Emerging Regulatory Framework for NBFCs

[For base layer and middle layer entities]

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Outline

1) **Introduction to NBFCs**
- Meaning
- Types of NBFCs
- Overview of SBR Framework
- Categorisation of NBFCs under SBR

1) **SBR Framework**
- Layering; Applicability and Timelines
- Prudential norms under SBR
- Corporate Governance norms under SBR
- Capital Regulations under SBR

1) **Digital Lending Guidelines**
2) **Corporate laws and NBFCs**
3) **Secretarial Audit of NBFCs - approach**

Meaning of NBFC

- NBFCs are companies which are **principally engaged in financial activities** such as extending loans and advances, investing in securities and other similar financial activities
- In order to qualify as 'Principal Business' –
  - At least 50% of the total assets should be investments in shares/ securities of other companies or loan assets; **and**
  - At least 50% of the gross income should come from such investments or loan assets
- NBFCs are regulated by the Reserve Bank of India (RBI)

Non-Banking

- Must not be a banking company

Financial

- Must be a financial institution, i.e. in the business of conducting financial activities
- The definition of financial activities as per section 45I(c) of the RBI Act, 1934
- Financial activities must be conducted as principal business

Company

- Has to be a company registered under Companies Act, 2013 or any other erstwhile laws
- A foreign body corporate or LLP is not a company
- Question of considering unincorporated entities does not arise

Principal Business Test

Quantitative factors

Press Release 1998-99/1269 dated April 8, 1999

Financial assets> 50% of its total assets

+

Income from financial assets> 50% of the gross income

→ Principal business test

Qualitative factors

- nature of the business of an entity,
- its principal thrust areas,
- schematic and consistent distribution of assets, resources and activities.

Thinkers???

- ABC Financial Company is extending vehicle loans. The Company wants to now sell vehicle accessories. Can it do so?

- XYZ Trading Company is selling furniture. It had surplus funds and made investments in shares and debentures of other companies. The operating assets are 40% and income from operations is 60%. Investments are 60% of total assets and income from such investments is 40%. Will it become an NBFC?

- Extending the above question, due to COVID, the XYZ could not sell a lot of furniture and the income significantly dropped. Now the operating assets are 40% and the income from operations also falls to 40%. Will is become an NBFC?

- MNO Investment Private Company is in the business of investments and is registered as an NBFC-ICC. The Company's financial income and assets fell below 50% in one year. Will it have to surrender its licence?

Difference between banks and NBFCs (1/2)

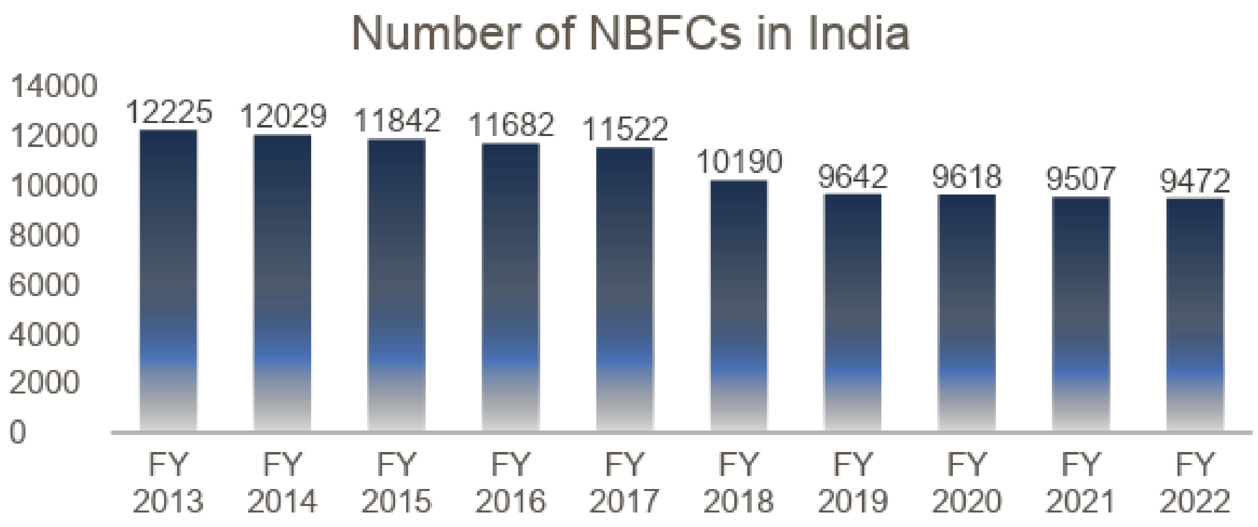
Particulars	Banks	NBFCs
Funding source	Banking is acceptance of deposits withdrawable by cheque or demand; NBFCs cannot accept demand deposits	Cannot accept demand deposits. Time deposits can be accepted by NBFC-D
Scope of business	Limited by sec 6 (1) of the BR Act	No bar on NBFCs carrying non- financial activities
Licensing requirements	Licensing requirements are quite stringent. Transfer of shareholding also controlled by RBI	It is quite easy to form an NBFC. Acquisition of NBFCs is procedurally regulated and are subject to approval
Major limitations on business	No non-banking activities can be carried	Cannot provide checking facilities
Major privileges	Can exercise powers of recovery under SARFAESI and DRT law	Only NBFCs with asset size > 100cr, specified by Central Government, have powers under SARFAESI or DRT law

Difference between banks and NBFCs (2/2)

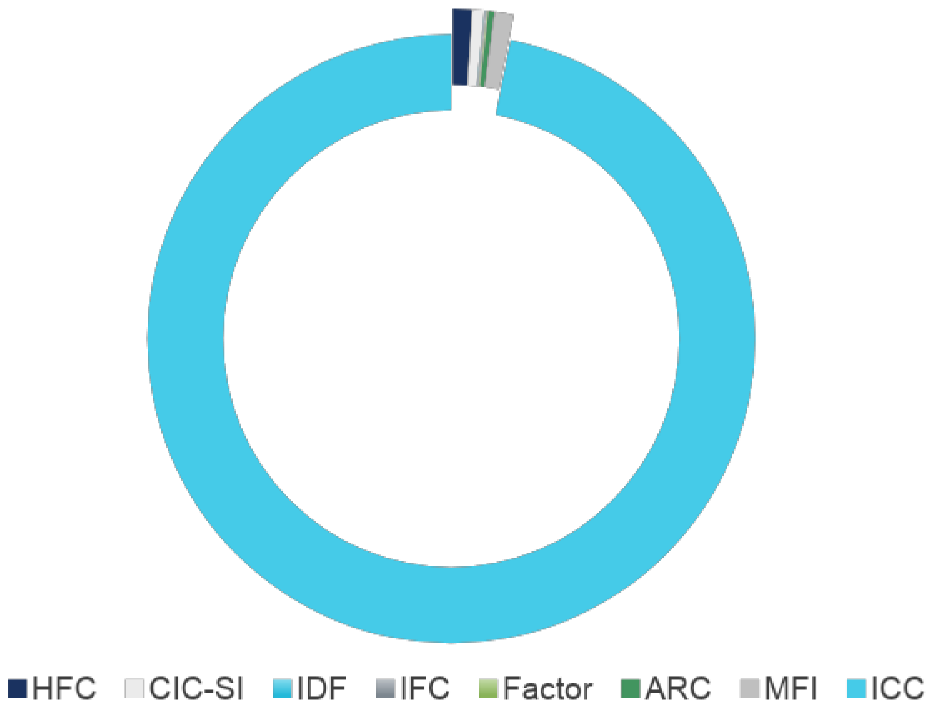
Particulars	Banks	NBFCs
Part of payment and settlement system	Banks are a part of the payment and settlement system	NBFCs are not a part of the payment and settlement system
Deposits	Can accept both demand deposits as well as term deposits	Only some NBFCs are allowed to accept term deposits
Foreign investment	Upto 74% allowed to private sector banks	Upto 100% allowed
Regulations	BR Act and RBI Act lay down stringent controls over banks	Controls over NBFCs are relatively lesser stringent
SLR/CRR requirements	Banks are covered by SLR/ CRR requirements	NBFC-Ds have to maintain a certain ratio of deposits in specified securities; no such requirement for non deposit taking companies
Priority sector lending requirements	Certain minimum exposure to priority sector required	Priority sector norms are not applicable to NBFCs

Overview of Non-Banking Sector in India

- The assets of shadow banking sector is around 15% of total financial assets in the country
- Of total liabilities of the NBFCs in India:
  - Around 19.67% are bank borrowings
  - Funding by way of debentures is around 30% - MFs are major investors in such debentures
  - Around 9.24% funding is through securitization- of which 43% is taken by MFs, 53% by banks and 2% by other NBFCs



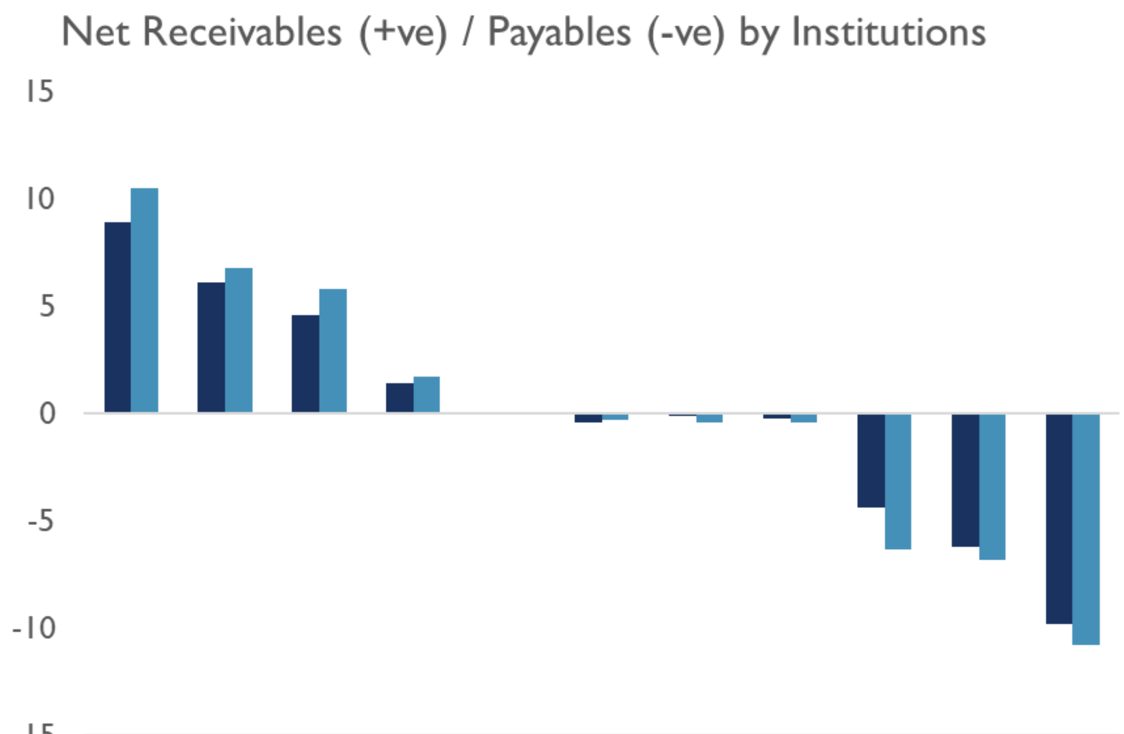
Over 95% of the registered NBFCs are Investment and Credit Companies



Data Source: RBI

Systemic Risk

- NBFCs are growing more and more relevant to the Indian financial sector, they are the largest receiver of funds followed by HFCs
- **Aggregate credit extended by NBFCs stood at 28.5 lakh crores in March 2022 and borrowings form approx. 62.5% of the source of funds**
- Net-payable by NBFCs to Financial Sector have grown by 10.2% and for NBFC and HFC together it grew by 10% in past 1 year
- IL&FS has given clear lessons on how NBFC sector can be the one that sets off the domino effect across financial sector
- **From being around 12% of the balance sheet size of banks (2010), they are now more than a 25% of the size of banks**
- NBFCs were the largest net borrowers of funds from the financial system, with gross payables of ₹12.46 lakh crore and gross receivables of ₹1.62 lakh crore as at end-March 2022. Over half of their borrowings were from SCBs and this share increased further during H2:2021-22 as their reliance on funding by AMC-MFs and insurance companies reduced.



	AMCs	Insurance	PSBs	PFs	UCBs	SFBs	FBs	AIFIs	PVBs	HFCs	NBFCs
Mar-21	8.9	6.1	4.6	1.4	0	-0.4	-0.1	-0.2	-4.4	-6.2	-9.8
Mar-22	10.5	6.8	5.8	1.7	0.1	-0.3	-0.4	-0.4	-6.3	-6.8	-10.8

Source: Financial Stability Report, June 2022 | In Lakh Crores

How do NBFCs contribute to systemic risk?

