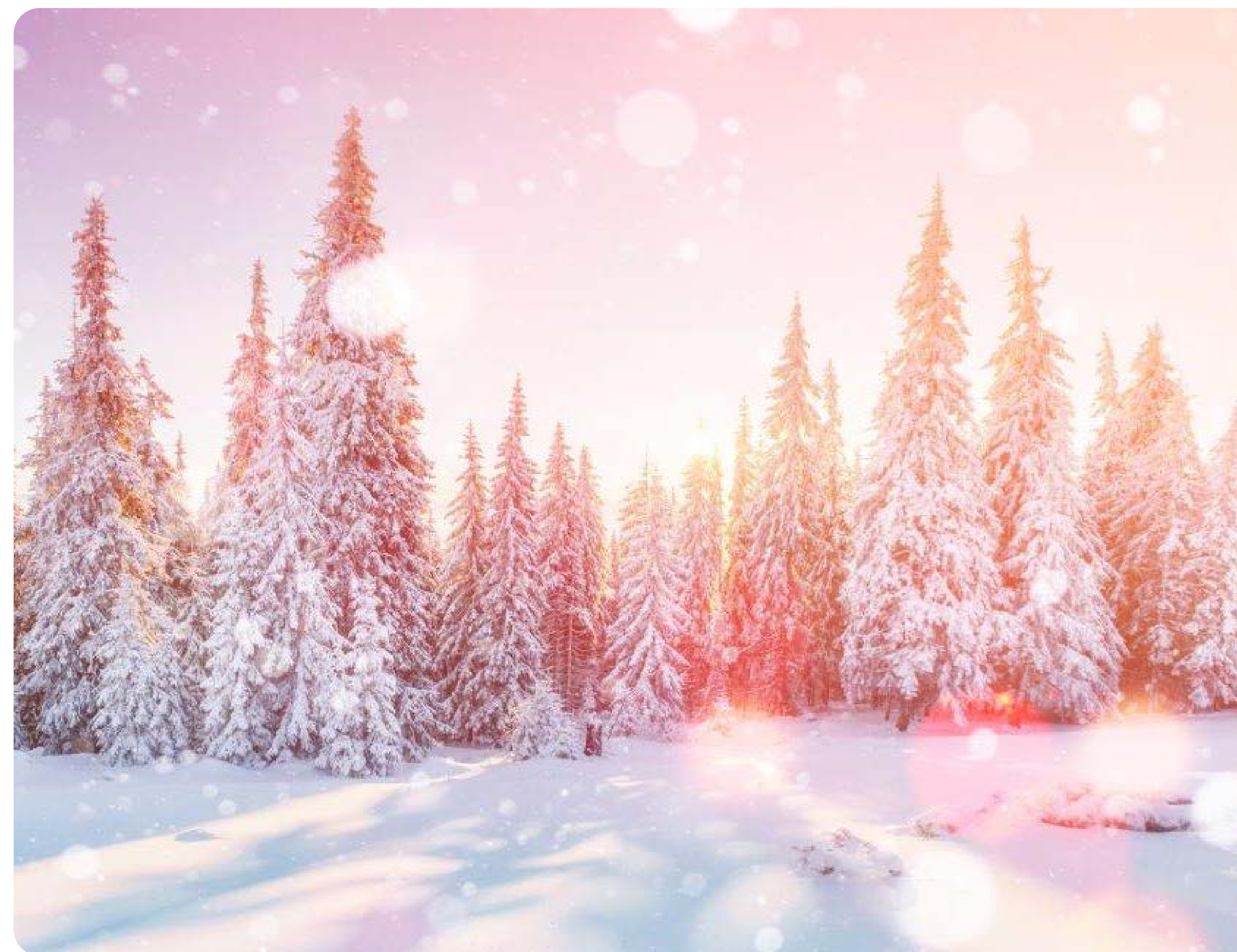
- **Board approved policy and implementation plan to be prepared within three months:** Within three months of being advised by the RBI regarding its inclusion in the NBFC-UL, the NBFC should put in place a board approved policy for adoption of the enhanced regulatory framework and chart out an implementation plan for adhering to the new set of regulations. This board approved implementation plan will be submitted to RBI and be subject to 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. Therefore, 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 readjust 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.



