Article

Ushering a new era for NBFCs' Regulations: RBI proposes major revamp of framework

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December 22, 2012

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RBI has ushered a new era of regulations for NBFCs by placing the draft guidelines[1] (Draft Guidelines) on its website on 12th December 2012, based on the recommendations by the Working Group on the Issues and Concerns chaired by Smt. Usha Thorat, former Deputy Governor, Reserve Bank of India. The Draft Guidelines are open for public comments till January, 2013.

The Draft Guidelines address issues relating to entry point norms, principal business criteria, prudential regulations, liquidity requirements for NBFCs and corporate governance.

History of NBFCs regulation in India:

Chapter III B of the Reserve Bank of India Act, 1934 (RBI Act) was introduced in 1964 to regulate the deposit taking companies which then graduated into full fledged regulations for the NBFCs sector. The low entry barriers and simplified regulations encouraged entry of NBFCs. In the absence of adequate regulations and mismanagement issues, several NBFCs were reporting defaults. RBI thereafter introduced Non Banking Companies (Reserve Bank) Directions, 1977 to protect the interest of the depositors. Simultaneously, section 58A of the Companies Act was introduced empowering Central Government to regulate the acceptance and renewal of public deposits and the Companies (Acceptance of Deposits) Rules, 1975 were framed at that time. Several Committee and Working Groups were formed to evaluate and look at the NBFCs sector, its importance and relevance in the emerging financial sector. While the Narasimham Committee in 1991 made valuable recommendations on role of NBFCs and their growth, the Working Group on Financial Companies chaired by Dr. A.C Shah recommended several regulatory changes which included entry point norms, minimum net owned fund requirements and more. As NBFCs were evolving and were seen to be playing a complimentary role with the banks, a set of regulatory and supervisory framework was put in place by way of Chapter III B, III C and V of the RBI Act. In 1998, the new regulatory framework for NBFCs was set wherein the NBFCs were classified into 3 categories (i) those accepting public deposits; (ii) those which do not accept public deposits and (iii) core investment companies and the NBFCs Acceptance of Public Deposits (Reserve Bank) Directions, 1998 came into effect.

In was only in 2007 when the need for differential regulations for deposit taking and non-deposit taking companies was recognised and separate prudential norms were issued. Currently there are directions with regard to exposure norms, provisioning, capital adequacy requirements for deposit accepting NBFCs and non-deposit accepting NBFCs, different set of regulations for several categories of NBFCs and more.

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[1] The text of the Draft Guidelines is available on the RBI website here
http://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=27757

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Ever since, the regulatory scenario for NBFCs has been undergoing changes with new categories of NBFCs being added, new instruments and products being introduced to the financial sector and more; while some regulations acted as catalysts to the growth of the segment others came with intentions to throttle the growth completely. Despite several regulatory amendments over the years the RBI had never gave up on regulating the small companies. It is for the first time over decades, when with these proposed changes in the Draft Guidelines, RBI has voluntarily given up the regulation of small companies.

Overall, as the NBFCs sector stands today, the NBFCs segment has assumed increasing significance and has added depth to the financial sector considerably. Considering the growth of the NBFCs sector, the dynamism displayed and its contribution to the development of the financial sector, the need for regulatory overhaul was felt. To add to the flavour, in the wake of the financial crisis that the world witnessed, for the regulators it become pertinent to analyse the systemic risks the sector could pose and the need to address them by way of amending or re-creating the regulatory architecture of the NBFCs sector.

In light of the above a Working Group was constituted under the Chairmanship of Mrs. Usha Thorat, former Deputy Governor, Reserve Bank of India. The Working Group made certain recommendations in August, 2011[2]. The Working Group made several recommendations in terms of changes in the regulatory framework addressing various concerns and issues impacting the NBFCs sector in the present day. Some of these recommendations have been adopted by RBI in the Draft Guidelines.