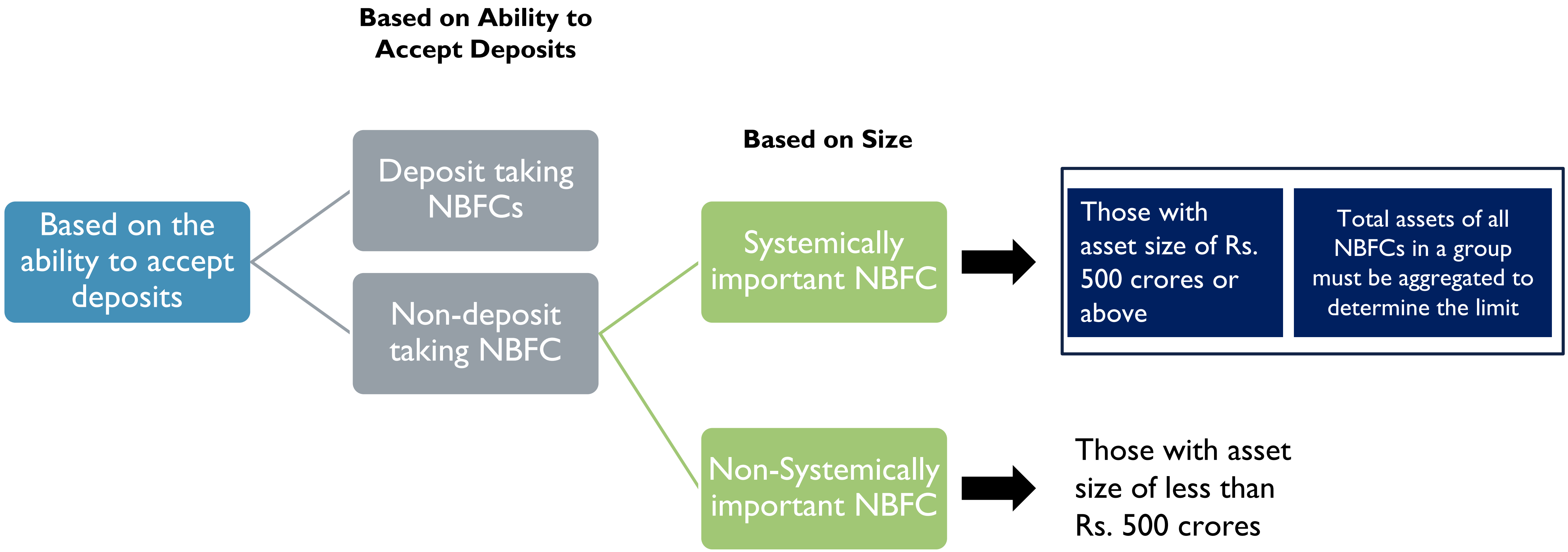
- For most time period, banks constituted predominant source of credit
- Due to rising NPA in banks, NBFCs started compensating for credit flow
- NBFCs borrow from:
  - Bonds and commercial paper - Major investors are MFs, PFs insurance companies etc.
  - Banks

Regulatory Arbitrage between Banks and NBFCs

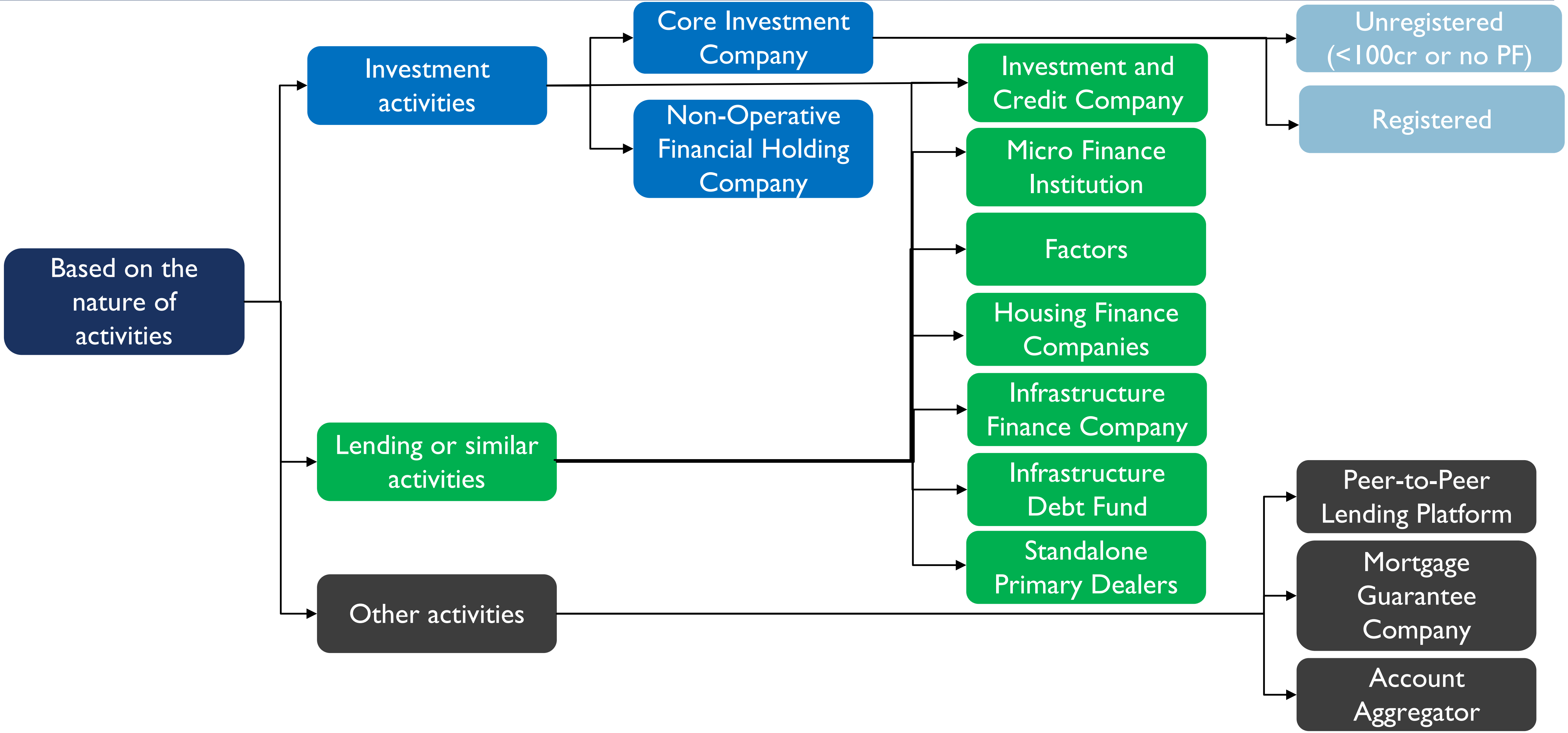
- Regulatory arbitrage has been the subject matter of policy makers' attention for long time; multilateral bodies have also been pointing the same out
- NBFCs can virtually do everything that banks can; however, without having similar regulations
- Structural arbitrage:
  - No CRR/SLR
  - No priority sector lending
  - No restriction on investments in shares of other companies
  - No Shareholding limits – not more than 10% shares in a banking co
  - FDI is freely allowed
- Prudential arbitrage
  - Licensing of banks is not all time open
  - Ownership restriction – business houses do not own banks – proposal currently under examination
  - Entry point capital requirement is much higher
  - Provisioning requirements – asset-based provisioning requirements in case of standard assets
  - Basel III has leverage

Can we have a one-size fits all approach for NBFCs?

Present Regulatory Framework



Present Regulatory Framework



Thinkers???

- Will an NBFC-ICC giving out Home loans will have to register as an HFC?

Overview of the SBR framework

- Four layers for regulatory supervision:
  - Most smaller NBFCs to be in the base layer
  - Present classification of "systemically important" NBFCs to be changed to "middle layer", with an asset threshold of Rs 1000 crores
- Do scale-based regulations override the existing regulatory framework?
  - NBFCs shall be subject to regulations as currently applicable, except for the changes under SBR
    - For NBFC-NSI & NBFC-SI (<1000crs)- Master Directions-ND-NSI and SBR Framework
    - For NBFC-SI (>1000crs)- Master Directions-ND-SI and SBR Framework
- What happens to existing functional classification?
  - Function-based classification will stay; layering into some layers is also dependent on the functional classification
    - The following will irrespective of asset size be classified as BL:
      - P2P, AA, NOFHC, NBFC with no PF and CI
    - The following will irrespective of asset size be classified as ML:
      - SPD and IDF
    - The following will be taken as at least as ML irrespective of size:
      - CIC, HFC, IFC and NBFC-D

Evolution of Regulatory Framework for NBFCs

Regulatory Framework -1998

New regulatory Framework in Jan-1998 after newly acquired powers under RBI Act.

Provided for

1. Categorisation of NBFCs
2. Defining "Deposit"
3. Min. credit rating and NOF
4. Prohibition on loan against own shares
5. Widen scope for "auditors certificate"

Classification of Systemically Important NBFCs – Usha Thorat report 2011

Classified NBFCs with asset size => Rs. 100 cr. as "Systemically Important"

Prudential Regulations such as CAR and exposure norms made applicable

Revised Regulatory Framework - 2014

Rapid growth of NBFC sector influenced RBI to review the regulatory framework in 2014

Provided for-

1. Min NOF of Rs. 2 cr.
2. Limit for classification as systematically important increase to Rs. 500 cr. from Rs. 100 cr.
3. Harmonization of norms
4. Review of corporate governance norms

Scale Based Regulations

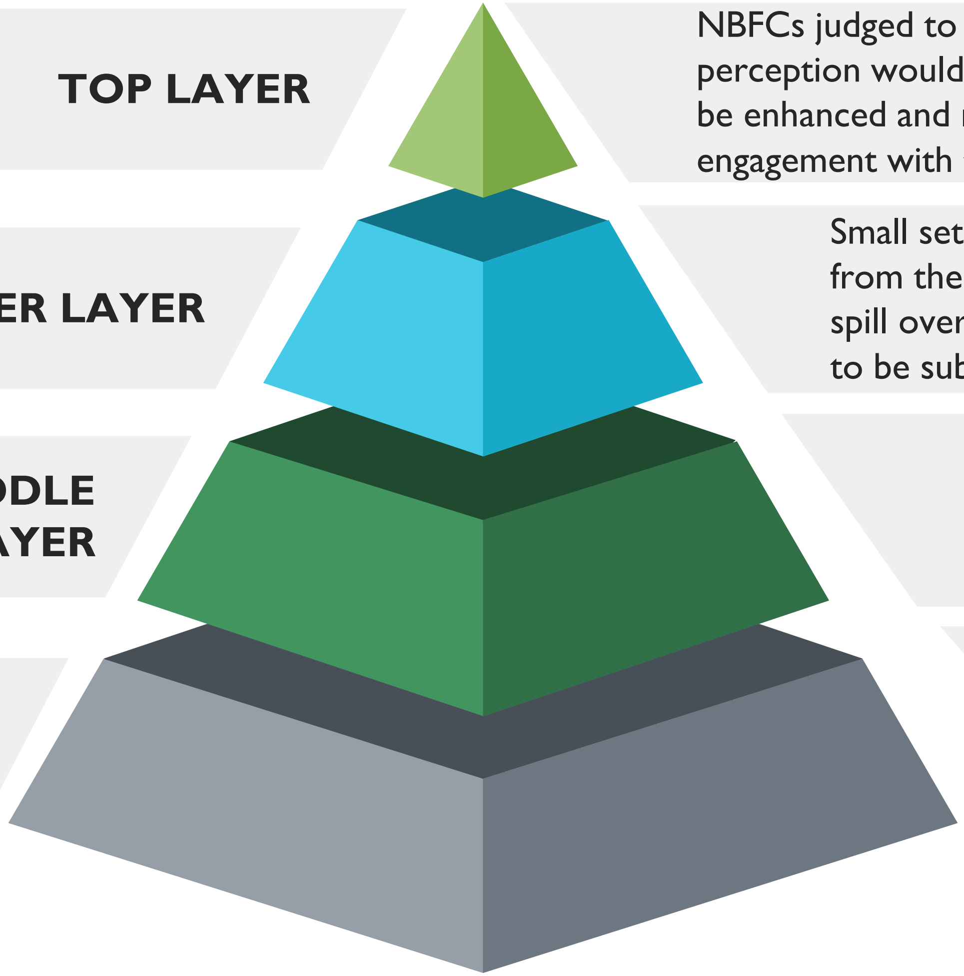
Discussion Paper was issued in January 2021

Align the regulatory framework for NBFCs keeping in view their changing risk profile

4 layer classification

- ✓ Threshold for systemic significance: Rs 100 crores in 2006
- ✓ A new category of CIC-SI was created in 2010
- ✓ In 2011, Usha Thorat Committee gave its report
- ✓ In 2014, the limit of systematic significance increased to Rs. 500 crores

Overview of Scalar Approach



TOP LAYER	NBFCs judged to be extreme in supervisory risk perception would be pushed to Top there will be enhanced and more intensive supervisory engagement with these NBFCs	Supervisory Discretion
UPPER LAYER	Small set of NBFCs which are significant from the point of view of systemic risk spill overs and are therefore required to be subjected to tighter regulations	Bank like regulations
MIDDLE LAYER	Shall consist of all non-deposit taking NBFCs having asset size > Rs. 1000 cr. and all deposit taking NBFCs	Arbitrages plugged
BASE LEVEL	Consist of NBFCs having asset size < Rs. 1000 cr.	Equivalent to current NBFC-ND-NSI

Scalar Approach: Filtering Process (1/2)

Size

Scale of Significance

Activity

Upper Layer

- Top 10 NBFCs to be included
- Top 50 NBFCs by asset size to go following filters
  - Size – 35%
  - Interconnectedness – 25%
  - Complexity – 10%
  - Supervisory Inputs – 30%

Middle Layer

- CICs
- HFCs
- IFCs

Always NBFC-ML

- IDFs
- Standalone Primary Dealers

Base Layer

- Type-I NBFCs
- Peer to Peer
- Account Aggregators
- NOFHC
- Asset Size upto Rs. 1000 cr

Scalar Approach: Filtering process (2/2)