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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 the supervisor if it is of the opinion that the entity is contributing significantly to 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 NBFCs are given in the table below, the notes annexed to the tables provide further explanations of these changes:

Regulatory revision	Regulatory revisions applicable to			Further clarification awaited from RBI	Reference
	NBFC-BL[5]	NBFC-ML[6]	NBFC-UL[7]		
A. Regulatory revisions applicable to all layers of NBFCs					
Revisions in regulatory guidelines					
• Raising net owned fund 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.				Note A.1
• 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-days NPA norm.			Note A.2
• 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.				
• 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 IPO funding). Ceiling on IPO funding will be applicable from 1 April 2022.				
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		Note A.3
• Disclosures	Expanded disclosure requirements for NBFCs.			✓	Note A.4
• Loans to directors, senior officers and relatives of directors	NBFCs to have a board approved policy on these matters.			✓	Note A.5

4. The regulatory provisions discussed in this article are the revisions that will be made in the existing regulatory framework.
5. 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 extant 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 hereunder.
6. NBFCs in the middle layer will be governed by the extant regulations applicable to NBFC-ND-SIs, NBFC-Ds, CICs, SPDs and HFCs.
7. NBFCs in the upper layer will be subject to regulations applicable to NBFC-ML and to the regulatory revisions sexplained in the table:

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Regulatory revision	Regulatory revisions applicable to			Further clarification awaited from RBI	Reference
	NBFC-BL	NBFC-ML	NBFC-UL		
B. Regulatory revisions applicable to NBFC-ML and NBFC-UL					
Revisions in capital guidelines					
• Introduction of Internal Capital Adequacy Assessment Process (ICAAP)	Not applicable	NBFCs in middle and upper layer to make a thorough internal assessment of the need for capital, commensurate with the risks in their business, on similar lines as ICAAP for banks.			Note B.1
Revisions in prudential guidelines					
• Concentration of credit/investment	Extant norms applicable	Merged lending and investment exposure limits into a single exposure limit. Limit to be computed as a percentage of Tier 1 capital.			Note B.2
• Sensitive Sector Exposure (SSE)	Not applicable	BoD approved internal limits to be fixed for SSE, separately for capital market and commercial real estate exposures. HFCs are required to follow extant regulations applicable.			Note B.3
• Regulatory restrictions on loans	Not applicable	Regulatory restrictions applicable on loans to directors, senior officers and on appraising loan proposals involving real estate.		✓	Note B.4
Revisions in governance guidelines					
• Key managerial personnel	Not appliable	Restrictions on KMPs from holding any office (including directorships) in any other NBFC-ML or NBFC-UL.			Note B.5
• Independent director	Not applicable	IDs are restricted from being on the BoD of more than **three NBFCs** at the same time.			Note B.6
• Disclosures in annual financial statements	Not applicable	With effect from **31 March 2023**, NBFCs are required to make the following additional disclosures in 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.		✓	Note B.7

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Regulatory revision	Regulatory revisions applicable to			Further clarification awaited from RBI	Reference
	NBFC-BL	NBFC-ML	NBFC-UL		
Revisions in governance guidelines					
• Chief compliance officer	Not applicable	Mandatory	Mandatory	✓	Note B.8
• Compensation guidelines	Not applicable	NBFCs to put in place a BoD approved compensation policy, which includes: • Constitution of remuneration committee • Principles for fixed/variable pay structures • Malus/claw back provisions.			Note B.6
• 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.		✓	Note B.10
• Introduction of core banking solution	Not applicable	Mandatory for NBFCs with 10 or more branches	Mandatory for NBFCs with 10 or more branches	✓	Note B.11
C. Regulatory revisions applicable only to NBFC-UL					
Revisions in capital guidelines					
• Common Equity Tier 1	Not applicable	Not applicable	CET 1 of at least **nine per cent of risk weighted assets**[8]	✓	-
• Leverage	Not applicable	Not applicable	Leverage requirement will be applicable.	✓	Note C.1
• Differential standard asset provisioning	Not applicable	Not applicable	Differential standard asset provisioning applicable, similar to provisions applicable to banks.	✓	Note C.2