Draft Guidelines released by RBI:

The Draft Guidelines review the regulatory framework for NBFCs in four parts, which are as follows:

1. Corporate Governance and Disclosures for NBFCs
2. Entry Point Norms, Principal Business Criteria (PBC), Multiple and Captive NBFCs
3. Liquidity Management for NBFCs
4. Prudential Regulations

Below we have tried to do a comparative on the extant guidelines and the suggestive amendments under the Draft Guidelines and the possible impact it may have on the NBFCs sector.

a. **Entry Point Norms, Principal Business Criteria (PBC), Multiple and Captive NBFCs[3] --** The purpose of the amendment seems to focus regulatory watch on

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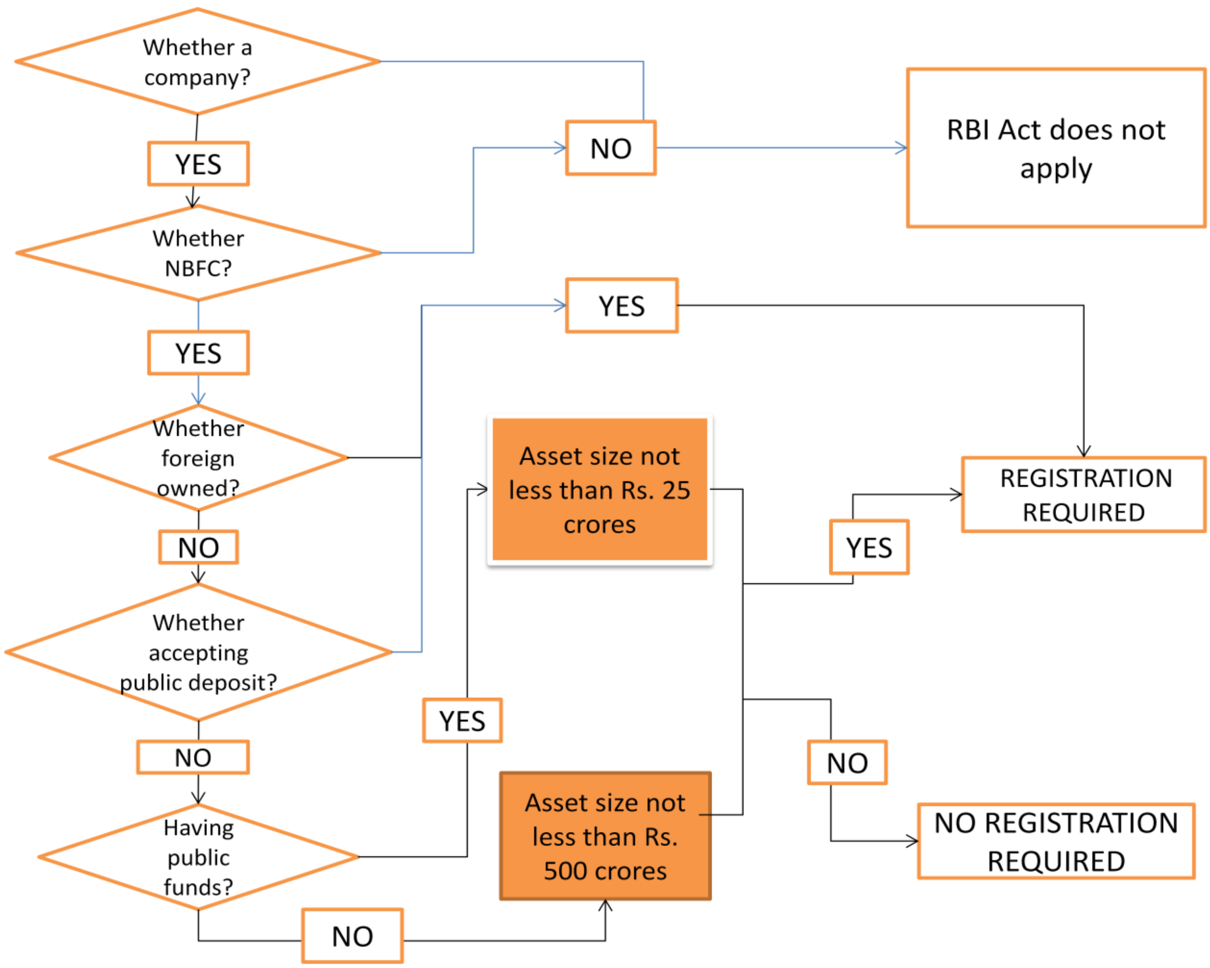
[2] Working Group on the Issues and Concerns in the NBFCs Sector – Report & Recommendations, August, 2011 -- http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/FRWS250811.pdf

[3] Entry Point Norms, Principal Business Criteria, Multiple and Capitive NBFCs - http://www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=2617

such NBFCs which carry a systemic risk and delineate those which are too small to be burdened with regulations. Some of the issues dealt by this section of the review are:

i. **NBFCs Categorisation** -- The RBI has categorised NBFCs in two broad categories – Exempted NBFCs and Registered NBFCs. The categorisation is keeping in mind the systemic risk and the disruption that the NBFCs may pose. The categorisation is explained below:



The flowchart above indicates several things below. The Draft Guidelines state that all deposit taking companies irrespective of the size need to be registered with RBI and would fall under the RBI regulations purview.