Two-Phase parametric Analysis for UL

Quantitative Factors

Weight – 70%

Qualitative Factors/ Supervisory Inputs

Weight – 30%

Quantitative Measures

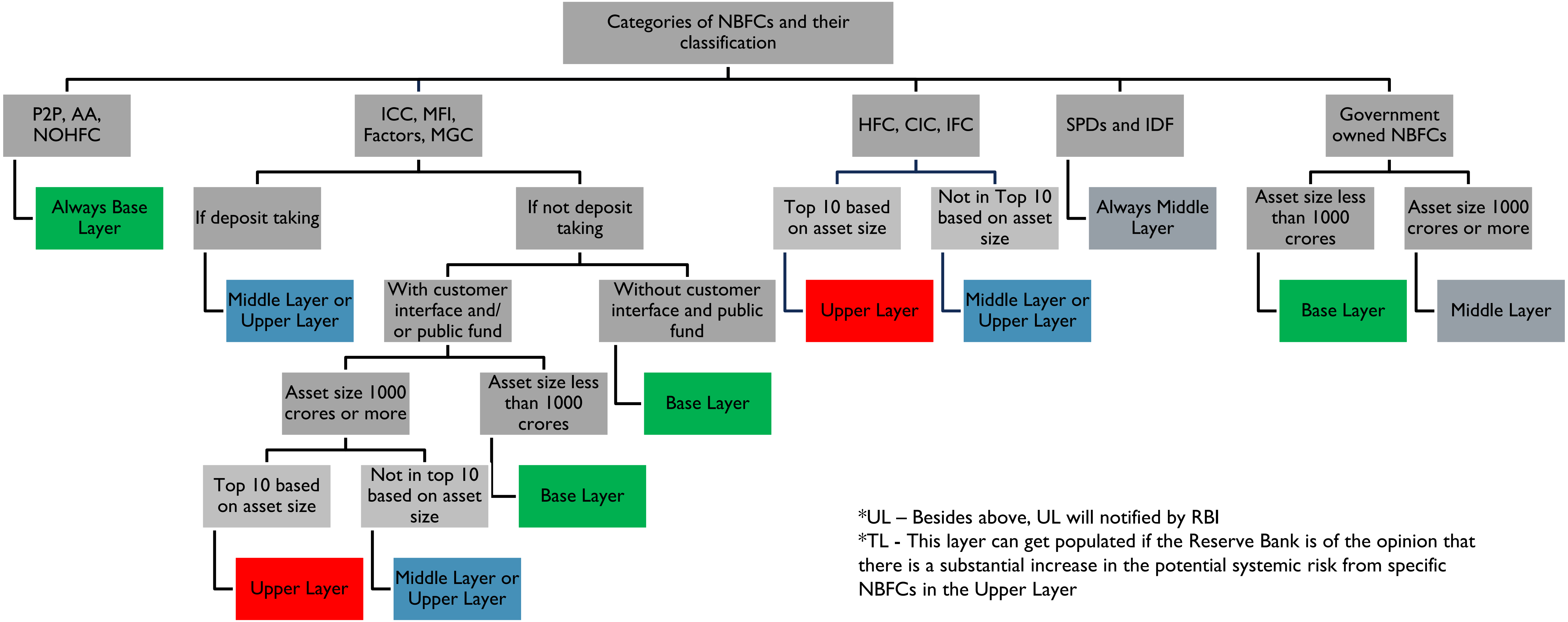
- Size & Leverage
- Inter-connectedness
- Complexity

Qualitative Measures

- Nature and type of liabilities
- Group Structure
- Segment penetration

- Upper layer entities to be identified by RBI based on a scoring methodology –
  - will require compliance with the Large Exposure Framework,
  - Minimum CET I requirement as well as well leverage restrictions,
  - Differential provisioning requirements for standard assets
  - Internal limits on exposure to 'important sectors' to be laid down
  - NBFC-UL shall be mandatorily listed within 3 years of identification

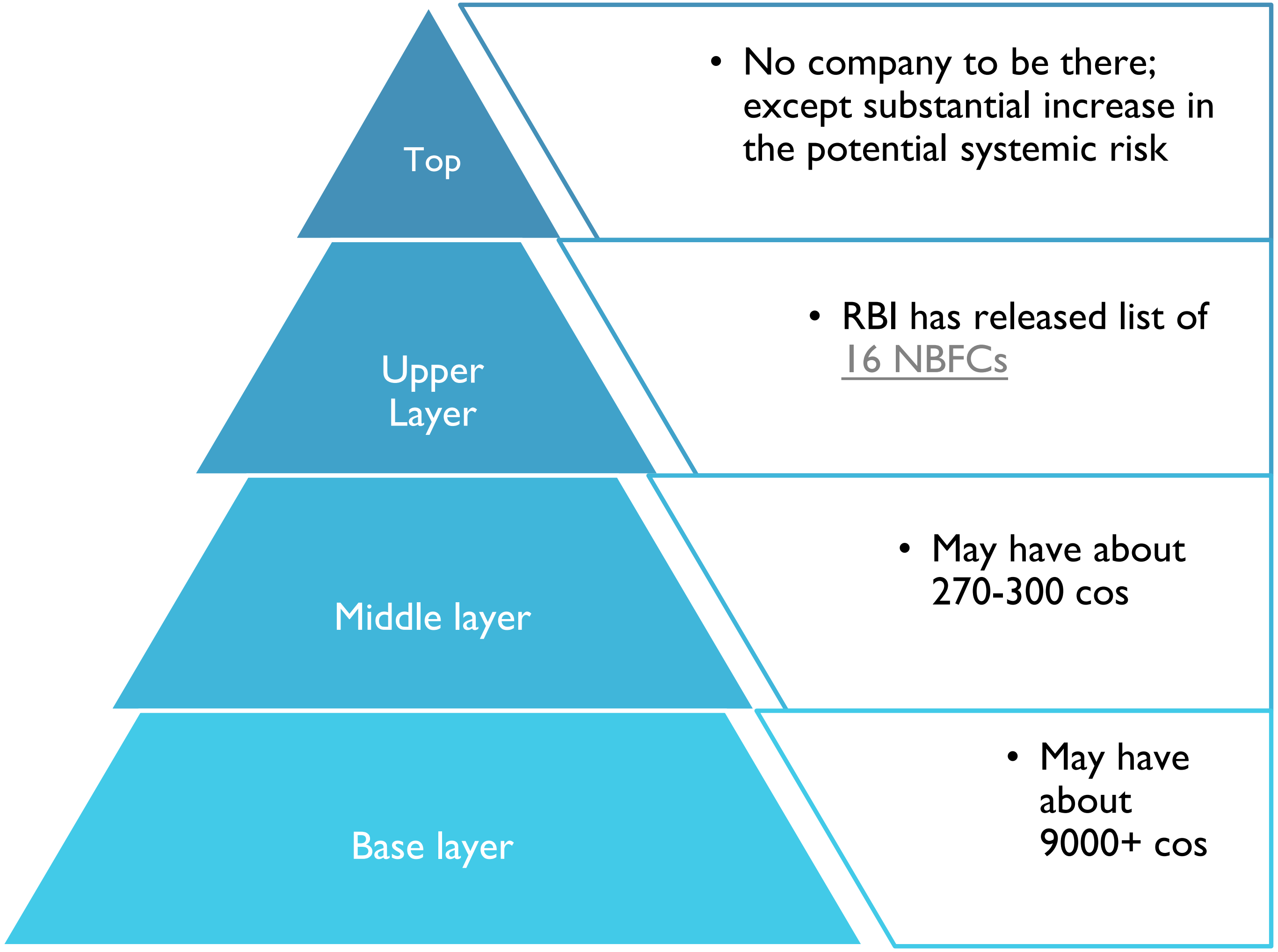
Classification Based on Categories and Scale of NBFCs



*UL – Besides above, UL will notified by RBI
*TL - This layer can get populated if the Reserve Bank is of the opinion that there is a substantial increase in the potential systemic risk from specific NBFCs in the Upper Layer

Scalar view by number

Type of NBFC (As on December 31, 2022)	Number (9471)
NBFCs-D	42
NBFC-ND-SI	420
NBFC-ND-NSI	8981
NBFC-ICC	9265
NBFC-MFIs	100
NBFC- Factors	8
NBFC-IDF	3
NBFC - P2P	25
Account Aggregator	6
NOFHC	3
CICs	55
NBFC - IFCs	8
HFC-D	15
HFC-ND	81



Multiple NBFCs in the group

Type of NBFC	Asset size on standalone basis	Classification on a standalone basis	Classification due to aggregation
NBFC-ICC	350 crs	NBFC-BL as the individual asset size is < 1000 crs	NBFC-ML as consolidated group asset size is > 1000 crs
NBFC-MFI	150 crs	NBFC-BL as the individual asset size is < 1000 crs	NBFC-ML as consolidated group asset size is > 1000 crs
HFC	250 crs	NBFC-ML as all HFCs will fall under middle layer unless classified as NBFC-UL	
NBFC-IFC	450 crs	NBFC-ML as NBFC-IFC shall always fall under the middle layer, irrespective of aggregation	
NBFC-P2P	100 crs	NBFC-BL as NBFC-P2P shall always fall under the base layer, irrespective of aggregation	
NBFC-without PF and CI	100 crs	NBFC-BL as such NBFCs shall always fall under the base layer, irrespective of aggregation	
Total Asset Size	**1400 crs**		

Group NBFCs may have any of the following:

- Subsidiaries and Holding Companies as per applicable accounting standards
- Joint ventures as per applicable accounting standards
- Associate Companies as per applicable accounting standards
- Promoters- Promotee as per SEBI Takeover Regulations for listed companies
- Entities that are related parties as per applicable accounting standards
- Entities having a common brand name
- Entities holding more than 20% of the equity capital of the investee company

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NBFC-P2P	100 crs	NBFC-BL as NBFC-P2P shall always fall under the base layer, irrespective of aggregation	
NBFC-without PF and CI	100 crs	NBFC-BL as such NBFCs shall always fall under the base layer, irrespective of aggregation	
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Regulatory Framework for NBFCs

Background and emerging framework

Regulatory framework based on constitution and registration

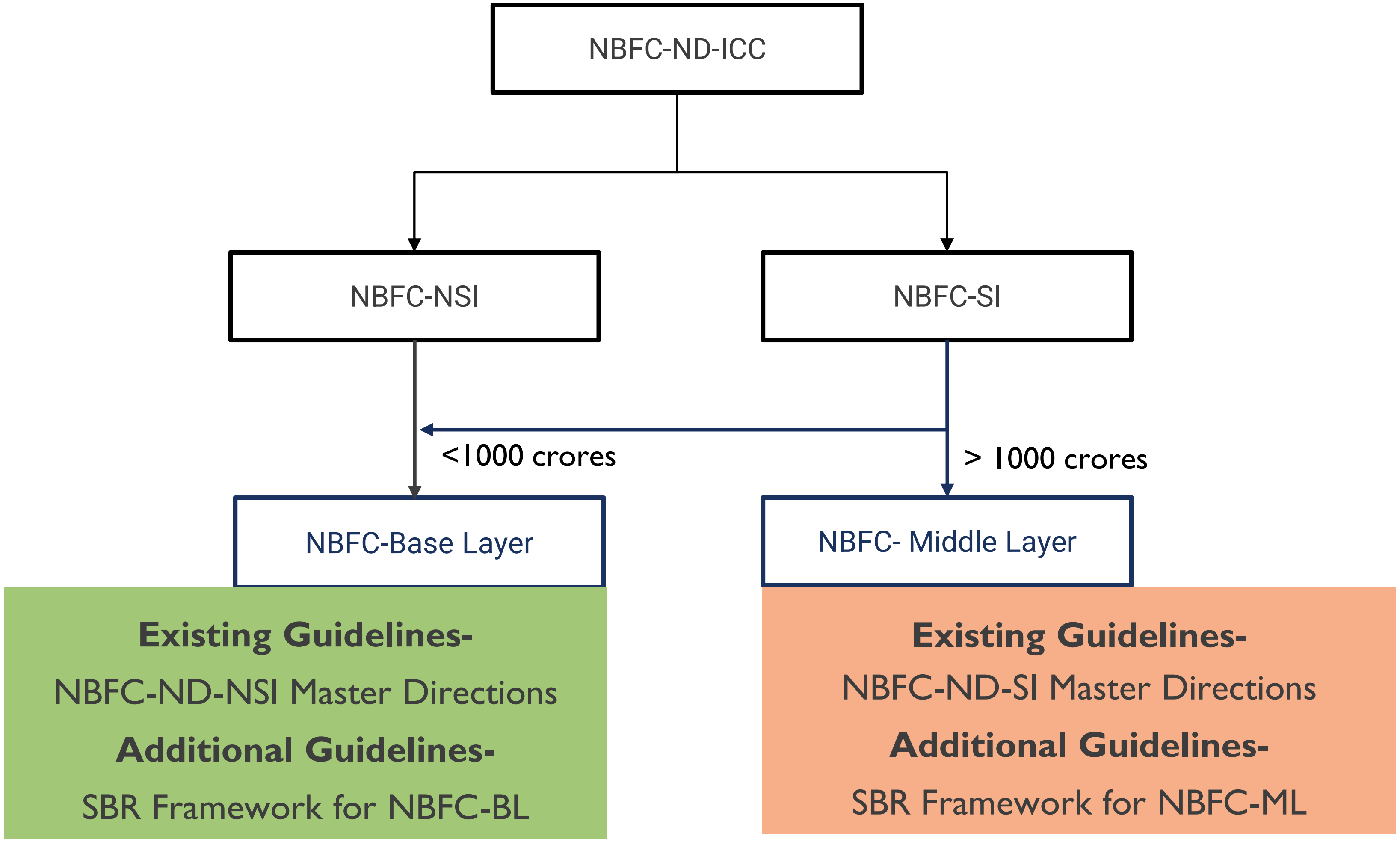
Applicable Laws for an NBFC

- MCA - Companies Act, 2013
  - Public
  - Private
- RBI
  - SBR Framework
  - Circulars/ directions issued
- SEBI (if listed)
  - Applicable SEBI regulations & circulars
- IRDA (depending on registration)
  - Corporate Agents Regulations

Regulatory Framework based on Systemic Importance

Particulars	Systemically Important NBFC (NBFC-SI) - i.e., asset size Rs. 500 crores and above	Non-Systemically Important NBFC (NBFC-NSI) - i.e., asset size below Rs. 500 crores
NOF requirement	Yes – earlier Rs. 2 crores	
Capital Adequacy	CRAR – at least 15%	Leverage Ratio – not more than 7
NPA classification norms	90 days	180 days
Corporate Governance	Applicable – required to constitute an Audit Committee and NRC, etc.	Not applicable
Concentration norms	Applicable	Not applicable
Policies	Required	Required
Digital Lending norms	Applicable (if the NBFC is engaged in Digital Lending)	

Transition for NBFC-NSI and NBFC-SI



Thinkers!