8. Currently, the provisions with regard to maintenance of CET 1 is not applicable to NBFCs.

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Regulatory revision	Regulatory revisions applicable to			Further clarification awaited from RBI	Reference
	NBFC-BL	NBFC-ML	NBFC-UL		
Revisions in prudential guidelines					
• Large Exposure Framework (LEF)	Not applicable	Not applicable	Guidelines on LEF to be issued by RBI. Credit concentration norms (under Note B.2) to be followed till these norms are made applicable	✓	Note C.3
• Internal exposure limits	Not applicable	Not applicable	BoD approved internal exposure limits to be set for important sectors to which credit is extended[9]. This is in addition to SSE limits (refer note B.3)		-
Revision in governance guidelines					
• Qualification of board members	Not applicable	Not applicable	Composition of BoD to include a mix of educational qualification and experience		Note C.4
• Listing and disclosures	Not applicable	Not applicable	NBFCs to get listed within three years of identification as NBFC-UL. Disclosure requirements applicable even before entity is listed		Note C.5
• Removal of independent directors	Not applicable	Not applicable	NBFC-UL to report to supervisors in case any ID is removed/resigns before the completion of his/her normal tenure. Such reporting was not required by NBFCs earlier		-

9. This is a new provision, NBFCs were not required to set such internal limits earlier.

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Note A: Revisions in regulatory guidelines applicable to all layers of NBFCs

Revisions in regulatory guidelines

1. **Raising Net Owned Fund (NOF) for certain NBFCs:** As per the extant regulatory framework applicable to the NBFC sector, certain NBFCs (such as NBFC-MFI, NBFC-Factors, NBFC-ICC) have a minimum NOF requirement of less than INR10 crore.

   RBI assessed that the ability of NBFCs to perform their role effectively and efficiently requires them to be adequately capitalised, financially resilient, and well-regulated so that they retain the confidence of their stakeholders, including their lenders and borrowers. In this regard, RBI felt the need to have stronger entry point norms that would lower the chances of failure arising from poor governance of non-serious players. Accordingly, RBI requires the minimum NOF for NBFC-ICC, NBFC-MFI and NBFC-factors to be increased to INR10 crore[10].

   In order to ensure non-disruptive transition, a well-defined glide path has been provided for the existing NBFCs to achieve the NOF. The glide path is given below:

NBFCs	Current NOF	NOF By 31 March 2025	NOF by 31 March 2027
NBFC-ICC	INR2 crore	INR5 crore	INR10 crore
NBFC-MFI	INR5 crore (INR2 crore in north-east region)	INR7 crore (INR5 crore in north-east region)	INR10 crore
NBFC-Factors	INR5 crore	INR7 crore	INR10 crore

2. **Harmonisation of NPA classification norms:** Currently the NBFCs-ND with an asset size of less than INR500 crore (i.e., non-systemically important, non-deposit taking NBFCs) classify assets with an overdue period of more than 180 days as NPA (NPA norm). All other NBFCs have an NPA norm of 90 days.

   RBI has now harmonised the NPA norms for all NBFCs to 90 days. This amendment will impact the NBFC-BL, which includes the NBFCs-ND. Accordingly, a glide path has been provided to NBFCs in the base layer to adhere to the 90 days NPA norm, as given below:

NPA norms	Timeline
> 150 days	By 31 March 2024
> 120 days	By 31 March 2025
> 90 days	By 31 March 2026

Clarifications issued by RBI on NPA classification

On 1 October 2021, RBI issued a Master Circular on Prudential Norms on Income Recognition, Asset Classification and Provisioning (IRACP)[11], which is applicable to all Commercial Banks (excluding Regional Rural Banks). Subsequently, on 12 November 2021, RBI issued a circular, providing certain clarifications on IRACP norms to ensure uniformity in its implementation and harmonising certain requirements for all lending institutions[12]. Some clarifications that will impact NPA classification for NBFCs, include:

- **Classification as Special Mention Account (SMA) and NPA:** The 'Prudential Framework for Resolution of Stressed Assets' requires lenders to recognise incipient stress in borrower accounts, immediately on default by classifying them as SMA. Further, these assets will be classified as NPA when they are overdue for more than 90 days. The general practice amongst NBFCs is to report SMAs/ NPAs based on position of the loan accounts at month end or quarter end.