However, in case of non-deposit accepting NBFCs, in case the NBFCs accepts "funds" then all NBFCs with asset size of Rs. 25 crores and above will require to be registered with RBI.

Further, where the NBFC is a non-deposit accepting type and is also not accepting public funds, directly or indirectly, such NBFCs with asset size of more than Rs. 500 crores will require registration with RBI.

	Existing Regulatory Framework	**Amendments suggested under Draft Guidelines**
Entry Point Norms	NBFCs to have Net owned funds (NOF) of Rs. 2 crores for the purpose of registration with the RBI and carry on NBFI business	New companies having NoF of not less than Rs. 2 crores and minimum asset size of Rs. 25 crores are required to obtain registration. *The above norms as illustrated in the flowchart will apply with regard to registration with RBI.* Foreign owned companies to require CoR from RBI before commencing NBFI business. Minimum capitalization norm as under FEMA to apply
Principal Business Criteria	More than 50 per cent of total assets (net of intangible assets) and income to come from financial assets and gross income for NBFCs classification	For NBFCs to come under the RBI purview: 1. In case of NBFC-ND, where: a. financial assets aggregate Rs 25 crore; **AND** b. financial assets constitute 75% and above of its total assets (net of intangible assets) and

	Existing Regulatory Framework	**Amendments suggested under Draft Guidelines**
		financial income constitutes 75% or above of its gross income. 2. In case of NBFCs with asset size of Rs. 1000 crores or above: a. financial assets constituting 50% of the total assets; **OR** b. financial income which as a proportion of the gross income is at least 50%. 3. In case of Asset Finance Companies: a. Principal Business Criteria has been revised to have minimum of 75% of the assets of the total assets; **AND** b. 75% of income of the total income to come from asset finance activities. RBI has provided for a roadmap for achieving the asset size minimum threshold in a phased out manner (by 2015). Existing NBFC-D failing to achieve the 75% threshold in financial assets and income by March, 2015 will not be

	Existing Regulatory Framework	**Amendments suggested under Draft Guidelines**
		allowed to accept fresh deposits or renew deposits thereafter. They will be required to repay deposits within a given timeframe as decided by the Bank and be deregistered thereafter.
Multiple NBFCs		Where several NBFC-ND have been floated as a part of a corporate group or are floated by a common set of promoters, such will not be viewed on a standalone basis instead the total assets of all the entities will be aggregated to meet the threshold limit of Rs. 100 crores assets for being called a systematically important NBFC (NBFC-ND-SI). In case the group has a deposit accepting NBFC, the same would be taken in isolation and supervised.
Captive NBFCs		A captive NBFC is defined as one which holds receivables generated on account of its parents activities at least to the extent of 90% of its total assets, net of intangible assets. NBFCs have been set up by manufacturing group for facilitating the sale of their products and services.

b. **Prudential Norms** – The prudential norms requirement have been revised[4], a comparative of the same is drawn below:

	Existing Regulatory Framework	**Amendments suggested**
Tier I capital	All deposit taking NBFCs and NBFC-ND-SI are required to maintain a CRAR of 15%. Therefore the Tier I capital cannot be less than 7.5% In case of Infrastructure Finance Companies (IFCs), therefore the Tier I capital cannot be less than 10%. In case of NBFCs engaged in lending against gold a minimum capital of Tier I of 12% will be required.	In case of all captive NBFCs, Tier I capital of 12% is required. The requirement of Tier I capital of 12% will be applicable for NBFCs that are lending to/ making investment in "***sensitive sectors***" namely capital market, commodities and real estate, to the extent of 75% or more of their total assets (net of intangible assets). Other NBFCs including IFCs shall maintain Tier I capital of 10%.
Risk weights for Capital Market Exposures (CME) and Commercial Real Exposures (CRE)		The risk weights on exposure to capital market and real estate, for NBFCs in a bank group shall be the same as specified for banks. Further, the risk weights for NBFCs that are not sponsored by banks or that are not part of a group that contains a bank may be raised to 150% for capital market exposures and 125% for CRE exposures.

