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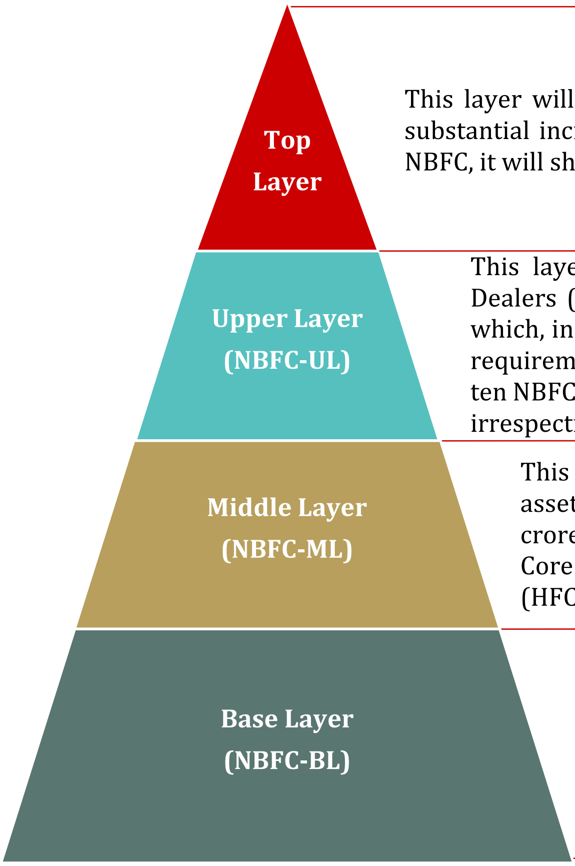
Scale Based Regulation: A Revised Regulatory Framework For NBFCs

To revamp the regulatory framework for non-banking financial companies ("**NBFCs**") in India, the Reserve Bank of India ("**RBI**") has issued a '*Framework for Scale Based Regulation for Non-Banking Financial Companies*' ("**Framework**") on October 22, 2021. While the Framework will come into force on October 1, 2022, the provisions regarding a ceiling on funding for an initial public offering ("**IPO**") will come into force on April 1, 2022.

Revised Regulatory Structure for NBFCs

The Framework divides NBFCs into four layers based on their size, activity, and perceived riskiness, which is represented in the chart below:



This layer will ideally remain empty. If the RBI is of the view that there is a substantial increase in the potential systemic risk from a specific Upper Layer NBFC, it will shift such NBFC to the Top Layer.

This layer will comprise of all NBFCs (except for Standalone Primary Dealers (SPDs), Infrastructure Debt Fund (IDF) and Government NBFCs) which, in the view of the RBI, should be subject to an enhanced regulatory requirement, based on the parameters provided in the Framework. The top ten NBFCs in terms of their asset size will always reside in the Upper Layer, irrespective of any other factor.

This layer will comprise of (a) all deposit taking NBFCs, irrespective of asset size, (b) non-deposit taking NBFCs with asset size of INR 1,000 crores and above, and (c) the following NBFCs (i) SPDs, (ii) IDF, (iii) Core Investment Companies (CIC), (iv) Housing Finance Companies (HFC) and (v) Infrastructure Finance Companies.

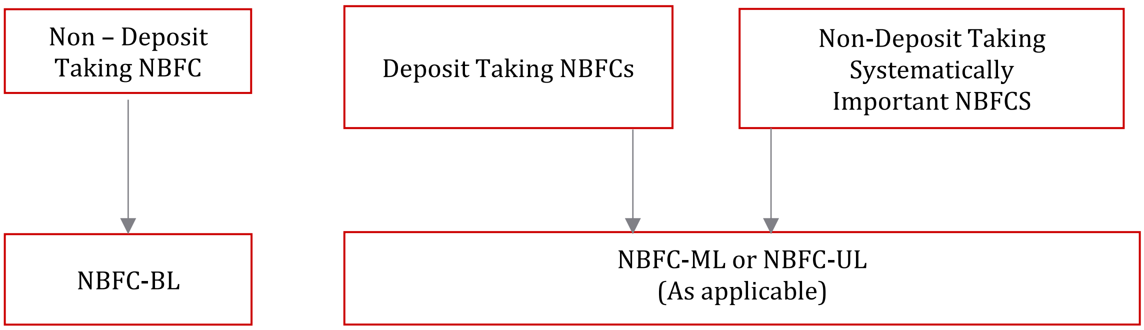
This layer will comprise of (a) non-deposit taking NBFCs below the asset size of INR 1,000 crores, and (b) the following NBFCs - (i) Peer to Peer Lending Platform (NBFC-P2P), (ii) Account Aggregator (NBFC-AA), (iii) Non-Operative Financial Holding Company, and (iv) NBFCs not availing public funds and not having any customer interface.

NBFCs namely, Investment and Credit Companies (ICC), Micro Finance Institution (MFI), Factors and Mortgage Guarantee Companies (MGC) can fall under any of the layers depending on the aforesaid Framework. Government owned NBFCs will be placed in the Base Layer or Middle Layer, as the case may be, but will not be placed in the Upper Layer till further notice. Further, the extant regulations (as modified) governing specific NBFCs (such as NBFC-P2P, HFC, IFC, etc.) will remain applicable. Unless otherwise provided, the regulatory provisions applicable to lower layers of NBFCs will automatically be applicable to higher layers of NBFCs.