  RBI has now clarified that borrower accounts should be flagged as overdue as part of the day end process for the 'due date' (and not at month end). This clarification is effective on an immediate basis.

- **SMA classification applicable to NBFC-ND:** Currently, the requirement to classify overdue borrower accounts as SMA as prescribed by the 'Prudential Framework for Resolution of Stressed Assets' is applicable to NBFC-ND-SI and NBFC-D, however, it is not applicable to NBFC-ND (i.e. non-systemically important, non-deposit taking NBFCs).

  With the clarifications issued by RBI, these provisions will now apply even to NBFC-ND. However, references to '90 days' for SMA-2/ NPA classification may be read as per the NPA norms applicable to NBFC-ND.

- **Upgradation of accounts classified as NPAs:** The IRACP norms specify that banks should upgrade accounts classified as NPA to 'standard' account, if arrears of interest and principal are paid by the borrower. RBI observed that many lending institutions upgrade NPA accounts to 'standard' category upon payment of only interest overdues, partial overdues, etc.

  RBI has now clarified that loan accounts classified as NPAs may be upgraded as 'standard' asset only if entire arrears of interest and principal are paid by the borrower. This clarification is effective on an immediate basis.

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10. NOF for NBFC-P2P, NBFC-AA and NBFCs with no public funds and no customer interface should continue to be INR2 crore. Further, there is no change in the existing regulatory minimum NOF for NBFCs-IDF, IFC, MGCs, HFC and SPD.

11. Earlier, the master circular on IRACP norms issued on 1 July 2015 was applicable to banks.

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Revisions in governance guidelines

3. **Risk management committee (RMC):** NBFCs are currently required to set up a RMC that would be responsible for evaluating the overall risks faced by the NBFC including liquidity risk and report to the BoD of the NBFC. The regulatory revisions now require the decision on composition of the RMC as a board-level committee or executive-level committee to be left to the discretion of the BoD of the NBFC.
4. **Disclosures[12]:** Disclosure requirements for NBFCs will be expanded to, *inter alia*, include types of exposures, related party transactions, loans to directors/senior officers and customer complaints. Currently, NBFCs are not required to make such disclosures.
5. **Loans to directors, senior officers and relatives of directors[13]:** NBFCs will be required to have a BoD approved policy on grant of loans to directors, senior officers, relatives of directors and to entities where directors or their relatives have major shareholding. Currently, NBFCs do not have any such policy.

Note B: Regulatory revisions applicable to NBFC-ML and NBFC-UL

In addition to Note A, the following regulatory revisions will be applicable to NBFCs in the middle and upper layer of the scale-based framework:

Revisions in Capital guidelines

1. **Introduction of Internal Capital Adequacy Assessment Process (ICAAP):** The objective of ICAAP is to ensure availability of adequate capital to support all risks in the business and also to encourage NBFCs to develop and use better risk management techniques for monitoring and managing their risks.

   As per the extant regulatory norms, NBFC-ND-SI and NBFC-D are on Basel I type framework (i.e., uniform risk weights for counterparties, market risk or operations risk is not considered when determining capital requirements) and are required to have a minimum capital of 15 per cent of the Risk Weighted Assets (CRAR).

   The regulatory revisions now require NBFCs in the middle and upper layer to make a thorough internal assessment of the need for capital, commensurate with the risks in their business. This internal assessment would be on similar lines as ICAAP prescribed for commercial banks under Pillar 2. For this purpose, NBFCs should consider credit risk, market risk, operational risk and all other residual risks as per methodology to be determined internally. This will facilitate an active dialogue between RBI and NBFCs on the assessment of risks and monitoring as well as mitigation of the same.

Revisions in prudential guidelines

2. **Concentration of credit/investment:** The extant regulatory norms prescribe separate limits for lending and investment exposures (concentration limits) for a single borrower and a group of connected borrowers. These concentration limits are computed as a percentage of owned funds.