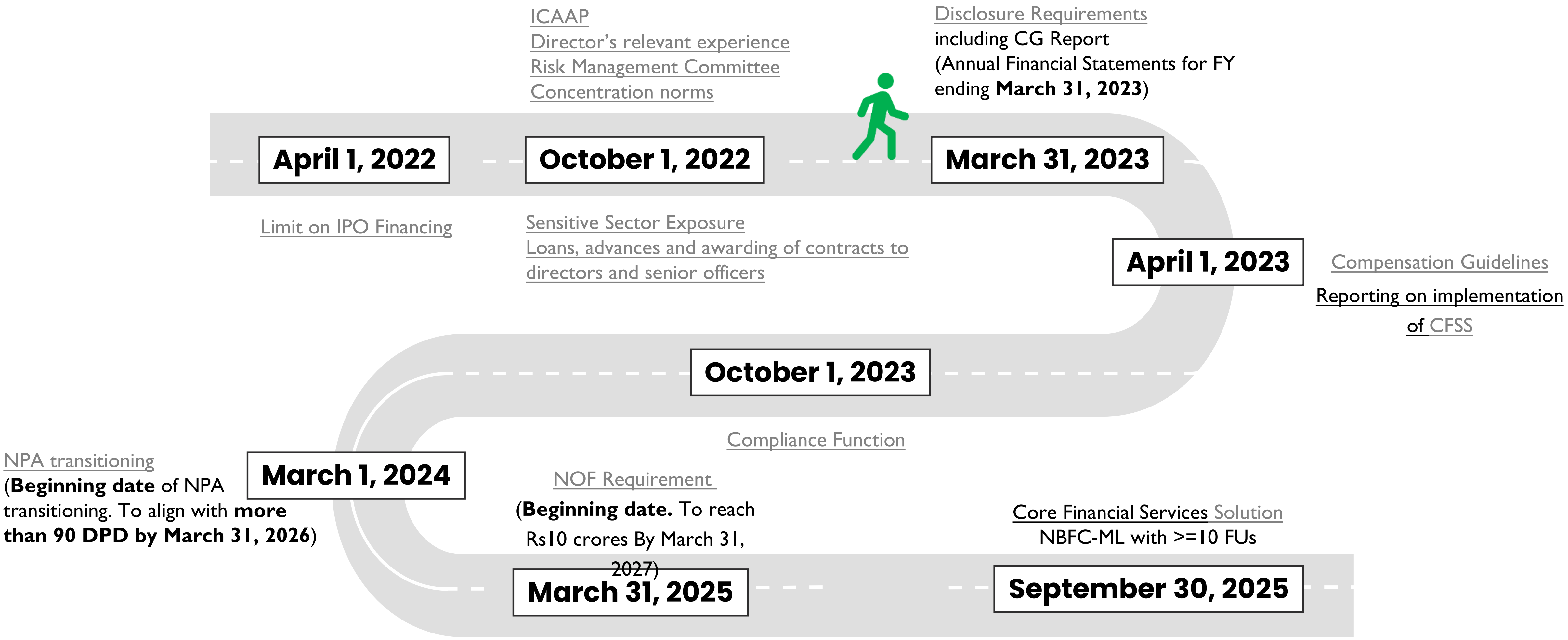
- ABC Limited is a private limited company (WOS of a foreign entity) registered as a NBFC with the RBI and has its debt (outstanding value of debt is over Rs. 500 crores) and CP listed on BSE and has raised ECB. As a secretarial auditor, which laws and regulations would one check?

- Are the erstwhile RBI regulations repealed?

- An NBFC with an asset size of Rs. 600 crores was earlier considered as Systemically Important. Now pursuant to SBR, the NBFC is classified as a NBFC-BL. Will they follow the NSI Directions or SI directions?

- There are multiple circulars issues under SBR, what will be the effective date of these circulars?

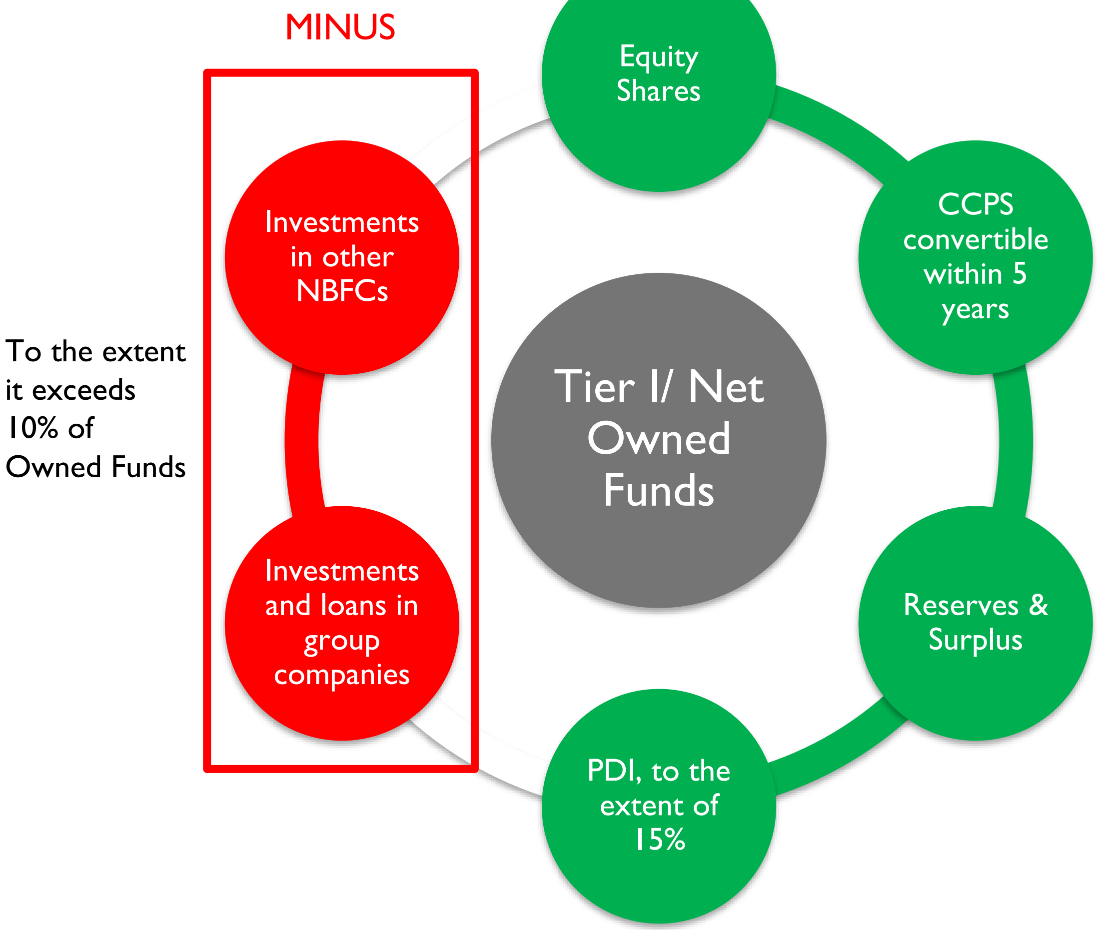
Timelines for applicability of specific guidelines on BL and ML



Regulatory changes under SBR for all the layers

NOF, IPO funding, NPA Transition

Important Terminologies



Public Funds

- Public Deposits
- Inter corporate deposits
- Bank Finance
- Commercial Papers
- Debentures (other than CCDs)

"customer interface" means interaction between the NBFC and its customers while carrying on its business.

Regulatory Provisions

<table>
<tr><th rowspan="2">List of Regulatory Provisions</th><th colspan="2">NBFC-NSI</th><th colspan="3">NBFC-SI</th><th colspan="2">HFC</th></tr>
<tr><th>Without customer interface and public funds</th><th>With customer interface or public funds</th><th>Asset size between 500-1000 crores</th><th>Asset size 1000 crores and above</th><th>Top 10 or identified as such</th><th>Not in Top 10</th><th>Top 10 or identified as such</th></tr>
<tr><td>Supervisory category</td><td>BL</td><td>BL</td><td>BL</td><td>ML</td><td>UL</td><td>ML</td><td>UL</td></tr>
<tr><td>NOF</td><td>No change, that is, Rs 2 crores</td><td colspan="4">Rs 5 crores by March 31, 2025
Rs 10 crores by March 31, 2027</td><td colspan="2">No change, that is,
Rs 15 crores by March 31, 2022
Rs 20 crores by March 31, 2023</td></tr>
<tr><td>NPA Norms</td><td colspan="2">>150 days overdue
By March 31, 2024
>120 days overdue
By March 31, 2025
> 90 days By March 31, 2026</td><td colspan="5">No change, that is, > 89 days</td></tr>
<tr><td>IPO funding ceiling, if extending such loans</td><td colspan="7">Rs 1 crore per borrower [effective from 1st April, 2022]</td></tr>
</table>

Net Owned Funds Requirements

NOF for different categories of NBFCs

2 Crore			10 Crore			20 Crore	100 Crore	150 Crores	250 Crores	300 Crore	
NBFC-P2P	NBFC-AA	ICC w/o public funds & customer interface	Other NBFC-ICC	NBFC-Factor	NBFC-MFI	HFC	NBFC-MGS	SPDs undertaking only core activities	SPDs which also undertake non-core activities	NBFC-IDF	NBFC-IFC
No Change	No Change	No Change	Currently 2 Crores	Currently 5 Crores (2 Crores in NE)	Currently 5 Crores	No change	No change	No Change	No Change	No Change	No Change

IPO Funding

- Similar to LAS, IPO Financing is loan against acquiring shares and making a short-term profit that is expected at the time of initial price discovery of the shares once the shares are listed.
- However, unlike LAS, it is specifically for funding subscriptions to IPOs.
- In case of an IPO Financing, the exposure is based on the borrower and the securities/ shares, if allotted, are taken as collateral for securing the obligations under the loan.
- The transaction forces the applicant to sell the shares once listed, hence, the idea cannot be to finance an investment in shares.

Will cover both retail and non-retail borrowers?

Applicable on IPO Funding- nomenclature only or intent to be seen?

Covers both IPO and FPO?

Only shares or debt securities also?

Joint application- Will individual limit be added?

Limit is per borrower per IPO or per borrorer or per IPO?

Outstanding at any point of time or per year ?

Applicable on ESOP?

Asset Classification for NBFCs - Thinkers?

- What is a Non-performing Asset (NPA)?
- A borrower has been performing well in terms of repayments and has never missed a payment, what will I classify that asset as?
- A borrower has missed making payments on one EMI, what will be the classification of such a borrower?
- What happens when an asset gets classified as an NPA?

Asset classification norms

Asset classification norms of RBI	Standard Asset				Non-performing Asset		
Loan Categorisation	No default	SMA-0	SMA-1	SMA-2	Sub-standard	Doubtful	Loss
		Upto 30 days	More than 30 - up to 60 days	More than 60 and up to 90 days	Remained NPA for not more than 12 months	Remained NPA for more than 12 months	Identified as such.

NPA Transition for NBFC-NSI

- As on March 31, 2023

>180 DPD

>150 DPD

- By March 31, 2024

- By March 31, 2025

>120 DPD

>90 DPD

- By March 31, 2026

Will NBFC-SI falling in BL avail the transition benefit or continue with 90 DPD?

Streamlining of IRAC Norms

- Specification of repayment date/due date
  - Exact due dates, frequency of repayment, breakup between principal and interest, examples of SMA/NPA classification dates, etc to be specified in agreements
- Classification as SMA/NPA
  - Day-end processing
  - Classification is to freeze at "day-end"
- NPA classification in case of interest payments
  - In case of interest payments in respect of term loans, an account will be classified as NPA if the interest applied at specified rests remains overdue for more than 90 days
- Upgradation to standard status
  - Upgradation of NPA to standard only if the interest or principal remains overdue for a period of 90 days or three months and above
    - February 15 Circular- NBFCs had time till September 30, 2022 to put in place the necessary systems
  - For borrowers having more than one credit facility, upgradation only upon repayment of entire arrears of interest and principal pertaining to all the credit facilities
- Consumer education
  - Lenders to educate borrowers about recognition of NPA, SMA status, through appropriate literature

Prudential Guidelines under SBR Framework for ML

Concentration Norms, Sensitive Sector Exposure, Regulatory restrictions on loans and advances

Regulatory Provisions- Prudential Norms

List of Regulatory Provisions	NBFC-NSI		NBFC-SI			HFC	
	Without customer interface and public funds	With customer interface or public funds	Asset size between 500-1000 crores	Asset size 1000 crores and above	Top 10 or identified as such	Not in Top 10	Top 10 or identified as such
Supervisory category	**BL**	**BL**	**BL**	**ML**	**UL**	**ML**	**UL**
Limits on Concentration of credit/investment	NA	NA	NA	Merged single exposure limit of 25% for single borrower/ party and 40% for single group of borrowers/ parties anchored to Tier I capital instead of Owned Funds	To be followed till Large Exposure Framework is put in place	Merged single exposure limit of 25% for single borrower/ party and 40% for single group of borrowers/ parties anchored to Tier I capital instead of Owned Funds	To be followed till Large Exposure Framework is put in place

Concentration Limits

Existing limit (as a percentage of Owned Fund)

	Lending	Investment	Total
Single borrower/ party	15	15	25
Single group of borrowers/ parties	25	25	40

Revised limit (as a percentage of Tier I Capital)

	Total Exposure
Single borrower/ party	25
Single group of borrowers/ parties	40

- The earlier limits were as a percentage of Owned Funds, the revised limits are basis the Tier I capital
- Earlier, there were sub-limits for lending and investment as a part of the total exposure limit to a single/ group borrower, now there is a single limit for aggregate exposure to a single/group entity
- Extant instructions on concentration norms for different categories of NBFC, other than the limit changes, will continue to remain applicable
- Will securitization exposure also be subjected to concentration limits?
  - As per para 70 of the SSA Directions, securitisation exposures of lenders will be governed by the Large Exposures Framework; however LEF is applicable to UL only

Regulatory Provisions- Prudential Norms

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	Without customer interface and public funds	With customer interface or public funds	Asset size between 500-1000 crores	Asset size 1000 crores and above	Top 10 or identified as such	Not in Top 10	Top 10 or identified as such
Supervisory category	BL	BL	BL	ML	UL	ML	UL
Sensitive Sector Exposure (SSE), that is, exposure to commercial real estate and capital markets	NA	NA	NA	Board-approved internal limits	Board-approved internal limits	Same as existing	
Large Exposure Framework	NA	NA	NA	NA	Applicable w.e.f October 1, 2022	NA	Applicable w.e.f October 1, 2022
Internal Exposure Limits to be set by the Board sectors other than sensitive sector (e.g., financial sector)	NA	NA	NA	NA	Applicable; details awaited	NA	Applicable; details awaited