[4] 'Review of NBFC Regulatory Framework – Recommendations of the Working Group on Issues and Concerns in the NBFC Sector – Prudential Regulations -- http://rbidocs.rbi.org.in/rdocs/Content/PDFs/CPRRE121212F.pdf

	Existing Regulatory Framework	**Amendments suggested**
Asset Classification & Provisioning norms	NBFCs are required to classify loans into NPAs at 180/ 360 days.	The NPA provisioning norms will be made similar to banks in a phased out manner. 120 days norm shall be applied from 1st April, 2014 to 31st March, 2015 and thereafter 90 days. Further, the provisioning for standard assets from 0.25% to 0.40% of the outstanding amount w.e.f. March 31, 2014 for all NBFCs.
Deposit taking NBFCs	An Asset Finance Company having net owned funds (NOF) of twenty five lakh of rupees or more and complying with all the prudential norms and with capital adequacy ratio of not less than 15% need not be rated for the purpose of acceptance of deposits.	All existing NBFCs-D, including AFCs, should be credit rated and that unrated NBFCs, including AFCs, should not be permitted to accept deposits. **Further, the limit for acceptance of deposits for rated AFCs is reduced from 4 times to 2.5 times NOF.**
Government NBFCs		All Government companies that qualify as NBFCs under the revised principal business criteria will be required to comply with the regulatory framework applicable to NBFCs at the earliest.

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c. **Liquidity Management for NBFCs** – The revised guidelines[5] with regard to regulatory framework on liquidity management for NBFCs are drawn as below:

	Existing Regulatory Framework	**Amendments suggested**
Maintenance of Statutory Liquidity Ratio	Deposit taking NBFCs are required to maintain a statutory liquidity ratio of 15% of aggregate deposit besides, making applicable ALM guidelines to those holding deposit of Rs. 20 crore and above. NBFCs are expected to ensure that the negative gap in the 1-30 day bucket does not exceed 15% of cash outflows.	All registered NBFCs should maintain high quality liquid assets in cash, bank deposits available within 30 days, money market instruments maturing within 30 days, investment in actively traded debt securities (valued at 90 per cent of the quoted price) and carrying a rating not lower than AA or equivalent, equal to the gap between total net cash inflows and outflows over the 1 to 30 day time bucket as a liquidity coverage requirement. For deposit taking NBFCs, the extant requirement of SLR will continue.

d. **Corporate Governance and Disclosures for NBFCs[6]** – Currently, all NBFCs are guided by the master circulars on Corporate Governance[7]. The guidelines on corporate governance were ***proposed for consideration*** of the Board of Directors of all deposit taking NBFCs with deposit size of Rs 20 crore and above and all non-deposit taking NBFCs with asset size of Rs 100 crore and above (NBFC-ND-SI).

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[5] **Review of NBFC Regulatory Framework – Recommendations of the Working Group on Issues and Concerns in the NBFC Sector – Liquidity Management for NBFCs** -- http://rbidocs.rbi.org.in/rdocs/Content/PDFs/LMNBF121212F.pdf
[6] **Revised Guidelines on Corporate Governance and Disclosure for NBFCs** -- http://rbidocs.rbi.org.in/rdocs/content/pdfs/CCORGO121212_A1.pdf
[7] The extant master circular on corporate governance as applicable to NBFCs can be seen here shttp://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=7325#gui
These master circulars have a sunset clause and are issued in July, every year

	Existing Regulatory Framework	Amendments suggested
Prior approval of RBI in case of any takeover, acquisition of control	Currently, any takeover or acquisition of control of any deposit accepting NBFC whether by way of acquisition of shares or amalgamations/ mergers or otherwise with another entity or any merger/amalgamation of any entity with a deposit taking NBFC, shall require prior written approval of the Reserve Bank of India. **Regulation applicable:** Non-Banking Financial Companies (Deposit Accepting) (Approval of Acquisition or Transfer of Control) Directions, 2009 issued by the Reserve Bank on September 17, 2009[8].	All registered NBFCs both deposit taking and nondeposit taking should take prior approval from the Reserve Bank where there is a change in control and / or increase of shareholding to the extent of 25 percent or in excess thereof, of the paid up equity capital of the company by individuals or groups, directly or indirectly. (*Acquisitions in the ordinary course of business by an underwriter, a stock broker and a merchant banker are not covered by this requirement.*) For any acquisitions and for all mergers under Section 391-394 of the Companies Act, 1956 by or of an NBFC, the NBFC involved should approach the Reserve Bank (even before filing for the same in the Courts) to ensure adherence to the basic tenets of corporate governance and overall health of the sector. Non-adherence to these guidelines will result in cancellation of the CoR of the concerned NBFC. There can be no change in control of the NBFC prior to commencement of business and regularization of its CoR. (*DNBsS(PD)CC.No.259/03.02.59/2011-12 dated March 15, 2012*)
Prior approval for appointment of CEO and		Appointment of CEOs of NBFCs with asset size of Rs. 1000 crore and above would require the Reserve Bank's prior approval.