   The regulatory revision has now merged the separate lending and investment exposure limit into a single exposure limit of 25 per cent for single borrower/party, and 40 per cent for single group of borrowers/parties[14]. Further, the concentration limits will be determined with reference to the NBFC's Tier 1 capital (instead of owned fund), as is currently applicable to banks.

   NBFC-UL should follow these norms till 'Large Exposure Framework' is put in place for them.
3. **Sensitive Sector Exposure (SSE):** Exposure to capital market (direct and indirect) and commercial real estate is reckoned as sensitive sector exposure for NBFCs. Currently, only HFCs are subject to specific regulation on SSE.

   RBI considered that the concentration risk resulting from undiversified portfolios, particularly in sensitive sectors, could prove detrimental to an NBFC's health. However, specifying hard coded sector-specific exposure limits may tantamount to altering the basic business model and risk appetite of certain NBFCs.

   Accordingly, regulatory revisions now require NBFCs to fix BoD approved internal limits for SSE separately for capital market and commercial real estate exposures. Further, NBFCs should conduct periodic dynamic vulnerability assessments of various sectors, which would help them determine such internal limits. While BoD of NBFCs are free to determine various sub-limits within the overall SSE internal limits, a sub-limit within commercial real estate exposure should be fixed for financing land acquisition.

   HFCs are required to follow specific regulations on SSE as per extant regulations[15].
4. **Regulatory restrictions on loans:** Currently, regulatory restrictions on loans and advances have not been imposed on NBFCs.

   The regulatory revisions have now extended regulatory restrictions in respect of:

   - **Loans to directors:** Granting loans and advances to directors, their relatives and to entities where directors or their relatives have major shareholding
   - **Loans to senior officers:** Granting loans to senior officers of NBFCs

12. This includes all commercial banks, co-operative banks, All-India Financial Institutions and all NBFCs (including HFCs).
13. RBI will be issuing a detailed circular on these provisions.
14. Extant instructions on concentration norms for different categories of NBFC, other than the changes above, will continue to remain applicable.
15. These regulations are specified in paragraph 22 and 23 of Master Direction – Non-Banking Finance Company – Housing Finance Company (Reserve Bank) Directions, 2021

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- **Appraising loan proposals involving real estate:** While appraising loan proposals involving real estate, NBFCs should ensure that borrowers have obtained prior permission from government/statutory authorities. Further, disbursements should be made only after the borrower has obtained requisite clearances form the government authorities.

(A detailed circular on these provisions will be issued by RBI in due course).

Revisions in governance guidelines

5. **Key Managerial Personnel (KMP):** The extant regulations do not lay any restriction on the offices and directorships that KMPs[16] of NBFCs can hold.

   The regulatory revisions have now restricted KMPs from holding any office (including directorships) in any other NBFC-ML or NBFC-UL. However, directorship in the subsidiary of the NBFC in which the individual is a KMP and directorship in NBFC-BL will be permitted. A timeline of two years, with effect from 1 October 2022 has been provided to KMP to ensure compliance with these norms.

6. **Independent Directors (ID):** The extant regulations do not lay any restriction on the number of directorships of IDs in NBFCs.

   In order to ensure that there is no conflict arising out of IDs being on the BoD of various NBFCs at the same time, including those of competing NBFCs, RBI has now restricted IDs from being on the BoD of more than **three NBFCs** at the same time[17] (restriction is applicable for IDs from being on the BoD of NBFC-ML and NBFC-UL, however there is no restriction on number of directorships in NBFC-BL). The onus of ensuring that there is no conflict will lie with the BoD of the NBFC.

7. **Disclosures in annual financial statements[13]:** As per the extant regulations, NBFCs are required to make certain regulatory disclosures in the annual financial statements.

   In addition to the existing disclosure requirements, NBFCs are required to make the following disclosures with effect from 31 March 2023:

   - **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
   - **Exceptional income or expenses** during the period
   - **Breaches in terms of covenants or defaults** in respect of loans availed by NBFC or debt securities issued
   - **Divergence in asset classification and provisioning** above a certain threshold to be prescribed by RBI.