Sensitive Sector Exposure

- What will be sensitive sector?
  - Capital markets
  - Commercial real estate
- Board approved limits to be set for each SSE -
  - based on dynamic vulnerability assessments of the sector and their impact on business
  - Subject to periodic evaluation
- Flexibility to the Board to set internal limits
  - May be based on asset size
- Sub-limit to be fixed for financing land acquisition within the CRE ceiling
  - Prohibited for banks
- HFCs to be governed by existing provisions under HFC Directions
- NBFCs are required to disclose under existing Master Directions and new Disclosure Requirements under SBR -
  - Residential mortgage exposure (Lending fully secured by mortgages on residential property and non-fund facilities)
  - Commercial real estate exposure (Lending secured by mortgages on commercial real estate and non-fund facilities)
  - Investments in MBS

Capital Market Exposure

- **Direct investment** in equity shares, convertible bonds, convertible debentures and units of equity oriented mutual funds the corpus of which is not exclusively invested in corporate debt
- **Advances against** shares / bonds / debentures or other securities or on clean basis to individuals for investment in shares (including IPOs / ESOPs), convertible bonds, convertible debentures, and units of equity oriented mutual funds
- Advances for any other purposes where shares or convertible bonds or convertible debentures or units of equity oriented mutual funds are **taken as primary security**
- Advances for any other purposes to the extent **secured by the collateral security** of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds i.e. where the **primary security** other than shares / convertible bonds / convertible debentures / units of equity oriented mutual funds **does not fully cover the advances**
- **Secured and unsecured advances to stockbrokers** and guarantees issued on behalf of stockbrokers and market makers
- Loans sanctioned to corporates against the **security** of shares / bonds / debentures or other securities or on clean basis for meeting promoter's contribution to the equity of new companies in anticipation of raising resources
- Bridge loans to companies **against expected equity flows / issues**
- **Underwriting commitments** taken up by the NBFCs in respect of primary issue of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds
- **Financing to stockbrokers** for margin trading
- All **exposures to Alternative Investment Funds**

Credit Exposure as CRE

As per [Basel Framework on CRE-Calculation of RWA for credit risk] and [RBI Guidelines on Classification of Exposures as Commercial Real Estate (CRE) Exposures] –

"Income-producing real estate (IPRE) refers to a method of ***providing funding to real estate*** *(such as, office buildings to let, retail space, multifamily residential buildings, industrial or warehouse space, and hotels)* ***where the prospects for repayment and recovery on the exposure depend primarily on the cash flows generated by the asset.*** *The primary source of these cash flows would generally be lease or rental payments or the sale of the asset…* ***The distinguishing characteristic of IPRE versus other corporate exposures that are collateralised by real estate is the strong positive correlation between the prospects for repayment of the exposure and the prospects for recovery in the event of default, with both depending primarily on the cash flows generated by a property".***

"From the definition of IPRE given above it may be seen that for an exposure to be classified as IPRE/CRE, ***the essential feature would be that the funding will result in the creation / acquisition of real estate*** *(such as, office buildings to let, retail space, multifamily residential buildings, industrial or warehouse space, and hotels)* ***where the prospects for repayment would depend primarily on the cash flows generated by the asset…….***"

"These guidelines will also be applicable to certain cases where the exposure may not be directly linked to the creation or acquisition of CRE ***but the repayment would come from the cash flows generated by CRE****. For example,* ***exposures taken against existing commercial real estate whose prospects of repayments primarily depend on rental/ sale proceeds of the real estate should be classified as CRE.***

- Lending secured by mortgages on commercial real estate
- Unsecured loans for the purchase/ development of real estate projects
- Loan repayable premised on the recovery from real estates
- Guarantee towards any such loan

Regulatory Provisions- Prudential Norms

List of Regulatory Provisions	NBFC-NSI		NBFC-SI			HFC	
	Without customer interface and public funds	With customer interface or public funds	Asset size between 500-1000 crores	Asset size 1000 crores and above	Top 10 or identified as such	Not in Top 10	Top 10 or identified as such
Supervisory category	BL	BL	BL	ML	UL	ML	UL
Regulatory Restrictions on 1. Loans to directors, senior officers, relatives of directors, entities where directors or their relatives have major shareholding 2. Real estate loan disbursements to be linked with needed approval	NA	NA	NA	Applicable w.e.f October 1, 2022			
Board approved policy on grant of loans to directors, senior officers and relatives of directors and to entities where directors or their relatives have major shareholding	Applicable						

Loans and Advances to Directors and Senior Officers

Loans/ advances granted and Awarding of contracts

- NBFC-BL
  - Internal thresholds for Board approvals to be set in Board-approved Policy
    - Directors
    - Relatives of directors
    - Senior Officers
    - Entities where directors or relatives have major shareholding.
- NBFC-ML
  - Abide by restrictions prescribed by RBI
    - Directors
    - Relatives of directors
    - Entities in which directors or relatives are interested
    - Senior Officers
    - Relatives of senior officers

For NBFC-ML - meaning of directors, relatives and entities in which directors are interested

Directors and other related parties

Director, including
- Chairman
- Managing Director

Relative of Director
- Members of HUF
- Husband and Wife
- Father and Mother
- Son and Son's Wife
- Daughter and Daughter's husband.
- Brother and Sister

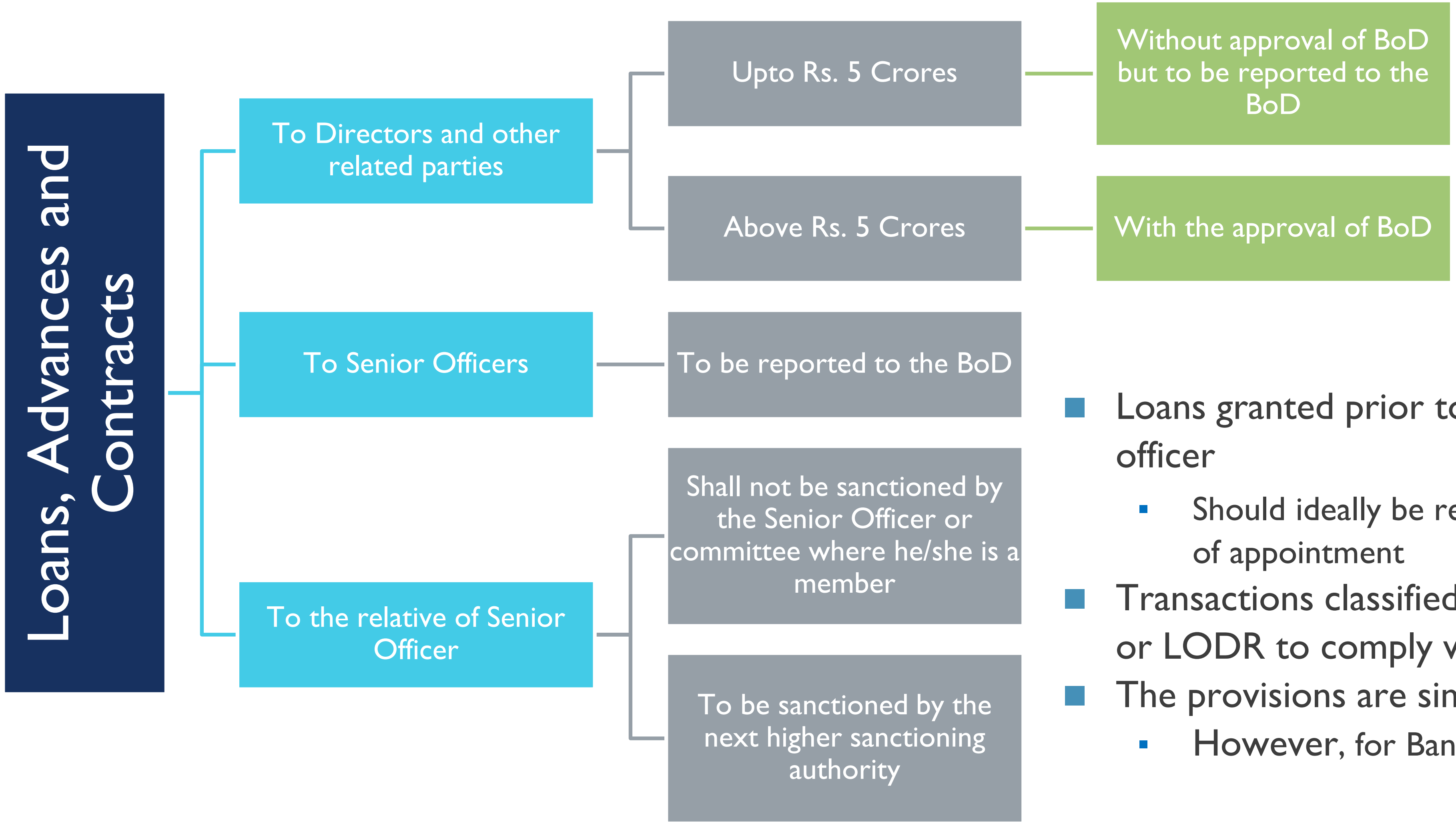
Firm where director or relative is interested as
- partner,
- manager,
- employee or
- guarantor

Company where director or relative is interested as
- major shareholder,
- exercises control **(in case of subsidiary or holding company)**,
- director, manager, employee or guarantor

Understanding the Terminologies

- Major Shareholder
  - person holding 10% or more of the paid-up share capital or Rs 5 crs in paid-up value of shares, whichever is lower
    - In our view, paid-up share capital shall include Equity and Preference Share Capital.
    - Threshold limit should be on the basis of face value- In case MV of the shares is volatile, shareholders with lesser number of shares may cross threshold
- Guarantor
  - No threshold; any quantum will trigger requirements
- Control
  - As per 2(27) of the CA, 2013
  - Right to appoint majority of directors or control management or policy decisions
  - Control has only been used in the context of a holding or a subsidiary
- Employee
  - on the payroll
- Senior Officer
  - As per section 178 of the CA, 2013
  - Personnel of the company who are members of its core management team excluding BoD comprising all members of management one level below the executive directors, including the functional heads
- Meaning of Awarding of contracts
    - All kinds of contracts involving sale of purchase of goods and/ or rendering of services to and by the NBFC
- Exclusion List - 'loans and advances' will not include
  - loans or advances against Government securities, Life insurance policies, Fixed deposits, Stocks and shares, Housing loans, car advances, etc. granted to an employee under any scheme applicable generally to employees.
  - In the aforesaid cases, it must be ensured that NBFC's interest/lien is appropriately marked with legal enforceability

Loans and Advances to Directors and Senior Officers- Thresholds



- Loans granted prior to becoming director/senior officer
  - Should ideally be reported to the Board at the time of appointment
- Transactions classified as RPT under the CA, 2013 or LODR to comply with applicable RPT provisions
- The provisions are similar to that for Banks
  - However, for Banks loans to directors is prohibited

Actionables w.e.f. October 01, 2022

Place the guidelines before the BoD

- Adoption of Policy before October 1, 2022

- The requirement of having a policy only provided in case of NBFC-BL
- However, we recommend for NBFC-ML and NBFC-UL to incorporate in loan policies/ separate policy

Requirement to obtain declaration from the Borrower- mandatory for ML and UL

- Negative confirmation may be taken from all

- In case of loans and advances aggregating Rs 5crs & above, mandatory to obtain declaration giving details of the relationship of the borrower to NBFC's directors/ senior officers
- Same is suggestive for NBFC-BL as well

Disclosure in Annual Financial Statement

- As per template prescribed

- Section 185(3)(b) of the CA, 2013 exempt an NBFC from the restrictions if it is providing such loans in its ordinary course of its business and that interest is charged at a rate not less than the rate of prevailing yield of Government security

Governance Guidelines under SBR Framework

Director related, RMC, Disclosures, Compliance Function, Compensation Guidelines, CBS

Regulatory Provisions- Corporate Governance

List of Regulatory Provisions	NBFC-NSI		NBFC-SI			HFC	
	Without customer interface and public funds	With customer interface or public funds	Asset size between 500-1000 crores	Asset size 1000 crores and above	Top 10 or identified as such	Not in Top 10	Top 10 or identified as such
Supervisory category	BL	BL	BL	ML	UL	ML	UL
Appointment of Director	Appoint at least one of the directors having relevant experience of having worked in a bank/ NBFC						
Except for directorship in a subsidiary, KMP shall not hold any office (including directorships) in any other ML or UL	NA	NA	NA	To ensure compliance by October 1, 2024			
Independent director shall not be on the Board of more than three NBFCs (NBFC-ML or NBFC-UL) at same time	NA	NA	NA	To ensure compliance by October 1, 2024			
Composition of the Board should ensure mix of educational qualification and experience within the Board	NA	NA	NA	NA	Applicable	NA	Applicable
Reporting removal of Independent Directors before tenure	NA	NA	NA	NA	Applicable	NA	Applicable

Director/KMP related Compliances

From October 1, 2022
For NBFC-BL and ML

- Appoint at least one directors having relevant experience of having worked in a bank/ NBFC
- Approvals and disclosures of loans to directors, senior officers and relatives of directors

From October 1, 2024
For NBFC-ML & UL

- Except for directorship in a subsidiary, KMP shall not hold any office (including directorships) in any other NBFC (excluding NBFC-BLs)
- Independent director shall not be on the Board of more than three NBFCs at the same time (excluding NBFC-BLs) and ensure there is no conflict of interest

Regulatory Provisions- Corporate Governance

List of Regulatory Provisions	NBFC-NSI		NBFC-SI			HFC	
	Without customer interface and public funds	With customer interface or public funds	Asset size between 500-1000 crores	Asset size 1000 crores and above	Top 10 or identified as such	Not in Top 10	Top 10 or identified as such
Supervisory category	**BL**	**BL**	**BL**	**ML**	**UL**	**ML**	**UL**
Risk Management Committee	To be constituted						
Disclosures to include types of exposure, RPTs, loans to Directors/ Senior Officers and customer complaints	Applicable						
Additional Disclosures in Annual Financial Statements	NA	NA	NA	Applicable with effect from March 31, 2023			
Other Governance matters **i) The Board shall 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.** **ii) Formulate a whistle blower mechanism for directors and employees to report genuine concerns.** **iii) Board shall ensure good corporate governance practices in the subsidiaries of the NBFC.**	NA	NA	NA	To be ensured by October 1, 2022			