[8] **Requirement for obtaining prior approval of RBI in cases of acquisition / transfer of control of NBFCs accepting deposits** -- http://rbidocs.rbi.org.in/rdocs/notification/PDFs/FCC160170909.pdf

	Existing Regulatory Framework	**Amendments suggested**
related matters		
Limit to number of Directorship		For all NBFCs with asset size of Rs. 1000 crores or more, the number of Directorships held by a single director of any NBFC, public or private, may not exceed the maximum number prescribed under Section 275 of the Companies Act 1956.
Compliance with Clause 49 of SEBI's listing agreement on corporate governance including induction of independent directors		For all NBFCs with asset size of Rs. 1000 crores or more, whether listed or not, will need to comply with Clause 49 of SEBI's listing agreement on corporate governance including induction of Independent Directors. NBFCs with assets of Rs. 100 crore and more but less than Rs. 1000 crore are encouraged to adopt Clause 49 principles in their governance practices.
Fit and Proper Criteria for Directors and related compliances thereof	NBFC-D with deposit size of Rs 20 crore and above and NBFC-ND-SI may form a Nomination Committee to ensure 'fit and proper' status of proposed/ existing Directors. This was recommendatory. Other recommendatory committee to be established were Audit Committee and Risk Management Committee.	All NBFCs-ND-SI and NBFCs-D shall ensure that there is a policy in place for ascertaining the fit and proper criteria for appointment of directors. The Nomination Committee of all NBFCs with asset size Rs. 100 crore and above shall certify annually to RBI on 'fit and proper' status of directors. RBI has laid down the following drafts in this regard: a. guidelines for ascertaining fit and proper criteria of directors b. declaration and undertaking to be given by the directors c. deed of covenant to be signed between the director and the company

	Existing Regulatory Framework	**Amendments suggested**
		Regular Compliances: a. All NBFCs-ND-SI and NBFCs-D to furnish Quarterly statement on change of directors certified by the auditors b. Certificate from the Managing Director that fit and proper criteria in selection of directors have been followed.
Remuneration & Compensation		All registered NBFCs with assets of Rs. 1000 crore and above shall constitute a Remuneration Committee to decide on the compensation payable to the executives. NBFCs with asset size below Rs. 1000 crore are encouraged to adopt such practices. *Guidelines on Compensation to management of NBFCs will be issued separately.*
Disclosures in Financial Statements	Current Regulations guiding disclosures: a. Accounting Standards b. Companies Act, 1956 c. SEBI regulation on disclosures for listed companies **d. RBI** Disclosures mandated by RBI are: 1. All NBFCs to attach a schedule to their	All registered NBFCs should disclose their registration with other regulator(s) such as SEBI, IRDA, Stock Market and Commodity Exchanges, as well as any credit ratings assigned by rating agencies. In addition, all registered NBFCs should disclose penalties, if any levied by any regulator. NBFCs with asset size of Rs. 1000 crore will need to disclose the following: a. Provision b. Coverage ratio, liquidity ratio c. Asset liability profile d. Extent of financing of parent company

	Existing Regulatory Framework	**Amendments suggested**
	balance sheet containing additional particulars of assets and liabilities and details of their non-performing assets. 2. For NBFCs-ND-SI a. Disclose Capital to Risk Asset Ratio b. Exposure (both direct and indirect) to the real estate c. The maturity pattern of their assets and liabilities.	e. Products f. NPAs and movement of NPAs g. Details of all off-balance sheet exposures, structured products issued by them as also securitization/assignment transactions and other disclosures. In the case of unlisted NBFCs with asset size of Rs.1000 crore and above, these disclosures should be made available on their websites.