8. **Chief Compliance Officer (CCO)[13]:** There is no current provision for appointment of a CCO by NBFCs.

   RBI observed that a compliance function has to be adequately enabled and made sufficiently independent so that it can ensure strict observance of all statutory and regulatory provisions.

   In this view, the regulatory revisions require NBFCs to appoint a CCO who would be sufficiently senior in the organisation hierarchy. NBFCs should also put in place a BoD approved policy laying down the role and responsibilities of the CCO with the objective of promoting better compliance culture in the organisation.

9. **Compensation guidelines[13]:** Currently, there are no compensation guidelines in place for NBFCs.

   In order to address issues arising out of excessive risk taking caused by misaligned compensation packages, it has been decided that NBFCs should put in place a BoD approved compensation policy. The guidelines should at the minimum include:

   - Constitution of remuneration committee
   - Principles for fixed/variable pay structures
   - Malus/claw back provisions.

   The Nomination and Remuneration Committee should ensure that there is no conflict of interest.

10. **Additional governance matters[13]:** RBI requires some additional governance matters to be complied with by NBFCs, these include:

    - BoD should delineate the role of various committees (audit committee, nomination and remuneration committee, risk management committee or any other committee) and lay down a calendar of reviews
    - NBFCs should formulate a whistle blower mechanism for directors and employees to report genuine concerns
    - BoD should ensure good corporate governance practices in subsidiaries of NBFCs.

11. **Introduction of Core Banking Solution (CBS)[13]:** Banks have implemented CBS which has brought significant benefits, including transparency, efficiency, reducing the scope of fraudulent flow and enhanced customer service experiences. NBFCs are currently not required to adopt CBS. With a view to inculcate similar benefits in NBFCs, RBI now requires NBFCs in the middle and upper layer of the scale-based framework, with 10 or more branches to mandatorily adopt CBS. A glide path of three

16. As defined in Section 2(51) of the Companies Act, 2013.
17. Limits permitted by the Companies Act, 2013 should be considered.

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years with effect from 1 October 2022 has been provided for the same.

Note C: Regulatory revisions applicable to NBFC-UL

In addition to Notes A and B, the following regulatory revisions will be applicable to NBFCs in the upper layer of the scale-based framework:

Revisions in capital guidelines

1. **Leverage[13]:** NBFCs are currently required to maintain a CRAR of 15 per cent. However, there is no leverage ratio[18] applicable to them.

   As per RBI, the NBFC-UL should be subjected to leverage requirement to ensure that their growth is supported by adequate capital, among other factors. A suitable ceiling will be prescribed subsequently by RBI.

2. **Differential standard asset provisioning[13]:** Systemically important NBFCs are currently subject to a flat rate of 0.40% as standard asset provision, whereas banks are subject to differential rate of standard asset provisioning for different sectors they lend to[19].

   In order to tune the regulatory framework for NBFC-UL to greater sensitivity, RBI now prescribes differential standard asset provisioning for NBFC-UL which would be similar to provisions applicable to banks.

Revisions in prudential guidelines

3. **Large Exposure Framework:** RBI has decided to introduce Large Exposure Framework for NBFCs placed in the upper layer. This framework is currently applicable to banks. Accordingly, large exposure of an NBFC to all counterparties and groups of connected counterparties (as will be defined by RBI) will be considered for exposure ceilings. Simplified and separate guidelines on this will be issued in due course.

Revision in governance guidelines

4. **Qualification of board members:** Currently, NBFCs should ensure that the directors appointed in the BoD meet the 'fit and proper' criteria as specified in the extant regulatory provisions.

   RBI now requires NBFCs in the upper layer to ensure that the composition of BoD include a mix of educational qualification and experience. Specific expertise of BoD members should be a prerequisite depending on the type of business pursued by the NBFC.

5. **Listing and disclosures:** Currently, there is no specific requirement for NBFCs to mandatorily get listed on a stock exchange, however, certain banks are required to get listed within a prescribed period.