Risk Management Committee

- Composition
  - To be formed at board or executive level
  - No prescription for qualification, experience, etc., for the members of the Risk Management Committee.
  - Frequency of meetings may be based on requirement- decided by the Board
- Roles and Responsibilities
  - Identification, monitor and measurement of the risk profile of the Company;
  - Overseeing development and implementation of risk measurement system;
  - Ensure that the Company has an appropriate and effective mechanism to identify, measure, control and monitor all applicable risks on a timely basis and as accurately as feasible; and
  - Perform such other act, including the acts and functions stipulated by the Act, the Reserve Bank of India and any other regulatory authority, as prescribed from time to time.
  - In order to strengthen the corporate governance structure, the Board may delegate monitoring and reviewing of the risk management plan to the Committee and such other functions as it may deem fit (such as cyber security)
  - Evaluate the overall risk faced by the NBFC, including liquidity risk, and report the same to the Board

Disclosure Requirements

- Common template for disclosures specified for all categories of NBFCs (i.e. ICC, HFC, CIC, etc.).
- Omission of line items/disclosures which are not applicable/permitted or no exposure/transaction in CY and PY
- Mere mention of an activity, transaction or item does not imply that it is permitted,
- Disclose comparative information in respect of the PY for all amounts reported in CY (even for narrative and descriptive information, if relevant)
- Disclosures for directors and relatives of directors should be made separately in separate columns from other KMPs and relatives of other KMPs
- Additional disclosures- do not substitute disclosures specified under other laws, regulations, or accounting and financial reporting standards.
  - However, if already covered repetition not required

Effective for annual financial statements for FY 2022-23 and onwards

Section I (Applicable for annual financial statements of NBFC-BL, NBFC-ML and NBFC-UL)

Exposures

- Exposure to real estate sector
- Exposure to capital market
- Sectoral exposure
- ***(new)*** Intra-group exposures
- ***(new)*** Unhedged foreign currency exposure & policies to manage currency induced risk

Related Party Disclosure *(new)*

- Related party – as per Companies Act, 2013 and applicable accounting standard
- Disclosures include: Borrowings#, deposits#, advances#, investments#, purchase/sale of assets, interest paid/received, etc. ***# The outstanding at the year end and the maximum during the year are to be disclosed.***

Disclosure of Complaints

- Received from customer
- ***(new)*** Received from the office of Ombudsman
- ***(new)*** Top five grounds of complaints received from customers *(indicative list has also been provided)*

Section II (Applicable for annual financial statements of NBFC-ML and NBFC-UL)

Corporate Governance Report new)

- Listed NBFC: as per SEBI LODR Regulations
- Unlisted NBFC:
  - As per formats given in this Circular which includes Board & committees' composition
  - Details of non-compliances, penalties, etc., shareholding of directors, no. of meetings.

Other disclosures

- ***(new)*** Breach of covenant of loan availed/debt securities
- ***(new)*** Divergence in Asset Classification and Provisioning.
  - Based on the assessment by RBI/NHB
- Roadmap for compliance with disclosure requirements of SEBI LODR ***(This is Section III- only for NBFC-UL)***

Contents of the disclosures

Additional Disclosures in AFS

- Corporate Governance report containing composition and category of directors, shareholding of non-executive directors
- Disclosure on modified opinion, if any, expressed by auditors, its impact on various financial items and views of management on audit qualifications
- Items of income and expenditure of exceptional nature
- Breaches in terms of covenants in respect of loans availed by the NBFC or debt securities issued by the NBFC including incidence/s of default
- Divergence in asset classification and provisioning above a certain threshold to be decided by the Reserve Bank

- Meaning of Exposure:
  - Fund based and non-fund-based exposures?
  - On balance sheet and off-balance sheet exposure?
  - Credit and Investment?
- Related Party:
  - all related parties as per the applicable AS
  - as defined under Section 2(76) of the CA, 2013
  - include trusts and other bodies in which the NBFC can directly or indirectly (through its related parties) exert control or significant influence
  - Relatives as defined under section 2(77)

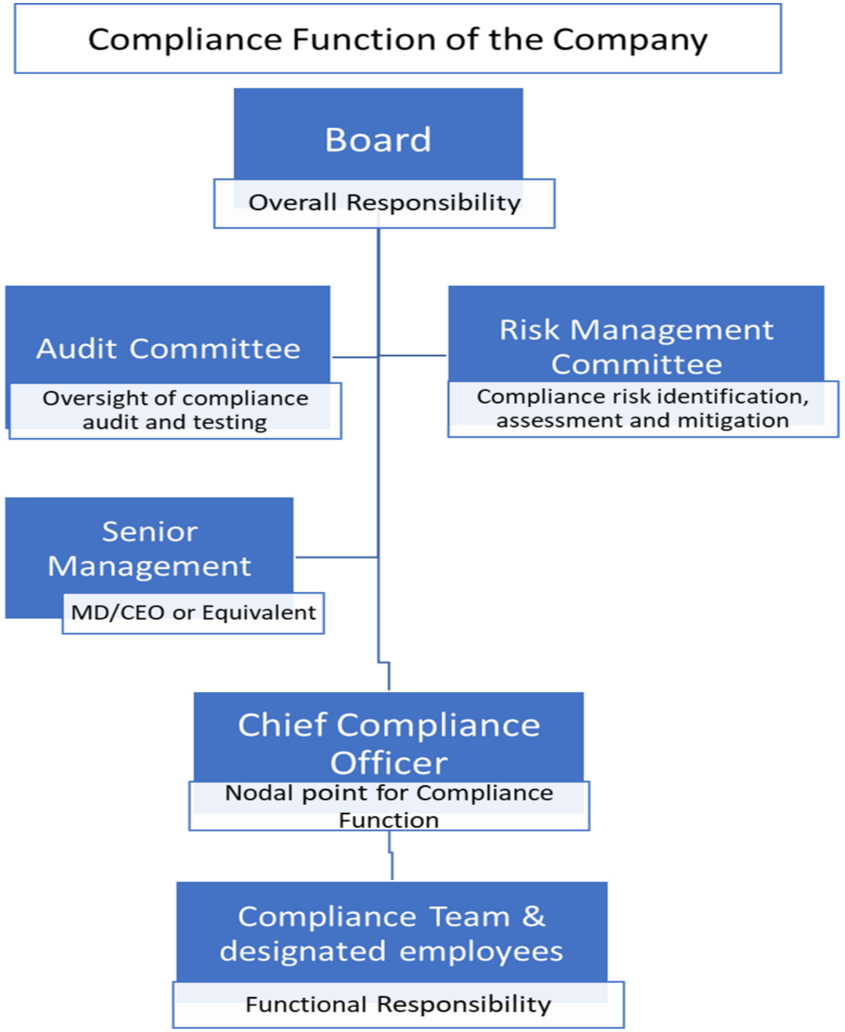
Regulatory Provisions- Corporate Governance

List of Regulatory Provisions	NBFC-NSI		NBFC-SI			HFC	
	Without customer interface and public funds	With customer interface or public funds	Asset size between 500-1000 crores	Asset size 1000 crores and above	Top 10 or identified as such	Not in Top 10	Top 10 or identified as such
Supervisory category	BL	BL	BL	ML	UL	ML	UL
Compliance Function and Appointment of a Chief Compliance Officer (CCO)	NA	NA	NA	To be ensured by October 1, 2023 for ML and April 1, 2023 for NBFC-UL			
Compensation guidelines: a) constitution of a Remuneration Committee, b) principles for fixed/ variable pay structures, and c) malus/ claw back provisions. NRC shall ensure that there is no conflict of interest.	NA	NA	NA	To be ensured by April 1, 2023			
Adoption of Core Banking Solution	NA	NA	NA	Applicable if having more than 10 branches- w.e.f. September 30, 2025 (70% by September 30, 2024)			
Mandatory listing of equity within 3 years	NA	NA	NA	NA	Applicable	NA	Applicable

Compliance Framework

- To ensure an effective compliance culture, RBI has proposed
  - an independent corporate compliance function;
  - a strong compliance risk management programme;
  - appointment of a functionally independent Chief Compliance Officer (CCO), sufficiently senior in the organization hierarchy
- Compliance Function is the sum total of systems procedures and organisation infrastructure which ensures the following:
  - Observance of all statutory and regulatory requirement
  - Standard of market conduct
  - Systems of managing conflict of interest
  - Dealing customer fairly
  - Ensuring suitability of customer service
- Compliance Function shall be subject to regular internal audit
- The Compliance Team has the functional responsibility for ensuring adherence to Applicable Laws, from time to time, by the Company.
- It shall be ensured that the Compliance Team is adequately staffed with professionals having qualifications in the field of law, accountancy, risk management, information technology, etc and practical experience in business lines / audit & inspection functions.
- There has been appropriate succession planning ensured by the Compliance Team to avoid any future skill gap in the Compliance Team.

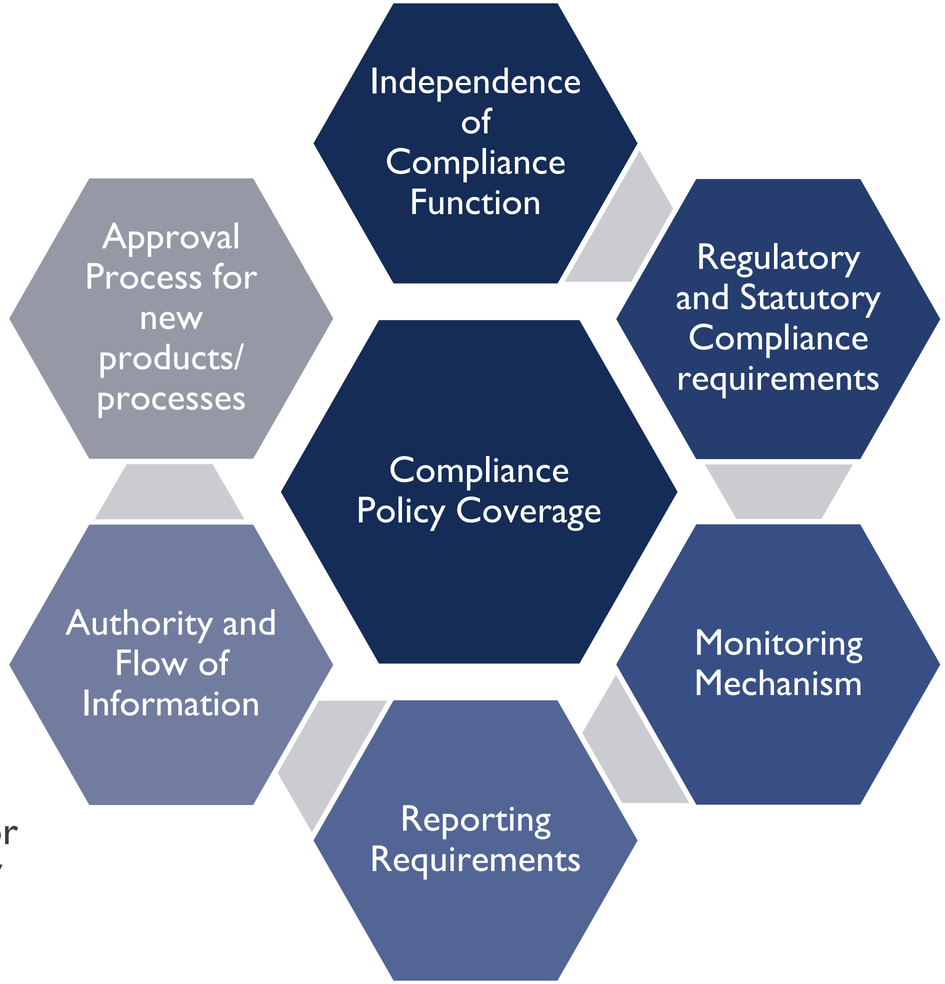
Compliance Function



- How large should the compliance function be?
  - Depends on organisational needs of the NBFC
- Can the compliance function be outsourced?
  - No, part of the core risk management function
- Compliance Function Vs Compliance Department
  - Para 34 of the Basel document clarifies: "Not all compliance responsibilities are necessarily carried out by a "compliance department" or "compliance unit". Compliance responsibilities may be exercised by staff in different departments."
  - In short, what the regulator requires is a "compliance function" and not necessarily a "compliance department", housed as such within the organisational structure.

Responsibility

- Board of Directors
  - Ensure compliance policy is in place and periodically reviewed
- Senior Management
  - Identify and assess the major compliance risk facing the NBFC and formulate plans to manage it
  - Carry out annual review of compliance risk
  - Report material compliance failures to the BoD
- Compliance Team/Department
  - Assist Board and SM in implementation of Compliance Policy
  - Monitor the compliance status, and its functioning
  - Carry out compliance testing
    - Report to the SM
  - Ensure compliance with all applicable laws
    - RBI as well as other regulators
  - CCO to liason between the NBFC and regulator
  - Serve as a reference point for the staff from operational departments for seeking clarifications / interpretation of various regulatory and statutory guidelines



Appointment and Function of CCO

- Board shall establish a well-defined selection process
- The Board shall be required to constitute a selection committee consisting of senior executives
- The CCO shall be appointed based on the recommendations of the selection committee
- Board to take final decision in the appointment of the CCO.