The Framework also provides a transition path and timelines for NBFCs which move to a higher layer.

Applicable Existing Regulations

According to the Framework, existing segregation for NBFCs will be adopted in the following manner:



Scale Based Regulatory Changes Introduced by the Framework

The Framework seeks to bring a suite of changes in relation to NBFCs, which are summarised below.

All Layers

(a) **Minimum NOF Requirement**: Minimum net owned funds requirement for NBFC-ICC, MFI, and NBFC-Factors will need to increase over a period of time as follows:

Type of NBFC	Current NOF Requirement	Minimum NOF Requirement by March 31, 2025	Minimum NOF Requirement by March 31, 2027
NBFC-ICC	INR 2 crores	INR 5 crores	INR 10 crores
NBFC-MFI	INR 5 crores (INR 2 crores in NE Region)	INR 7 crores (INR 5 crores in NE Region)	INR 10 cores
NBFC-Factors	INR 5 crores	INR 7 crores	INR 10 crores

The NOF requirements for NBFC-P2P, NBFC-AA and NBFCs with no public funds and no customer interface will continue to remain INR 2 crores. Further, there is no change in the in the existing regulatory minimum NOF for NBFCs - IDF, IFC, MGCs, HFC, and SPD.

(b) **NPA Classification**: NPA classification norms have been standardised for an overdue period of more than 90 days for all categories of NBFCs. This will be done in a phased manner by March 31, 2026 as provided under the Framework.

(c) **IPO Financing**: Finance for subscription to an IPO will be allowed only up to INR 1 crore for each borrower.

(d) **Board Experience**: At least one of the directors of the NBFC should have relevant experience of working in a bank or NBFC.

(e) **Risk Management**: A risk management committee should be constituted at the Board or at the executive level.

Other changes include, expansion of disclosure requirements, and requirement of a Board approved policy for grant of loans to directors, senior officers and relatives of directors and to entities where directors or their relatives have major shareholding. The RBI will issue detailed circular in relation to the same on a later date.

Middle Layer And Above Layers

(a) **ICAAP**: NBFC-ML should have an internal capital adequacy assessment process proportionate to the scale and complexity of its operations.

(b) **Credit concentration**: Credit concentration limits for lending and investments will be merged, and need to be capped at 25% for a single borrower and 40% for single group of borrowers. The concentration limits will be calculated based on the NBFC's Tier 1 Capital rather than its Owned Fund.

(c) **Sensitive Sector Exposure**: Exposure limits to sensitive sectors (i.e., capital market (direct and indirect) and commercial real estate) should be fixed internally. Specific sub-limits for financing land acquisition and IPO funding must be prescribed. However, HFCs will continue to follow the extant regulations on sensitive sector exposure applicable to them.

(d) **KMPs**: Key managerial personnel of an NBFC-ML should not hold office or directorships in any other NBFC-ML or NBFC-UL (except for directorships in a subsidiary of these NBFCs), and an independent director should not be on the Board of more than three NBFCs in the middle layer or the upper layer.

Other changes include enhanced disclosure requirements in annual financial statements from March 31, 2023, appointment of a chief compliance officer, adoption of a Board approved compensation policy, adoption of core banking solution by NBFCs with more than 10 branches, and certain other governance requirements (including a whistle blower mechanism). RBI will issue detailed circulars on a later date in relation to these requirements.

Upper Layer And Above Layers

(a) **Common Equity Tier 1**: In order to enhance the quality of regulatory capital, an NBFC-UL will have to maintain Common Equity Tier 1 capital of at least 9% of risk weighted assets.

(b) **Leverage**: In addition to a CRAR, NBFC-UL will be subject to leverage requirements as well as a suitable ceiling for leverage.

(c) **Differential Standard Asset Classification**: NBFC-UL will be required to hold differential provisioning towards different classes of standard assets.

(d) **Exposure requirements**: A large exposure framework will be introduced for NBFC-UL. Further, exposure limits to different sectors will need be determined internally by the Board.

(e) **Board experience**: Directors should have the relevant educational qualification and experience in line with the specific business of the NBFC.

(f) **Listing**: NBFC-UL should be listed within 3 years of being identified as an NBFC-UL, and the disclosure requirements applicable for a listed company should be complied with from the date of being identified as an NBFC-UL.

RBI will issue detailed circulars on a later date in relation to the changes to capital guidelines for NBFC-UL.

Top Layer

The regulatory guidelines for NBFC-TL will be specifically communicated whenever an NBFC is classified as a NBFC-TL.

JSA Viewpoint

With the Framework introduced by the RBI, the regulatory oversight on NBFCs is set to increase. NBFCs will be required to comply with stricter norms and be subject to superior governance standards. At the same time, the Framework is expected to ensure that NBFCs will have a stronger financial and administrative standing.

For more details, please contact km@jsalaw.com advocates & solicitors

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