   NBFCs lying in the upper layer of the scale-base framework have the ability to cause adverse systemic risks, and hence need to maintain higher corporate governance standards and a diffused ownership structure to minimise the possibility of abuse of dominance. Accordingly, RBI has mandated such NBFCs to get listed within three years of identification as NBFC-UL. Disclosure requirements would be put in place on the same lines as applicable to a listed entity, even before the actual listing.

Our comments

- Over the years, the NBFC sector has evolved in terms of its size, operations, technological sophistication with entry into newer areas of financial services and products. To keep pace with the same, regulations also need to evolve to address the accompanying risks and concerns. With the revised scale-based framework, RBI aims to increase regulatory supervision, governance and disclosures of NBFCs, the aim of which is to keep in check the vulnerabilities posed by NBFCs with large scale operations and pose systemic risk in the financial system.
- RBI has introduced some significant regulatory guidelines for NBFCs in the middle and upper layer of the scale-based framework. This, *inter alia*, includes introducing ICAAP, ceiling on IPO funding, having BoD approved policies for SSE and large exposure frameworks, adoption of CBS for certain NBFCs, mandatory listing for NBFCs in the upper layer, capping the maximum number of directorships for IDs of NBFCs and the directorships and other interests of KMP of NBFCs. Some of these requirements will require significant restructuring in the governance and operating norms of NBFCs. However, RBI has provided adequate transition period to meet these requirements.
- The institution of IDs plays a crucial role in governance of entities. Provisions pertaining to IDs have been under constant review by all regulators. Companies and IDs of companies will need to consider the provisions of all regulations while appointing or accepting the appointment as IDs in companies. The maximum number of directorships prescribed for IDs under the Companies Act, 2013, the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (LODR) and the scale-based framework has been given below:
  - As per the **Companies Act, 2013**, a person can hold directorship, including alternative directorship in not more than 20 companies, and not more than 10 public companies
  - As per **LODR,** directors of entities that have listed their specified securities[20] on a recognised stock exchange (listed entities) or directors of high value debt listed entities[21] should not hold directorship in more than seven listed entities. Further, a person should

18. The Basel Committee on Banking Supervision introduced 'leverage ratio' in the 2010 Basel III package of reforms. The leverage ratio is defined as the capital measure divided by exposure measure, expressed as a percentage. The leverage ratio basically calculates a bank's health.
19. For example, farm credit and SME @ 0.25%, CRE @ 1.0%, CRE-RH @ 0.75%, and all other loans @ 0.4%
20. Specified securities are defined as equity shares and convertible securities in the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirement) Regulations, 2015.
21. Entities that have listed their non-convertible debt securities exceeding INR500 crore

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not serve as an ID in more than seven listed entities. Additionally, a person who is serving as a whole-time director/managing director in any listed entity should not serve as an ID in more than three listed entities

- As per the scale-based framework, IDs of NBFCs in the middle and upper layer of the scale-based framework should not be on the BoD of more than three NBFCs at the same time (restriction is for NBFC-ML and NBFC-UL only, and not to directorships in NBFC-BL). Further, the KMP of NBFCs in the middle and upper layer of the scale-based framework should not hold any office (including directorships) in any other NBFC-ML and NBFC-UL (directorship in NBFC-BL is permitted).

- As per the scale-based regulations, once NBFCs have been identified to be classified in the upper layer of the scale-based framework, they will need to get listed within three years of such classification. Therefore, it seems that the listing requirements will be applicable to NBFCs even when they don't meet the parametric requirements in subsequent years (post the NBFC-UL classification), unless they strategically reduce the scale of their operations.
- RBI, in its circular dated 12 November 2021, provided a clarification on IRACP norms i.e. loan accounts classified as NPAs may be upgraded as 'standard' assets only if entire arrears of interest and principal are paid by the borrower. Till date most NBFCs have been upgrading accounts classified as NPA on partial payment, such as payment of only interest or only one installment. However, with this clarification, loans accounts classified as NPA will remain as such till the time the entire outstanding amount of interest and principal is repaid. Accordingly, accounts classified as NPA cannot be upgraded to SMA, they will directly be classified as zero days past due. This will result in a higher number of accounts being classified as NPAs, and thereby a higher asset provisioning and capital requirements for NBFCs.

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