Role of Chief Compliance Officer

- Head the Compliance Department
  - Supervise the activities of other compliance function staff
  - Approving compliance manuals for various functions
- Overall responsibility for coordinating the identification and management of the compliance risk
  - Obtain information of audit findings related to Compliance
  - Communicate with staff members and have access to all records or files in respect of compliance issues
  - Periodically reporting on the position of compliance risk to the senior management
  - Assisting the senior management in managing effectively the compliance risks faced by the NBFC
- Act as the nodal point of contact between the NBFC and the RBI
  - Interact with regulators / supervisors directly and ensure compliance
  - Participate in structured or regular discussions held with RBI

Fit and Proper Criteria

Tenure

- Minimum fixed tenure of not less than 3 years

Transfer/ Removal

- Only in exceptional circumstances, with the explicit prior approval of the Board / Audit Committee, after following a well-defined and transparent internal administrative procedure

Ranking

- A senior executive of the NBFC with a position not below two levels from the CEO (In the case of NBFCs-ML, this requirement can be relaxed by one level further)

Skills

- Good understanding of industry and risk management practices, knowledge of regulations, legal requirements, sensitivity to supervisory expectations

Stature

- CCO shall have the ability to exercise judgment independently. Also, shall have the freedom and authority to interact with regulators / supervisors directly and ensure compliance

Conduct

- CCO shall have a clean track record and unquestionable integrity
- Not be a member of any committee which conflicts her / his role as CCO

Reporting Line

- CCO shall have direct reporting lines to the MD & CEO and / or Board / Audit Committee. The CCO shall not have any reporting relationship with the business verticals

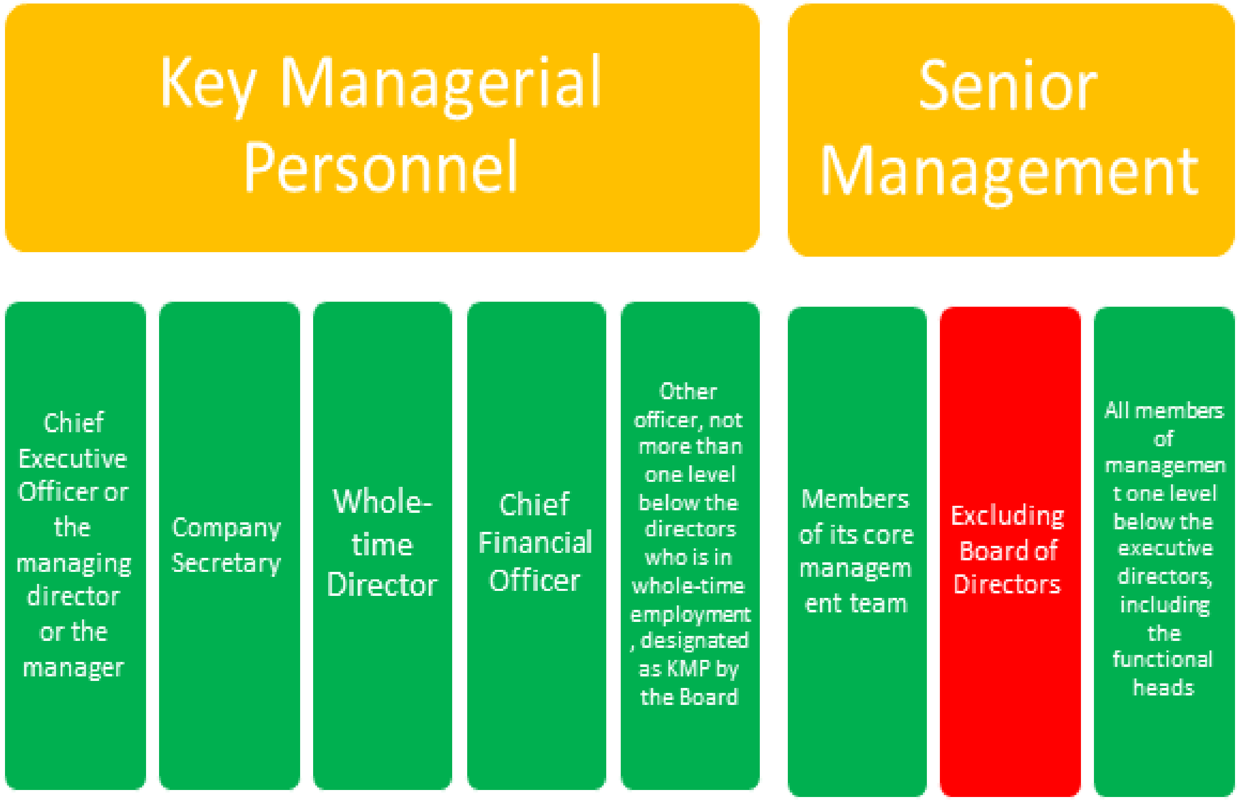
Para 28 of Basel Committee on Banking Supervision- Compliance and the compliance function in banks:
"The independence of the head of compliance and any other staff having compliance responsibilities may be undermined if they are placed in a position where there is a real or potential conflict between their compliance responsibilities and their other responsibilities. It is the preference of the Committee that compliance function staff perform only compliance responsibilities. The Committee recognises, however, that this may not be practicable in smaller banks, smaller business units or in local subsidiaries. In these cases, therefore, ***compliance function staff may perform non-compliance tasks, provided potential conflicts of interest are avoided"***

Thinkers!

- Disclosure requirements are to be ensured for which FY?
- Can the CS or Compliance officer for listing regulations also be the CCO?
- What is the need for a CCO and Compliance Function in an NBFC?

Compensation Guidelines

- To address issues due to excessive risk taking caused by misaligned compensation packages and imbalance between fixed pay structures and variable pay structures leading to excess risk taking
- To ensure no conflict of interest
- Similar to provisions for Banks w.r.t. Compensation of WTD/ CEO/ Material Risk Takers & Control Function staff
- Is it different/ contradictory/ in addition to provisions under Companies Act, 2013?
    - CA, 2013 is limited to "managerial personnel" which includes directors, managing director and manager; Compensation Guidelines include senior management
    - Intent of the CA, 2013- shareholder's approval for managerial remuneration;
    - Compensation Guidelines – Board room sensitization, structured approach to compensation policies, and fixing accountability for compensation structures

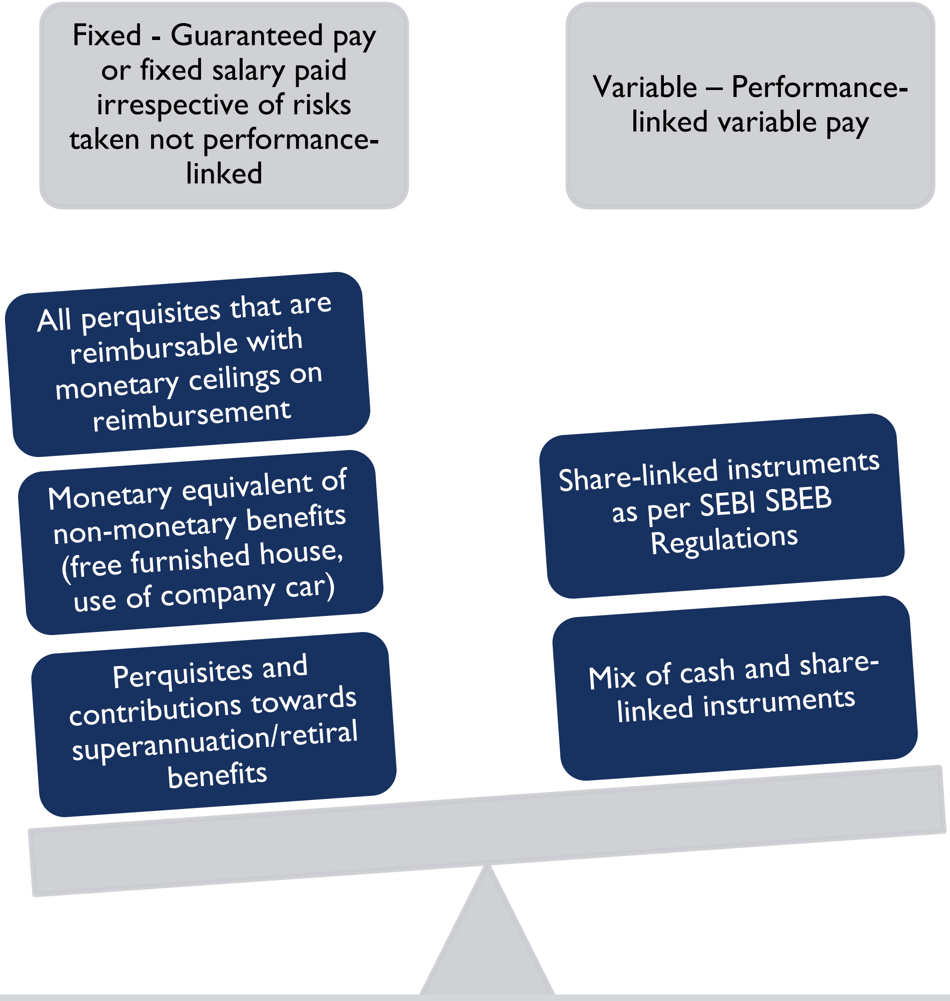


Applicability

Designation	Applicability
Whole-time directors	Applicable WTD is a KMP
Non-executive directors	Not Applicable NEDs are not KMP or senior management However, Companies Act principles on managerial remuneration will be applicable
Head of Departments	Applicable Personnel appointed as Head of Department are classified as Senior Management
Company Secretary	Applicable CS is classified as a KMP
CEO/CFO/MD	Applicable CFO/CEO/MD is classified as a KMP
CXO	Applicable As the designation itself implies, the officer is the chief of a particular function

Compensation Policy

- Board approved compensation policy
  - NRC should frame, review and implement the policy
- Contents of the policy
  - Constitution of NRC; scope and applicability
  - Broad philosophy of the entity about senior management compensation
  - Governance structure - distribution of powers between the Board, NRC and the HR department
  - Prudent risk taking principles
  - Principles for determining the ratio of fixed/ variable pay in the total compensation of the KMP and senior management;
  - Material risk takers, non risk takers etc
  - Performance management systems, key performance indicators
  - Malus/ clawback provisions
  - Provision against guaranteed bonus, permission for joining bonus
  - Variable pay in different scenarios - death, incapacity, termination of employment, disciplinary action, etc.



Guidelines do not specify a proportion of fixed and variable components

Variable Pay

- Mix of cash, equity or other forms
- Proportion of variable pay
  - Commensurate with the role and prudent risk-taking profile of KMPs/ SM
  - Variable pay should be increased with the level of the designation in hierarchy
  - Can be reduced to zero, based on performance
- Deferral of variable pay
  - Certain portion of variable pay, as decided by the Board may be deferred to time horizon of the risks
    - Time horizon - estimated time period over which the results/outcome of the risk assumed is realised in which the risk may or may not materialize
    - Payments should not be finalised over short periods where risks are realised over long periods
  - Can be for cash and non-cash components
- Control and assurance function personnel- personnel engaged in financial control, risk management, compliance and internal audit
  - To be compensated in a manner independent of the business areas they oversee
  - May have higher proportion of fixed compensation
  - Reasonable proportion of variable pay, to exercise the options of malus and/or clawback, when warranted

Important Concepts

- Guaranteed Bonus
  - Compensation which is not linked to performance
  - May not be paid to KMPs and senior management
  - For new hiring joining/sign-on bonus could be considered
    - Neither be considered part of fixed or variable pay
  - Will thirteenth -month salary i.e. an additional month's salary that remains with the company for the entire fiscal be considered as a guaranteed bonus?
    - Yes. Cannot be made part of compensation except as above
- Malus - employee is not allotted/granted the compensation to which he is entitled to
  - Does not permit reversal of compensation already paid
- Clawback - employee returns the previously paid incentives
- As per para 4, deferred compensation may be subject to malus/clawback arrangements
  - non-performing employees do not get rewarded
- Reasons to invoke -
  - Negative financial performance of the company
  - Negative financial performance in relevant line of business
  - Employee misconduct
- Representative set of situations may be identified
  - Specify a period during provisions can be applied
    - Mandatorily be equal to at least the deferral amd retention period
- Whether mandatory or voluntary?
  - Language suggests voluntary in nature, as per intent of Guidelines, clauses should ideally be provided in the compensation arrangement.

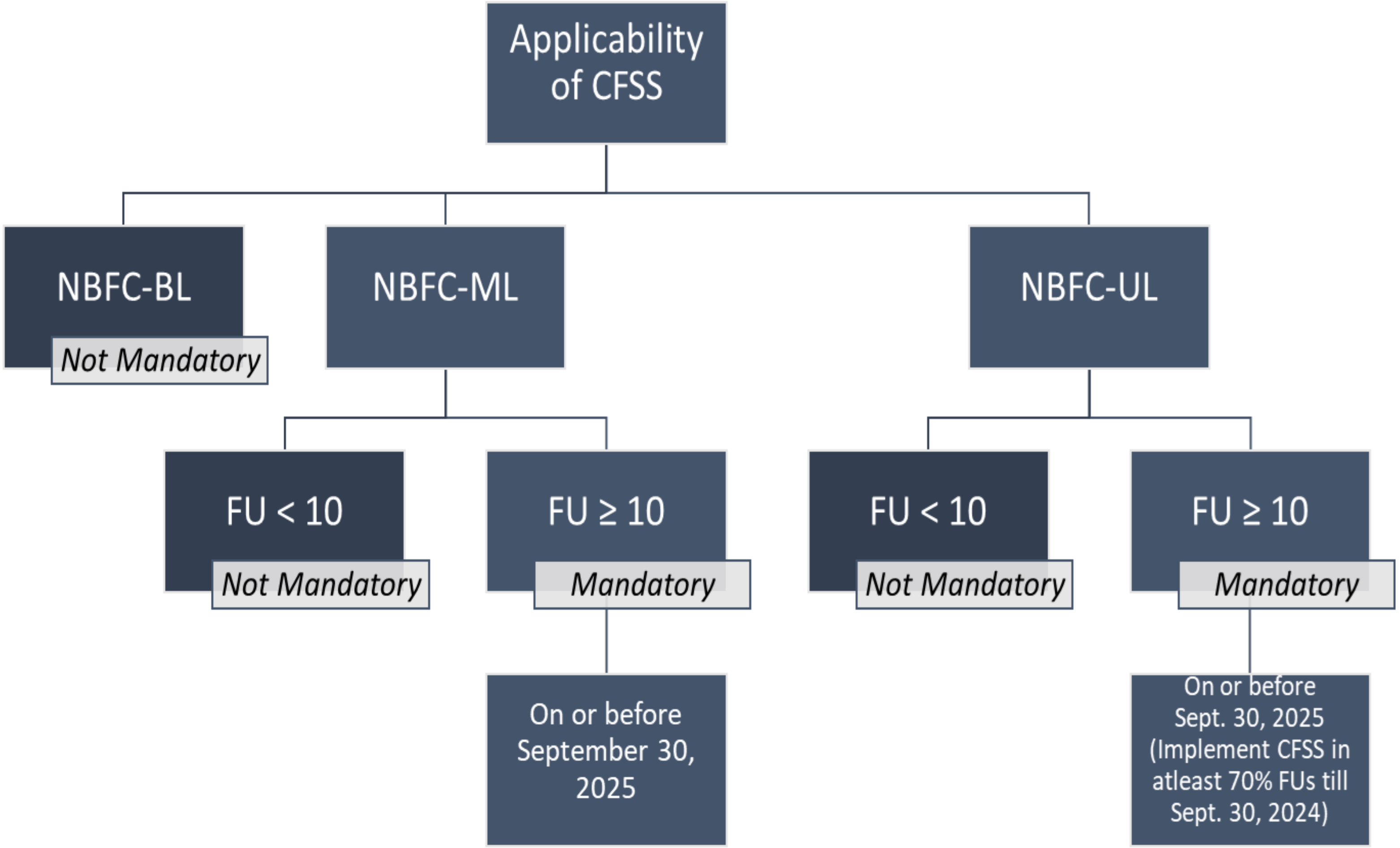
Actionable

- Guidelines are effective from April 1, 2023
  - However, the interim period should be seen as a period allowed for preparations
  - NBFCs should ideally start aligning their practices
- NBFCs which do not have a compatible compensation structure should align with the Guidelines
- Any appointments made in the interim period should consider the Guidelines
  - The same is important in our view, as this would make the NBFCs ready to transition
- NBFCs which do not have an NRC would now be required to have an NRC with constitution, powers, functions and duties as laid down in section 178 of the Companies Act, 2013
  - atleast 3 NEDs, out of which atleast half IDs
  - Earlier, NBFC Master Directions did not specify ‘constitution’; only specified powers, functions and duties

Impact on the compensation agreed or paid during the FY 2022-23, i.e., before the applicability date

- Compensation agreed and paid prior to the effective date
  - No Effect
- Compensation agreed prior to the effective date but paid after the effective date
  - Should be aligned with the Guidelines.
  - However, no explicit clarity on this aspect - RBI may give clarification.
- Compensation agreed and paid after the effective date:
  - The same should be in accordance with the Compensation Guidelines.

Core Financial Services Solution (CFSS)



FU: Fixed point service delivery unit

- *A place of operation from where the business activity of non-banking financial intermediation is carried out by the NBFC;*
- *Manned either by its own staff or outsourced agents;*
- *Carries uniform signage with the NBFC's name and functions under its administrative control.*

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'.

Features of CFSS

- CFSS shall be 'akin to the Core Banking Solution (CBS) adopted by banks'
- RBI Circular prescribes key fundamental must-haves
- Decision w.r.t. functionality & design of CFSS - as per NBFCs business requirements

Digital front-end for products & offerings of the NBFC

- Digital customer interface
- Intent is to provide a seamless interface which includes all digital offerings & related transactions
- May include:
  - checking loan eligibility,
  - carrying out KYC,
  - EMI payments,
  - accessing e-statement,
  - Updating personal info,
  - Reach customer care,
  - Locate nearby branch

Anytime anywhere accessibility

- Many NBFCs operate through physical branches
- Intention is to make digital customer interface *(which is a part of CFSS)* available and accessible 24*7.

Integration with systems

- Backend requirement
- NBFCs systems should either be integrated or interlinked
- New modules may be added on top of existing systems
- The intent is to limit human intervention for smooth functioning

Centralised database

- CFSS will require database mgmt. systems
  - Ability to collate, store & retrieve client and operational information
  - Including accounting records.
- Ensures interlinkage of systems
- Maintain logs of all changes & be auditable
- Intent is to ensure integrity & consistency of the data

Reporting & MIS

- Backend requirement
- CFSS should be able to deliver information to its users – NBFC, employees, customers, regulators, etc.
- CFSS modules should have reporting requirements as per regulatory formats.
- Intent is early identification of red flags and detection of frauds.

Actionables

Identify the applicable CFSS modules to be adopted and implemented based the products offered

Either hire an external agency for developing the CFSS modules or develop it in-house

Prepare a roadmap and action plan for implementation of CFSS, approved by the Board / Board Committee

The roadmap should be divided into stages for proper implementation and its reporting

Initiate the implementation procedure

Submit Board/Committee approved progress report to the RBI on quarterly basis stating the milestones achieved in implementing the CFSS

Challenges in implementation

- Expensive solutions
  - NBFCs provide selected product offerings unlike banks
  - Technology providers generally offer complete platform based solutions
  - Ensure only necessary modules are adopted to minimise costs
  - Additional costs for customising it to cater to specialised lending practices
- Adoption by employees and customers
  - Human link is the weakest point for implementation
  - NBFCs may face employee resistance to such a shift in systems.
  - Training programs for employees will be required
  - User experience should have ease of adoption
- The integration problem
  - NBFCs will have existing customer-relationship-management (CRM) systems, data management, reporting and risk management systems.
  - Will require significant commitment to integrate these systems without data loss and disruptions
  - NBFCs may either build on existing systems to ensure integration or adopt new solution separate from current system and migrate customers/ backend data in a phased manner

Reporting to RBI
Periodicity - Quarterly
When - starting from quarter ending March 31, 2023
What - progress report on implementation of the CFSS, along with various milestones as approved by the Board / Board Committee

Capital Guidelines under SBR Framework

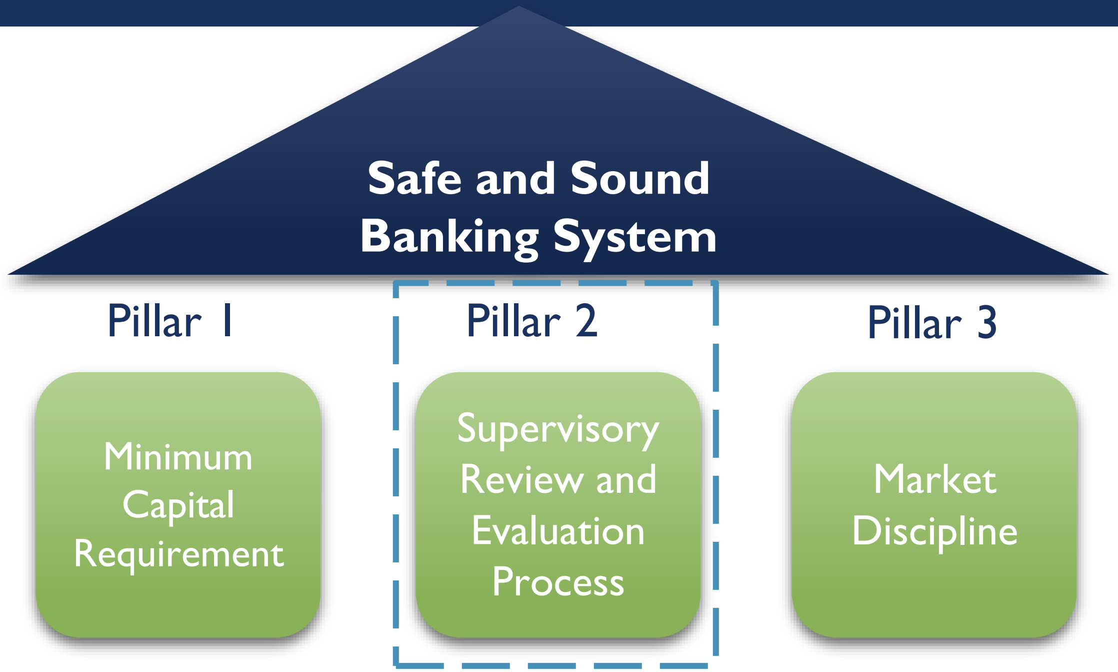
ICAAP

Regulatory Provisions

List of Regulatory Provisions	NBFC-NSI		NBFC-SI			HFC	
	Without customer interface and public funds	With customer interface or public funds	Asset size between 500-1000 crores	Asset size 1000 crores and above	Top 10 or identified as such	Not in Top 10	Top 10 or identified as such
Supervisory category	BL	BL	BL	ML	UL	ML	UL
Internal Capital Adequacy Assessment Process (ICAAP)	NA	NA	NA	Applicable	Applicable	Applicable	Applicable
Maintain Common Equity Tier I capital of at least 9% of Risk Weighted Assets	NA	NA	NA	NA	Applicable	NA	Applicable
Leverage limits (in addition to CRAR)	NA	NA	NA	NA	To be prescribed	NA	To be prescribed
Differential standard asset provisioning	NA	NA	NA	NA	Applicable w.e.f October 1, 2022	NA	Applicable w.e.f October 1, 2022

Internal Capital Adequacy Assessment Process (ICAAP)

- NBFCs are required to make internal assessment of the need for capital, commensurate with the risks in their business
- This internal assessment shall be on similar lines as ICAAP prescribed for commercial banks under Pillar 2
- While pillar 2 regulation are not compulsorily applicable but methodology shall commensurate with size and risk profile of the NBFC
- A board approved policy in this regard has to be put in place
- Based on ICAAP, RBI will review and evaluate the NBFCs' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure compliance with the regulatory capital ratios. If they are not satisfied with the result of this process, RBI may include prescription of additional capital to be maintained
- Capacity building for ICAAP for NBFCs may take significant efforts from this stage itself



Components of ICAAP

- Capital Adequacy
- Identification of the major risks
- Methodology and Assumptions
- Capital Transferability
- Risk Management System
- Off-balance Sheet Exposures with a focus on Securitisation
- Assessment of Reputational Risk and Implicit Support
- Assessment of valuation and Liquidity Risk
- Stress Testing

Objectives of ICAAP

- What should be the final goal, or what are we exactly trying to achieve by ICAAP?
- Since the capital adequacy ratio prescribed by the RBI under the Pillar I of the Framework is only the regulatory minimum level,
  - It addresses only the three specified risks (viz., credit, market and operational risks),
- Holding additional capital might be necessary for banks, on account of:
  - the possibility of some under-estimation of risks under the Pillar I and
  - the actual risk exposure of FI
- The outcome of the ICAAP may be higher or lower than the regulatory capital requirements.
- FI has to maintain higher of the two.
- Efforts should be made that Tier I capital should be adequate to absorb all risk

Covered by Regulatory CRAR:

- Credit Risk
- Market Risk
- Operational Risk

Not captured by Regulatory CRAR:

- Credit concentration risk
- Liquidity risk
- Settlement risk
- Reputational risk
- Strategic risk, etc.

ICAAP should strive to include:

- the risks that are not fully captured by the minimum capital ratio prescribed under Pillar I;
- the risks that are not at all taken into account by the Pillar I; and
- the factors external to the bank.

Essential Elements of ICAAP

- RBI in the circular itself recognises that "there is no one single approach for conducting the ICAAP and the market consensus in regard to the best practice for undertaking ICAAP is yet to emerge. The methodologies and techniques are still evolving particularly in regard to measurement of non-quantifiable risks, such as reputational and strategic risks. These guidelines, therefore, seek to provide only broad principles to be followed by banks in developing their ICAAP. "
- ICAAP for an NBFC commensurate with their size, level of complexity, risk profile and scope of operations
- Ideally ICAAP should be undertaken at various levels:
  - Entity Level – Standalone entity
  - Consolidated basis – Entire group (may include only financial sector entities)
- Authority for Analysis:
  - Ultimate responsibility with Board
  - Undertaken by relevant department supervised by senior management
  - NBFCs are now having Risk Governance Dept.
- ICAAP should appropriately factor future business plan of the Company - Capital plan should align with business plan
- Senior Management should consider ICAAP results while taking business decisions

ICAAP is
entity specific

ICAAP is
Forward looking

ICAAP is
Risk based process

ICAAP is
Integral to decision making

ICAAP Policy and Methodology

- Drafting of ICAAP Policy covering the following -
  - Background
  - Governance Structure
  - Manner of drawing future business plan
  - Asset mix of Company
  - Predicting capital needs and capital planning
  - Approach to risk taking and risk tolerance
  - Interrelation with risk policy
  - Assessment of risk factors
  - Assessment of adequacy of capital
- Developing ICAAP and Stress testing methodology
- Stress testing to consider scenario and sensitivity analysis
- Risk to be considered:
  - Credit Risk
  - Marker Risk
  - Foreign Exchange Risk
  - Interest Rate Risk
  - Equity Price Risk
  - Liquidity Risk
- Scenarios to be considered
  - Institution-specific crisis scenarios
  - General market crisis scenarios
  - Combined scenarios

Stress testing scenarios

- One of the major intents of the ICAAP analysis is to do evaluate the impact of plausible, however, severely impacting stress scenarios
- Scenarios may be both internal and external
- Some external scenarios to be modeled (dependent on the nature of the company's business and the factors that may impact its loan portfolios:
  - GDP
  - Share prices (e.g,, loan against shares)
  - Property prices (LAP, home loans, etc)
  - Interest rates
  - Unemployment and urban incomes (personal loans, fintech loans, etc)
  - Geographical risk factors
  - Business cycle
- Internal factors
  - Concentricity in portfolios
  - inherent correlation in portfolios
  - Business continuity risks etc

ICAAP Report

- What is ICAAP report:
  - Ongoing assessment of the NBFC's entire spectrum of risks
  - How are the risks intended to be mitigated
  - how much capital will be required for the risks, after considering the risk mitigation measures
- The approach is to appraise the board and the RBI about adequacy of capital
- ICAAP document/report:
  - submitted periodically to the RBI
  - after being approved by the board of directors
  - risk management methodologies may be annexed, including internal or external reviews

- Contents of ICAAP Report (based on bank format)
  - Executive Summary - primarily focusing on adequacy of capital, risk management, further capital plans
  - Background - group structure, financial performance, etc
  - Summary of current and projected financial and capital positions - projected business should be matched with projected capital requirements
  - Capital Adequacy - quantitative assessment of risks, capital and other mitigating factors
  - Key sensitivities and future scenarios - to external factors
  - Aggregation and diversification - aggregation of various risk and impact of diversification
  - Testing and adoption of the ICAAP - challenging and testing of ICAAP report, including external consultant
  - Use of the ICAAP within the NBFC - capital management practices

Corporate Laws on NBFCs

Since it is a Company, Companies Act is applicable.

- Section 185
- Section 186 (11) - except section 186(1)
  - Lending NBFC
  - Investment NBFC
- Deposits chapter
- Specific Charges
- Section 117 (g) - filing of mgt-14

If listed

- Listing Regulations
  - Chapter II, III, V of SEBI Regulations
  - If HVDLE or Equity listed, then chapter IV
- PIT Regulations

Common areas under Companies Act and RBI Regulations

- Auditors' Appointment
- Private Placement
- Loans to directors
- NRC
- Corporate Governance
- etc.

Speak to us!

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